

Corporate Valuation

A Guide for Managers
and Investors



Daves • Ehrhardt • Shrieves

Corporate Valuation: A Guide for Managers and Investors

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Preface

We believe corporate valuation is important for all finance students, all managers, all financial analysis, and all individual investors. We especially believe that our focus on “fundamental” valuation analysis is vitally important because the process of projecting financial statements and cash flows requires the analyst to identify and understand a company’s fundamental value-drivers. Thus, the insights gained through fundamental analysis are exactly those needed by investors who are searching for undervalued stocks and by corporate managers who are striving to maximize their company’s value.

There are other books on corporate valuation, but they are extremely difficult to read and apply unless you already have a strong knowledge of accounting and finance. Our objective in *Corporate Valuation: A Guide for Managers and Investors* is to create a book that can be understood by someone with only a modest background in accounting and finance. We accomplish this through an iterative approach in which we first provide the reader with a complete valuation framework as applied to a very simple company. We then build the reader’s skills by extending the analysis to value a series of increasingly complex companies. Finally, we lead the reader through a valuation of an actual company with the user-friendly spreadsheet-based valuation model that is available at the book’s web site, <http://daves.swlearning.com>.

The valuation model is structured to guide the user through the entire valuation process, beginning with the input of actual historical financial statements from a variety of sources. The model then guides the user through an in-depth analysis of the company’s current and historical financial position. After this analysis, the model provides a structured framework for estimating the cost of capital and the inputs required to project financial statements. Using the projected statements, the model calculates expected future free cash flows and discounts them to find the current estimated fundamental stock price.

We provide detailed explanations throughout the analysis for accessing and using data available on the Internet, especially the data provided through the Thomson ONE-Business School Edition, available to purchasers of this book.

Intended Market and Use

Corporate Valuation can be used as a supplement for investment and corporate finance courses, at both the graduate and undergraduate levels. It can also be used by general managers and finance professionals, as well as individual investors.

Investment and Corporate Finance Courses

Our book is ideally suited for investment courses that emphasize fundamental valuation or corporate finance courses that cover corporate valuation, merger analysis, financial strategies, or value-based management. Its strength relative to standard texts is its emphasis on understanding and using financial information to provide insights into the way corporate strategic choices affect a company’s value.

Managers and Finance Professionals

General managers can use the book's model to estimate the impact their decisions have on the value of their company, particularly with respect to decisions that affect more than one functional area in the company, such as supply chain management. For example, it is easy to measure the costs but not the benefits of many strategic initiatives, because the costs are usually incurred by a particular operating unit whereas the benefits accrue to the entire company. The corporate valuation model explained in this book is an especially useful tool for evaluating such situations having localized costs but global benefits.

Financial managers can use the spreadsheet model to estimate the value of potential acquisitions and divestitures, conduct long-term financial planning, identify future capital requirements, and evaluate potential compensation systems.

Financial analysts who are charged with making buy/sell recommendations can use the valuation spreadsheet as a part of their analyses. The model can also be used by any other analysts who must estimate the value of a company, including accountants who estimate the value of privately held companies for tax purposes.

Individual Investors

Finally, *Corporate Valuation* is ideally suited for individual investors who wish to use their own judgment in picking stocks for their portfolios. With our emphasis on building the necessary financial skills and accessing the relevant data, individual investors can use the same techniques as professional analysts.

Key Features of the Text

Following are some key features:

1. **Corporate Valuation Spreadsheet Model.** As described earlier, *Corporate Valuation's* web site has user-friendly corporate valuation Excel spreadsheet models that allow students to conduct their own valuation analyses.
2. **Thomson ONE-Business School Edition.** Purchasers of the book receive access to Thomson ONE-Business School Edition, provided by Thomson Financial, a global leader in financial information. Thomson ONE provides downloadable financial statements in Excel worksheets for 500 well-known companies, which can be pasted into the book's valuation model. Thomson ONE also provides I/B/E/S earnings estimates, ratio comparisons with peer companies, Datastream stock prices, Thomson Financial market data, Worldscope market data, and current company news.
3. **End-of-Chapter Excel Spreadsheet Projects.** The first eight chapters have a series of Excel spreadsheet projects that develop students' spreadsheet skills as well as valuation expertise. The remaining chapters have spreadsheet projects that lead students through the valuation of actual companies.
4. **PowerPoint Presentations.** PowerPoint presentations are available for each chapter. These presentations provide a structured way for an instructor to cover each chapter's material.

5. **Instructional Audio/Video Files.** The book's web site has a series of instructional audio/video files that lead the viewer through a complete valuation analysis using the book's spreadsheet valuation model. These files are available in two formats, either as stand-alone files that may be viewed without any additional software or as AVI files that may be viewed through widely available software such as Windows Media® Player or RealPlayer®.
6. **Supplementary Web Materials.** The book's web site has resources to help readers conduct their own valuation analyses. These include answers to *Frequently Asked Questions* and a section containing *Tips and Advice for Using the Corporate Valuation Model*.
7. **Instructor's Resources.** In addition to the previously described features that are available to all students, the book's web site has additional resources available only for instructors, including solutions to all end-of-chapter spreadsheet projects.

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We are grateful to our colleagues and students at the University of Tennessee who have given us many useful suggestions. The South-Western and DPS Associates staffs—especially Mike Reynolds, Elizabeth Thomson, Kara ZumBahlen, Vicky True, John Barans, Mark Sears, Charlie Stutesman, and Crystal Bullen—helped greatly with all phases of text development, production, and marketing.

We especially want to thank our families, who have supported us during the many, many hours we have worked on this project.

Conclusion

Corporate valuation, with its importance to investment analysts and corporate managers, plays a vital role in promoting well-functioning financial markets and economically healthy business firms. Because it is so important, corporate valuation should be thoroughly understood by all investors and managers. However, this is easier said than done, because the topic is relatively complex and requires specialized skills and knowledge. We sincerely hope that *Corporate Valuation: A Guide for Managers and Investors* will help readers understand and conduct their own valuation analyses.

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Contents

About the Author x

Preface xii

PART 1 Basic Concepts of Corporate Valuation 1

Chapter 1 Why Corporate Valuation? 2

Introduction 2

Our Goals 3

Our Approach: One Step at a Time 4

Discounted Cash Flow Techniques 4

Accounting Skills 6

Technology Skills 6

Preview of What's Ahead 6

Summary 7

Chapter 2 A Complete Corporate Valuation for a Simple Company 8

Introduction 8

The Basic Concepts of Valuation 9

Valuing a Very Simple Company 9

Investors 9

The Corporate Valuation Model 11

The Weighted Average Cost of Capital 11

Calculating Free Cash Flows 12

An Overview of Financial Statements 13

The Balance Sheet 13

The Income Statement 14

Calculating Free Cash Flows 15

Calculating NOPAT 15

Calculating Operating Capital 16

Free Cash Flow 17

Corporate Valuation 18

Corporate Performance: The Return on Invested Capital 20

Applications of the Corporate Valuation Model 22

Mergers and Acquisitions 22

Value-Based Management 23

Fundamental Investing 23

Summary 23

Spreadsheet Problems 24

Appendix 2 Comparing Bond and Stock Valuation Models with the Corporate Valuation Model 26

Bond Pricing 26

The Discounted Dividend Model of Stock Pricing 27

The Uses of Free Cash Flow 28

PART 2 Intermediate Concepts of Corporate Valuation 29

Chapter 3 Financial Statements and Free Cash Flow 30

Introduction 30
What Is Cash Flow, Anyway? 31
 When Do You Record It? A “Cruel” Rule 32
 The Balance Sheet 33
 The Income Statement 35
 The Statement of Shareholder’s Equity 37
 The Statement of Cash Flows 37
ACME’s Free Cash Flow 42
 Defining Free Cash Flow 42
ACME’s Operating Performance 45
Summary 46
Spreadsheet Problems 46

Appendix 3 Reconciling Free Cash Flow with the Statement of Cash Flows 48

Chapter 4 Estimating the Value of ACME 51

Introduction 51
The Weighted Average Cost of Capital 51
Risk and Return 51
Estimating the Cost of Debt 52
Estimating the Cost of Common Stock 54
Estimating the Target Weights 55
Putting the Pieces Together: Calculating the WACC 55
Estimating the Future Expected Free Cash Flows 56
Alternative Valuation Approaches: The Method of Multiples 61
Summary 63
Spreadsheet Problems 63

Appendix 4 Security Valuation 65

The Whole versus the Sum of the Parts 65
 Fundamentals of Security Valuation 65

PART 3 Projecting Financial Statements 77

Chapter 5 Projecting Free Cash Flows 78

Introduction 78
Requirements for Useful Financial Projections 78
Van Leer, Inc. 79
Projecting Financial Statements 81
 Modeling the Financial Statements 81
 Choosing Inputs for the Model 84
 Calculating Free Cash Flow 88
Summary 89
Spreadsheet Problems 89

Chapter 6	Projecting Consistent Financial Statements: The Miracle of Accounting 92
	Introduction 92
	Financial Policies and Projecting Financial Statements 92
	Projecting Long-Term Debt and Dividends 93
	Making Balance Sheets Balance: The Plug Approach 94
	Projecting Interest Expense and Interest Income 95
	Completing the Projections: Implementing the Financial Policies 97
	Projecting a Complete Income Statement 98
	Projecting Complete Balance Sheets 98
	Checking Your Projections for Plausibility 102
	Summary 104
	Spreadsheet Problems 105
Chapter 7	Multiyear Projections and Valuation 108
	Introduction 108
	One-Year versus Multiyear Projections 108
	In the Short Run Anything Can Happen. In the Long Run. . . 111
	Considerations for the Long Run 112
	Projecting Operating Profit 112
	Projecting Operating Capital 114
	Projecting Operating Taxes 118
	Dividend and Debt Ratios 118
	The Projected Statements 120
	Balancing 120
	Checking the Projections 120
	Using Projections for Valuation 125
	Summary 126
	Spreadsheet Problems 127
Chapter 8	Technical Issues in Projecting Financial Statements and Forecasting Financing Needs 129
	Introduction 129
	When Projections Aren't a Percentage of Sales 130
	Linear Model with Intercept 130
	Nonlinear Models 132
	Lumpy Assets 134
	Financial Modeling: Art versus Science 137
	Alternative Financing Policies 137
	Alternative Dividend Policies 137
	Alternative Common Stock Policies 142
	Projecting Interest Expense Based on the Average Debt during the Year 147
	Algebraic Solution to Circularity 148
	Spreadsheet Solution to Circularity 148
	An Illustration Using Van Leer 149
	Summary 149
	Spreadsheet Problems 150

PART 4 Valuing Actual Companies with the Corporate Valuation Spreadsheet 153

Chapter 9 The Starting Point for Corporate Valuation: Historical Financial Statements 154

Introduction 154

An Overview of the Corporate Valuation Spreadsheet 154

Step 1: Get the Actual Historical Financial Statements of a Company 156

Step 2: Link the *Actual* Statements to the *Comprehensive* Statements 156

Step 3: Condensing the Comprehensive Statements 160

Step 4: Analyzing the Current and Historical Financial Position of the Company 162

Step 5: Estimating the Weighted Average Cost of Capital 163

Step 6: Choose the Inputs for Your Projections 163

Step 7: Completing the Valuation 163

Getting Financial Statements from the Internet 164

1. Thomson Financial and Thomson ONE-Business School Edition 164

2. Edgar 165

3. EdgarScan 165

4. Yahoo! 165

5. Company Web Pages 165

Mapping Your Financial Statements from the *Actual* Worksheets into the *Comprehensive* Worksheet 166

Income Statement 167

Balance Sheets 171

Required Special Items 177

Optional Special Items 178

Summary 180

Spreadsheet Problems 181

Appendix 9 Why We Condense the Financials 182

Chapter 10 The Condensed Financial Statements and Historical Analysis 184

Introduction 184

The Condensed Statements 184

Additional Detail on Operating Performance 185

Additional Detail on Nonoperating Performance 188

Adjustments Due to GAAP 190

Calculating Free Cash Flow 191

NOPAT Calculation 191

Free Cash Flow Calculations 193

Analyzing Home Depot's Past and Present Condition 195

Analysis of Ratios Required to Project Financial Statements 196

Analysis of Traditional Ratios as Compared to Competitors 199

Summary 204

Spreadsheet Problems 205

Appendix 10 Mapping the Comprehensive Statements to the Condensed Statements: Advanced Issues in Measuring Free Cash Flows 206

Introduction 206

Overview of Financial Statement Adjustments and Condensing 206

Income Statements 207

Balance Sheets: Current Assets 208

Balance Sheets: Long-Term Assets 209

Balance Sheets: Current Liabilities 209

Balance Sheets: Long-Term Liabilities and Equity 210

An Explanation of Complicated Accounting and the Impact on FCF 210

Goodwill 211

Minority Interests 214

Investments and Advances 217

Operating Leases 217

Pension-Related Liabilities 219

LIFO Reserves 220

Foreign Currency Translations 221

Employee Stock Options 222

Summary 222

Chapter 11 Estimating the Weighted Average Cost of Capital 223

Introduction 223

Estimating the Target Weights 223

Estimating the Values of the Financing Components 224

Estimating the Target Weight for Long-Term Debt 226

Estimating the Target Weight for Short-Term Debt 226

Estimating the Target Weight for Preferred Stock 227

Estimating the Target Weight for Common Equity 227

Estimating the Cost of Long-Term Debt 228

Estimating the Cost of Short-Term Debt 233

Estimating the Cost of Preferred Stock 233

Estimating the Cost of Common Stock 234

Putting the Pieces Together: Calculating the WACC 235

Complications and Advanced Issues 235

Convertible Securities 235

Privately Held Firms and Divisions 237

Summary 237

Spreadsheet Problems 238

Chapter 12 Projecting Cash Flows for an Actual Company : Home Depot 240

Introduction 240

A Useful Perspective on Projections 240

The Mechanics of Projecting the Condensed Statements 241

Using Fade Rates to Input Forecasted Growth Rates 242

Using Fade Rates to Forecast Home Depot's Growth Rates 250

Choosing the Other Inputs Needed to Project Free Cash Flow	252
Choosing the Inputs to Project NOPAT	254
Choosing the Inputs to Project Operating Capital	256
Choosing the Inputs to Calculate Operating Taxes	257
Choosing Inputs to Complete the Projections	257
Specifying the Dividend and Capital Structure Policies	257
Specifying the Nonoperating Items	259
Specifying Interest Rates	259
Completing the Inputs	260
Using Quarterly Data to Improve Your Inputs	260
Reviewing Your Choices of Inputs	262
Avoiding an Error in Your First Year's Projections	263
Spotting Errors	264
Summary	264
Spreadsheet Problems	265

Appendix 12 Top-Down Analysis 266

The Macro Prospective: Global and National	266
The Industry-Level Perspective	266
The Firm-Level Point of View	268

Chapter 13 The Valuation of an Actual Company: Home Depot 269

Introduction	269
Horizon Value Methods	269
The Continuing Value Horizon Formula	269
The Book Value Horizon Formula	271
The Convergence Value Horizon Formula	272
The General Value Horizon Formula	273
The Horizon Value for Home Depot	273
The Value of Operations for Home Depot	274
The Half-Year Adjustment	275
Estimating the Value at Times Other than Fiscal Year-End	276
The Valuation of Home Depot	277
Projections of Other Financial Measures	281
Reverse Engineering/Scenario Analysis	284
Valuing a Company with a Changing Capital Structure	285
Summary	285
Spreadsheet Problems	286

Appendix 13 The Adjusted Present Value Method 288

Capital Structure and the Value of a Company	288
Too Much Debt and Bankruptcy Costs	289
Too Much Debt and Managerial Behavior	290
Valuation When Debt Is Moderate	291
The Unlevered Value of Operations	291
The Value of the Tax Shield	292

PART 1

Basic Concepts of Corporate Valuation

- | | |
|-------------------|---|
| Chapter 1 | Why Corporate Valuation? |
| Chapter 2 | A Complete Corporate
Valuation for a Simple Company |
| Appendix 2 | Comparing Bond and Stock
Valuation Models with the
Corporate Valuation Model |

Chapter

Why Corporate Valuation?

Introduction

You make financial decisions every day. If you're an individual investor, you make daily decisions to buy, sell, or hold stock. If you're a senior executive, you make critical strategic choices. If you're a manager, you make and implement operating decisions. If you are on the financial staff, you regularly evaluate potential acquisitions and divestitures. In each case, the success or failure of your decisions depends on whether you correctly identify, measure, and evaluate a firm's underlying sources of value. In a nutshell, your success depends on understanding corporate valuation.

Despite its obvious importance to individual investors and corporate managers, corporate valuation was until recently an arcane science, limited to a select few at investment banks and brokerage firms. If you're old enough to remember the movie *Wall Street* or the book *Barbarians at the Gate*, then you probably remember investment banker analysts portrayed as quantitative whizzes running sophisticated computer programs that sifted through mountains of data to determine an offer price. Stock analysts employed by brokerage firms used the same complex set of analytic methods to produce their buy and sell recommendations. Whether conducted by financial analysts or investment bankers, valuation analysis required long years of training in quantitative methods, sophisticated computer technology, and access to large, proprietary databases. These requirements formed an insurmountable barrier to ordinary investors and corporate managers, preventing them from performing their own analyses.

But we have good news for you. Almost all individual investors, executives, and managers now have desktop computers or laptops with more power than the mainframe supercomputers of a decade ago. Powerful but easy-to-use spreadsheet software is standard on these computers, and financial data and information are now just a click away on the Internet. Many web sites are free, but because you bought this book, you have access to Thomson ONE-Business School Edition. This combination of hardware, software, and data levels the playing field and makes it possible for you to conduct an in-depth corporate valuation. If you are an individual investor, you can now do your own valuations, identifying the upside potential and downside risk of your investments. You can also evaluate the management teams behind your stocks, and vote with your feet if performance is not what it should be.

If you are a manager, you can now easily use the same analytic tools that Wall Street uses. You can quickly analyze all of your decisions with the same attention that was once reserved only for high-profile mergers and acquisitions. Not only will corporate

valuation tools help you improve your decisions and increase the value of your firm, but your own wealth may also increase, if you are among the many managers today who are compensated with stock options or bonuses that mirror stock performance.

Whether you are an analyst, an individual investor, or a corporate manager, don't get too excited just yet! Acquiring the skills explained in this book will take a bit of serious effort on your part. But don't get discouraged, either, because we have made this as easy as possible for you by presenting the concepts and tools in a step-by-step approach with lots of examples.

Our Goals

Corporate valuation techniques have progressed at a rapid pace over the last three decades. Within the last few years, the financial community has reinvented investment valuation, creating new analytical measurements such as free cash flow, return on invested capital, and economic value added. Of course, there is vigorous competition among investment bankers and various consulting groups, each promoting its own trademarked variation of valuation analysis, and each claiming to offer the best approach.

Our objective in writing this book is to provide investors and managers with the basic knowledge necessary to value an entire company or a division of a company using a model that is nonproprietary, understandable, and, most importantly, easily implemented by any financial manager or investor.¹ To accomplish this, we focus on the free cash flow (FCF) valuation framework and implement it in Microsoft® Excel. No model is useful without accurate data for inputs, so throughout our discussion we incorporate references to easily accessible online data sources, particularly Thomson ONE-Business School Edition. Our examples demonstrate how these sources can be used to identify a company's underlying sources of value, determine its "leverage points," and estimate its fundamental value.

The model we develop can be used in a variety of ways. Investors can use it for identifying undervalued stocks and those with the most growth potential. They can also use it to critically assess the quality of any professional investment advice they receive. Managers can use this model to make better business decisions for their companies, performing useful "what if" analyses of alternative decisions. And by applying it to their customers or suppliers, managers can also use it to gain insight into the companies with which they negotiate.

In summary, our goals are to explain the concepts underlying corporate valuation and to develop a comprehensive spreadsheet-based valuation model that you can use for investment analysis and financial decision-making. We'll begin slowly, explaining the concepts and the spreadsheet applications one step at a time. With this approach, you'll understand how the model is designed, programmed, and implemented from the ground up. This comprehensive model, combined with a knowledgeable user, is a powerful tool and will enable you to make better investment and business decisions.

¹As we stated in the Preface, the same valuation principles apply to all companies, even financial institutions and start-up companies. However, the application is more complicated, and so we focus on nonfinancial companies that have matured beyond the start-up stage.