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VALUATION

Measuring and Managing the Value of Companies

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VALUATION

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About the Authors

The authors are all current or former consultants of McKinsey & Company's Strategy & Corporate Finance Practice. Together, they have more than 100 years of experience in consulting and financial education.

* * *

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* * *

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* * *

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* * *

McKinsey & Company is a global management consulting firm, working with clients across the private, public, and social sectors. McKinsey combines bold strategies and transformative technologies to help organizations innovate more sustainably, achieve lasting gains in performance, and build workforces that will thrive for this generation and the next.

Preface

The first edition of *Valuation* appeared in 1990, and we are encouraged that it and the subsequent editions have continued to attract readers around the world. We believe the book appeals to readers everywhere because the approach it advocates is grounded in universal economic principles. While we continue to improve, update, and expand the text as our experience grows and as business and finance continue to evolve, those universal principles do not change.

In the 35 years since that first edition, managers and executives have dealt with major economic challenges, including the COVID-19 pandemic, the economic crisis of the late 2000s, and the fallout from the internet boom at the turn of the century. All these events have strengthened our conviction that the core principles of value creation are general economic rules that continue to apply in all market circumstances. Thus, the extraordinarily high anticipated profits represented by stock prices during the internet bubble never materialized, because there was no "new economy." Similarly, the extraordinarily high profits seen in the financial sector for the two years preceding the start of the 2007–2009 financial crisis were not "real," in the sense that they didn't adequately set aside reserves for loan losses. The laws of competition should have alerted investors that those extraordinary profits couldn't last and might not be real.

Over time, we have also seen that, for some companies, some of the time, the stock market may not be a reliable indicator of value. At the time of this writing, ten different companies had market capitalizations greater than $1 trillion. We cannot predict whether all these companies can grow enough and maintain their profits and cash flows sufficiently to justify these values. Knowing that value signals from the stock market may occasionally be unreliable makes us even more certain that managers must always understand the underlying, intrinsic value of their companies—and thus how they can create more value. In our view, clear thinking about valuation and skill in using valuation to guide business decisions are prerequisites for company success.

Furthermore, there remains confusion about what it means to truly create value for shareholders. As we explain in Chapter 1, creating value for shareholders is not the same as pumping up today's share price. Rather, it means creating value for the collective of current and future shareholders by applying the techniques explained in this book. As they do so, companies will thrive, and ultimately, society as a whole will benefit.

WHY THIS BOOK

If CEOs and other executives are to do their jobs well and fulfill their responsibilities, they need to understand how value is created. This book's practical focus reflects its origins as a handbook for McKinsey consultants. We publish it for the benefit of current and future managers who want their companies to create value and also for investors. It aims to demystify the field of valuation and clarify the linkages between strategy and finance. So while it draws on leading-edge academic thinking, it is primarily a how-to book and one we hope you will use again and again. This is no coffee-table tome: if we have done our job well, it will soon be full of underlining, marginal notations, and highlighting.

The book's messages are simple: Companies thrive when they create real economic value for their shareholders. Companies create value by investing capital at rates of return that exceed their cost of capital. These two truths apply across time and geography. The book explains why these core principles of value creation are genuine and how companies can increase value by applying them.

The technical chapters of the book aim to explain, step-by-step, how to do valuation well. We spell out valuation frameworks that we use in our consulting work, and we illustrate them with detailed case studies that highlight the practical judgments involved in developing and using valuations. Just as important, the management chapters discuss how to use valuation to make good decisions for a company—specifically, by helping with the following tasks:

- Decide among alternative business strategies by estimating the value of each strategic choice
- Develop a corporate portfolio strategy, based on which business units a corporate parent is best positioned to own and which might perform better under someone else's ownership
- Assess major transactions, including acquisitions and divestitures
- Improve a company's strategic planning and resource allocation so the company's parts are aligned to execute strategic priorities and create value

- Communicate effectively with investors
- Design a capital structure that supports the corporation's strategy and minimizes the risk of financial distress

STRUCTURE OF THE BOOK

In this eighth edition, we continue to expand the practical application of finance to real business problems, reflecting past economic events, new accounting rules, new developments in academic finance, and our own experiences. The edition is organized into five parts, each with a distinct focus.

Part One, "Foundations of Value," provides an overview of value creation. We make the case that managers should focus on long-term value creation for current and future shareholders, not just some of today's shareholders looking for an immediate pop in the share price. We explain the two core principles of value creation: (1) the idea that return on invested capital and growth drive cash flow, which in turn drives value, and (2) the conservation-of-value principle, which says anything that doesn't increase cash flow doesn't create value (unless it reduces risk). We devote a chapter each to return on invested capital and to growth, including a new discussion of strategic principles and empirical insights for companies based in Europe.

Part Two, "Core Valuation Techniques," is a self-contained handbook for using discounted cash flow (DCF) to value a company. The reader will learn how to analyze historical performance, forecast free cash flows, estimate the appropriate opportunity cost of capital, identify sources of value, and interpret results. We also show how to use multiples of comparable companies to supplement DCF valuations.

Part Three, "Advanced Valuation Techniques," explains how to analyze and incorporate in a valuation such complex issues as taxes, pensions, leases, capital-light business models, inflation, and foreign currency. It also discusses alternative return-on-capital measures and applications.

Part Four, "Managing for Value," applies the value creation principles to practical decisions that managers face. It explains how to design a portfolio of businesses, how to run effective strategic-planning and resource allocation processes, how to create value through acquisitions and divestitures, how to construct an appropriate capital structure and payout policy, and how companies can improve their communications with the financial markets. New to the eighth edition are chapters on how to apply a value creation focus to issues of sustainability and new digital innovations.

Part Five, "Special Situations," is devoted to valuation in more complex contexts. It explores the challenges of valuing leveraged buyouts, venture capital, high-growth companies, companies in emerging markets, cyclical companies, and banks. In addition, it shows how uncertainty and flexibility affect value and how to apply option-pricing theory and decision trees in valuations.

Finally, our nine appendixes provide a full accounting of our methodology in this book. They provide theoretical proofs, mathematical formulas, and underlying calculations for chapters where additional detail might be helpful in the practical application of our approach. Appendix I, in particular, pulls into one place the spreadsheets for the comprehensive valuation case study of Costco featured in this edition.

VALUATION SPREADSHEET

An Excel spreadsheet valuation model is available via Web download. This valuation model is similar to the model we use in practice. Practitioners will find the model easy to use in a variety of situations: mergers and acquisitions, valuation of business units for restructuring or value-based management, and tests of the implications of major strategic decisions on a company's value. We accept no responsibility for any decisions based on your inputs to the model. If you would like to purchase the model (ISBN 978-1-394-27950-0), please call (800) 225-5945, or visit www.wileyvaluation.com.

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No book is solely the effort of its authors. This book is certainly no exception, especially since it grew out of the collective work of McKinsey's Strategy & Corporate Finance Practice and the experiences of its consultants throughout the world.

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Connor Guy, our lead editor, ensured that our ideas were expressed clearly and concisely. Jonathon Berlin and his team edited and oversaw the production of more than 400 exhibits, ensuring that they were carefully aligned with the text. Karen Schenkenfelder provided careful editing and feedback throughout the process. We are indebted to her excellent eye for detail.

The intellectual origins of this book lie in the present-value method of capital budgeting and in the valuation approach developed by Nobel laureates Merton Miller and Franco Modigliani in their 1961 *Journal of Business* article titled "Dividend Policy, Growth, and the Valuation of Shares." Others have gone far to popularize their approach. In particular, Professor Alfred Rappaport (Northwestern University, professor emeritus) and the late Joel Stern (Stern Stewart & Co.) were among the first to extend the Miller-Modigliani enterprise valuation formula to real-world applications.

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Part One

Foundations of Value

1

Why Value Value?

Among the most important decisions executives face is the question of how to allocate their organizations' resources. Many leaders find themselves overwhelmed by the technicalities and nuances, often resorting to rules of thumb rather than robust analysis. This text aims to demystify how these highly complex decisions should be made by providing a clear, systematic approach to measuring value and a comprehensive understanding of how and why it is created.

In addition to the math of value creation, we show how to apply a value creation perspective to the complicated decisions that frequently arise in the course of managing a business—decisions such as whether to enter a new market, invest in product development, build a new plant, acquire another company, or divest a business.

While these questions can be daunting, the core concept behind business value creation is refreshingly simple: companies that grow and earn a return on capital that exceeds their cost of capital create value. Articulated as early as 1890 by Alfred Marshall,[1] the concept has proven to be both enduring in its validity and elusive in its application.

Nevertheless, managers, boards of directors, and investors sometimes ignore the foundations of value because of weak analyses or misaligned incentives. The tulip mania of the early 1600s, the collapse of Japan's economy in the 1990s, the internet bubble, and the mid-2000s real estate frenzy that touched off the financial crisis of 2007–2008 can all, to some extent, be traced to a misunderstanding or misapplication of this guiding principle. We see individual companies regularly misapplying the core principles of valuation—to get bigger, to beef up short-term earnings per share (often at the expense of long-term value creation), or to avoid hard choices.

This chapter was coauthored by Michael Birshan and Andy West.

[1] A. Marshall, *Principles of Economics* (New York: Macmillan, 1890), 1: 142.

Today, phenomena such as global climate change, the distribution of wealth within advanced economies, and the rise of corporations that are more highly valued than any in history are fueling debates about shareholder-oriented capitalism. These are important topics, but the discussion sometimes risks muddling two distinct issues: the perils of short-termism and the question of what responsibilities a company has beyond lawful operations and value creation for shareholders. Much, though not all, of the criticism of shareholder-oriented capitalism is really a critique of companies' short-term behavior.

If we are to truly understand the challenges we face, we must untangle these two issues. Doing that requires a deeper understanding of value, so this chapter begins by describing what value creation does and does not mean. We then discuss the dangers of short-term behavior, followed by the task of reconciling the competing interests of shareholders and other stakeholders. The chapter closes with an overview of what will be covered in the remainder of the book.

WHAT IT MEANS TO CREATE VALUE FOR SHAREHOLDERS

Particularly at this time of reflection on the role of business in society, it's critical that managers and board directors have a clear understanding of what value creation means. For value-minded executives, the definition cannot be limited to simply maximizing today's share price. Rather, a better objective is maximizing a company's collective value to all its shareholders, now and in the future.

In the first decade of this century, some banks acted as if maximizing short-term profits would maximize value—a mistake that ultimately precipitated a financial crisis and destroyed billions of dollars of shareholder value while also hurting non-shareholders, including employees who lost their jobs, borrowers who were taken advantage of, communities where homebuilding ground to a halt, and taxpayers to the extent they funded bailouts. Similarly, companies whose short-term focus leads to environmental disasters destroy shareholder value by incurring cleanup costs and fines and by inflicting lingering reputational damage. While these might be extreme examples, the best managers don't skimp on safety, don't make value-destroying decisions just because their peers are doing so, and don't use accounting or financial gimmicks to boost short-term profits, nor do they underinvest in their people.[2] Such actions undermine the interests of all stakeholders, including shareholders. They are the antithesis of value creation.

If a company's investors knew as much about its operations as its managers do, maximizing its current share price might be equivalent to maximizing its value over time. But in the real world, investors have only a company's

[2] A. Madgavkar, B. Schaninger, D. Maor, et al., "Performance through People: Transforming Human Capital into Competitive Advantage," McKinsey Global Institute, February 2, 2023, www.mckinsey.com.

published financial results and their own assessment of the quality and integrity of its management team. Investors in most companies don't know what is really going on inside the company or what decisions managers are making. They can't know, for example, whether the company is improving its margins by finding more efficient ways to work or by underinvesting in important areas such as product development, human capital development, maintenance, or marketing.

Since investors have limited information, companies can pump up their share price in the short to medium term. One global consumer product company consistently generated annual growth in earnings per share (EPS) between 11 and 16 percent for seven years. Managers attributed the company's success to improved efficiency. Impressed, investors pushed the company's share price above those of its peers—unaware that the company was shortchanging its investments in product development and brand building to inflate short-term profits even as revenue growth declined. Finally, managers had to admit what they'd done. Not surprisingly, the company went through a painful period of rebuilding. Its stock price took years to recover.

It would be a mistake, however, to conclude that the stock market is not "efficient" in the academic sense that it incorporates all public information. Markets do a great job with public information, but markets are not omniscient. In other words, they cannot take into account information they don't have. Think about the analogy of selling an older house. The seller may know that the boiler makes a weird sound sometimes or that some of the windows are a bit drafty. But unless the seller discloses those facts, a potential buyer may have great difficulty detecting them, even with the help of a professional house inspector—and these problems would not be incorporated into the market value of the house.

Overall, the evidence suggests that companies with a long strategic horizon create more value than those run with a short-term mindset.[3] Banks that had the insight and courage to forgo short-term profits during the real estate bubble of the 2000s, for example, earned much better total shareholder returns (TSR) over the longer term. In fact, when we studied the patterns of investment, growth, earnings quality, and earnings management of hundreds of companies across multiple industries over a 14-year period, we found that companies with a long-term focus tended to generate superior TSR, with a 50 percent greater likelihood of being in the top quartile by the end of the period studied.[4] In separate research, we've found that long-term revenue growth is the most important driver of shareholder returns for companies with high

[3] The studies we cite in this paragraph acknowledge that correlation is not causation. In fact, one could argue there is reverse causation—that is, companies' satisfactory financial performance gives them the luxury to place greater emphasis on long-term concerns.

[4] *Measuring the Economic Impact of Short-Termism*, McKinsey Global Institute, February 2017, www.mckinsey.com.

returns on capital.[5] In our 2023 survey of 721 executives, respondents who said their companies prioritize long-term value creation over short-term profits were 2.3 times more likely than other respondents to describe their company as more innovative than its peers and 2.5 times more likely to say their five-year revenue growth exceeded that of their peers. What's more, investments in research and development (R&D) correlate powerfully with long-term TSR.[6] Further evidence on employee and customer satisfaction indirectly supports the benefits of a long-term orientation.[7]

What this means is that managers who create value for the long term will not take actions to increase today's share price if those actions are likely to damage the company down the road. For example, they don't shortchange product development or reduce product quality. When considering investments, they take into account likely future changes in regulation or consumer behavior, especially with regard to environmental and health issues. All of this is easier said than done. Making long-term value-creating decisions requires courage and often a mindset that extends beyond one's own time in a specific role. But the fundamental task of management and the board is to demonstrate this courage, despite the possibility of short-term consequences.

SHORT-TERMISM RUNS DEEP

Despite evidence that what investors really want is long-term value creation,[8] too many managers continue to plan and execute strategy—and then report their performance—against shorter-term measures, particularly earnings per share (EPS). The widespread occurrence of short-termism presents challenges to managers but also a set of opportunities for companies and investors with greater foresight.

The Pressure on Managers

As a result of their focus on short-term EPS, major companies often pass up long-term value-creating opportunities. The CFO of one very large company instituted a standing rule: every year, every business unit must increase its profits faster than its revenues. Some of the units had profit margins above

[5] B. Jiang and T. Koller, "How to Choose between Growth and ROIC," *McKinsey on Finance*, no. 25 (Autumn 2007): 19–22, www.mckinsey.com. However, we didn't find the same relationship for companies with low returns on capital.
[6] We've performed the same analyses for 15 and 20 years and with different start and end dates, and we've always found similar results.
[7] A. Edmans, *Grow the Pie: How Great Companies Deliver Both Purpose and Profit* (Cambridge University Press, 2020), chap. 4.
[8] R. N. Palter, W. Rehm, and J. Shih, "Communicating with the Right Investors," *McKinsey Quarterly* (April 2008), www.mckinsey.com. Chapter 36 of this book also examines the behaviors of intrinsic and other investor types.

30 percent and returns on capital of 50 percent or more. Increasing margins every year sounds great if your horizon is the next annual report. But for units that already have high margins and a high return on capital, such a rule may incentivize passing up attractive future growth opportunities.

This example is by no means an isolated case. In a seminal survey of 400 chief financial officers in 2006, two Duke University professors found that fully 80 percent of the CFOs said they would reduce discretionary spending on potentially value-creating activities such as marketing and R&D in order to meet their short-term earnings targets.[9] In 2023, when we surveyed 721 executives working in various roles, only 35 percent said their organization prioritizes long-term value creation over short-term profit targets. In 2017, researchers published a paper showing that CEOs tended to reduce R&D spending and increase EPS guidance around the times when their stock options were vesting.[10] That's no way to run a railroad—or any other business.

Some analysts and some short-term-oriented investors will always clamor for short-term results. However, even though a company bent on growing long-term value will not be able to meet their demands all the time, this continuous pressure has the virtue of keeping managers on their toes. Sorting out the trade-offs between short-term earnings and long-term value creation is part of a manager's job. Perhaps even more important, it is up to corporate boards to investigate and understand the economics of the businesses in their portfolio well enough to judge when managers are making the right trade-offs and, above all, to protect managers when they choose to build long-term value at the expense of short-term profits.

THE STAKEHOLDER CONUNDRUM

One concern that has been posed consistently to business leaders for decades is skepticism over whether they are adequately considering the impact of their actions on others, beyond just shareholders. In some places, such as certain European countries, the interests of other stakeholder groups are embedded in corporate governance structures. Similarly, in many jurisdictions, companies are now required to be more transparent about their greenhouse gas emissions and the risks that climate change poses to their financial health.

We agree that for most companies around the world, creating long-term shareholder value requires satisfying other stakeholders as well. You can't create long-term value by ignoring the needs of your customers, suppliers, and

[9] J. R. Graham, C. R. Harvey, and S. Rajgopal, "Value Destruction and Financial Reporting Decisions," *Financial Analysts Journal* 62, no. 6 (2006): 27–39.

[10] A. Edmans, V. W. Fang, and K. A. Lewellen, "Equity Vesting and Investment," *Review of Financial Studies* 30, no. 7 (July 2017): 2229–2271, doi.org/10.1093/rfs/hhx018.

employees and the impact on the environment and climate. And investing for sustainable growth should and often does result in stronger economies, higher living standards, and more opportunities for individuals.

When Interests Collide

Research has shown that many corporate social-responsibility initiatives create shareholder value.[11] Inevitably, though, there will be times when the interests of a company's stakeholders are not entirely complementary. Strategic decisions involve trade-offs, and the interests of different groups can be at odds with one another. These are times for managers to lead, and in many cases the most pragmatic approach is to focus on the long-term interests of shareholders—subject to law and regulation, of course, which are the primary mechanisms for ensuring that the activity of companies is aligned with the overall interests of society. As we will show in the next section, long-term value creation leads to better resource allocation across the economy and better economic health, which ultimately creates more jobs and a higher standard of living for all. While skilled managers focus on the long-term interests of shareholders above all, they must also actively consider a broad set of priorities when making difficult decisions.

Consider employee stakeholders. A company that tries to boost profits by providing a shabby work environment or underpaying employees will have trouble attracting and retaining productive employees. Operating with less capable or motivated employees can result in lower-quality products, reduced demand, and damage to the brand reputation. Given these circumstances, many companies choose to pay wages that are high enough to attract suitable employees and keep them motivated and productive. Companies, then, must strike a careful balance, calibrating compensation so it is competitively attractive but not significantly above the market rate.

Similarly, consider pricing decisions. Here, too, the interests of customers are not entirely aligned with the interests of shareholders. When considering any adjustments to prices, managers must weigh the value of a lower price to buyers against the value of a higher price to shareholders and perhaps other stakeholders.

Economy-Wide Benefits of Prioritizing Value Creation

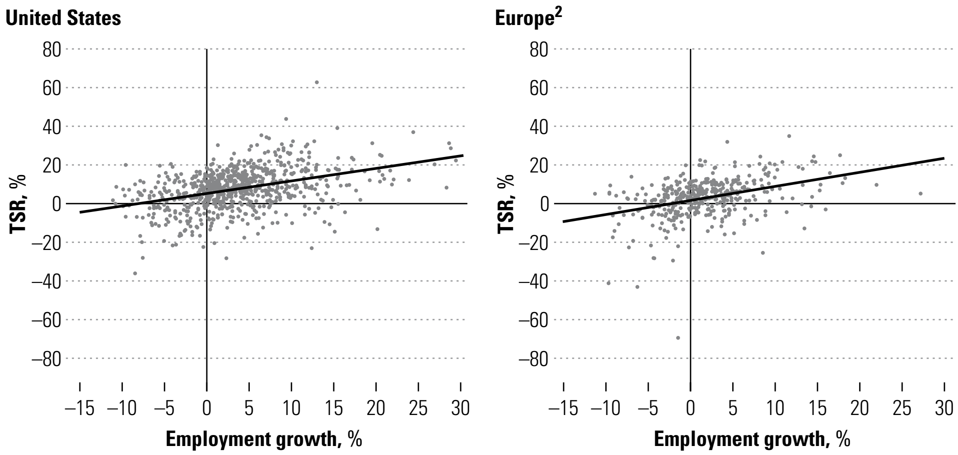
Value creation also plays a meaningful role in the health of an economy. When we examined employment from 2014 to 2023, we found that the U.S. and European companies that created the most shareholder value, measured as total shareholder returns, showed stronger-than-average employment growth

[11] S. Bonini, T. Koller, and P. H. Mirvis, "Valuing Social Responsibility Programs," *McKinsey Quarterly* (July 2009), www.mckinsey.com.

EXHIBIT 1.1 **Companies Creating More Shareholder Value Create More Jobs**

Correlation between total shareholder returns (TSR) and employment growth[1]

Compound annual growth rate, 2014–2023



[1] Sample includes companies with real revenues greater than $1,000 million and excludes 2% top and bottom outliers in employment growth.

[2] Includes companies from EU27, United Kingdom, and Switzerland.

Source: Corporate Performance Analytics by McKinsey.

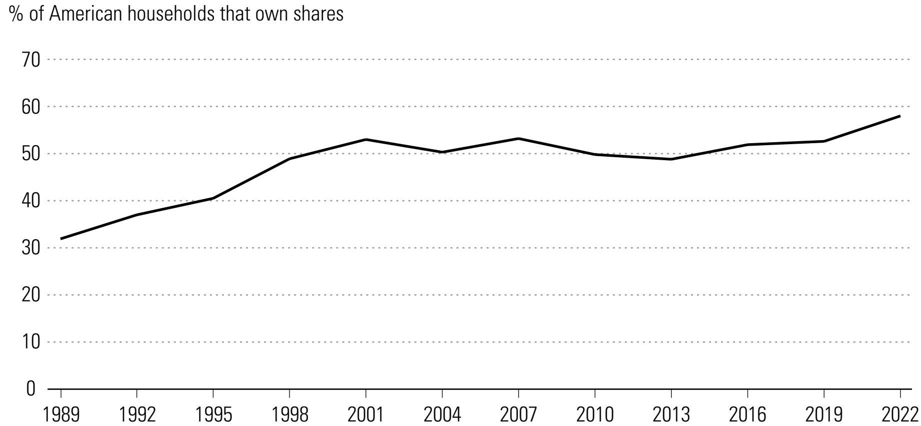
(Exhibit 1.1). This finding suggests an association between long-term corporate success and employment.[12]

Yet this is not the full picture. Sometimes, managers face unhappier circumstances. For example, companies in mature, competitive industries may have to grapple with whether to keep open high-cost plants (which support employment and local suppliers even as they sometimes lose money). In some cases, investing in innovation, productivity, and differentiation can justify higher-cost locations and create a win-win situation. In others, however, securing a future for the company as a whole—and all who depend on it—requires tough choices. In our experience, managers carefully weigh shareholder value impact *and* agonize over decisions that have pronounced consequences on workers' lives and community well-being.

For those making these difficult trade-offs, it's important to also consider who ultimately benefits from shareholder value creation. It is comforting to know that shares in most listed companies are held by retail investors, pension funds, and mutual funds. The ultimate beneficiaries are mostly people saving for retirement. In fact, a recent report found that the portion of shares owned by individuals—whether direct or indirect holdings—has continued to

[12] We've performed the same analyses for 15 and 20 years and with different start and end dates, and we've always found similar results.

EXHIBIT 1.2 **Increasing Percentage of American Households Owning Stocks**



[1] Sum of direct and indirect stock holdings. Examples of indirect holdings are pooled investment funds, retirement accounts, and other managed assets. Indirect holdings, particularly through tax-deferred retirement accounts, are much more common than direct holdings.

Source: Board of Governors of the Federal Reserve System, Survey of Consumer Finances (SCF), federalreserve.gov, accessed Jan. 2024.

increase and reached an all-time high of just under 60 percent in 2022, compared with 30 percent in 1989 (Exhibit 1.2).[13]

We can observe the importance of long-term value creation to the overall economy in widespread improvements to the standard of living in advanced economies such as the United States, where access to conveniences such as air conditioning, automobiles, and mobile phones has steadily increased over time. In 2020, almost 90 percent of U.S. homes had air conditioning.[14] In the 1940s and 1950s, such conveniences were far less common. In 1900, the agriculture sector required almost 40 percent of the workforce to feed the country's population. By 1950, thanks to technological advances and improvements in efficiency, that number had dropped to just over 10 percent, and it has since fallen below 2 percent.[15]

In their 2022 book, *Superabundance: The Story of Population Growth, Innovation, and Human Flourishing on an Infinitely Bountiful Planet*, authors Marian Tupy and Gale Pooley measure economic progress in terms of time prices—the hours of work required to buy a certain quantity of goods. They report, "Between 1980 and 2020, while [global] population grew by 75 percent, time prices of the 50 key commodities that sustain life dropped by

[13] H. Miao, "More Americans than Ever Own Stocks," *Wall Street Journal*, December 18, 2023, www.wsj.com.

[14] "Nearly 90% of U.S. Households Used Air Conditioning in 2020," *Today in Energy* (U.S. Energy Information Administration), May 31, 2022, www.eia.gov.

[15] "Changes in Agriculture, 1900 to 1950," in *1950 Census of Agriculture*, vol. 5, *Special Reports* (US Census Bureau, 1952), available at www.census.gov.