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About the Authors

The authors are all current or former consultants of McKinsey & Company’s corporate finance practice. Collectively they have more than 50 years of experience in consulting and financial education.

**McKinsey & Company** is a management-consulting firm that helps leading corporations and organizations make distinctive, lasting, and substantial improvements in their performance. Over the past seven decades, the firm’s primary objective has remained constant: to serve as an organization’s most trusted external advisor on critical issues facing senior management. With consultants deployed from over 80 offices in more than 40 countries, McKinsey advises companies on strategic, operational, organizational, financial, and technological issues. The firm has extensive experience in all major industry sectors and primary functional areas, as well as in-depth expertise in high-priority areas for today’s business leaders.

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Preface

The first edition of this book appeared in 1990, and we are encouraged that it continues 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.

The 20 years since that first edition have been a remarkable period in business history, and managers and investors continue to face opportunities and challenges emerging from it. The events of the economic crisis that began in 2007, as well as the Internet boom and its fallout almost a decade earlier, 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 financial crisis were overstated, as subsequent losses demonstrated. The laws of competition should have alerted investors that those extraordinary profits couldn’t last and might not be real.

Over the past 20 years, we have also seen confirmed that for some companies, some of the time, the stock market may not be a reliable indicator of value. Knowing that value signals from the stock market may occasionally be unreliable makes us even more certain that managers need at all times to understand the underlying, intrinsic value of their company and how it 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.
PREFACE

WHY THIS BOOK

Not all CEOs, business managers, and financial managers do understand value in great depth, although they need to understand it fully if they are to do their jobs well and fulfill their responsibilities. This book offers them the necessary understanding, its practical intent reflecting its origin 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 their investors. It aims to demystify the field of valuation and to 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 that 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 underlinings, margin notations, and highlightings.

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. And these two truths apply across time and geography. The book explains why these core principles of value creation are true and how companies can increase value by applying the principles to decisions, and demonstrates practical ways to implement the principles in their decision-making.

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 about courses of action for a company. Specifically, they will help business managers understand how to:

- Decide among alternative business strategies by estimating the value of each strategic choice.
- Develop a corporate portfolio strategy, based on understanding 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, divestitures, and restructurings.
- Improve a company’s performance management systems to align an organization’s various parts to create value.
- Communicate effectively with investors, including both who to talk and listen to and how.
- Design an effective capital structure to support the corporation’s strategy and minimize the risk of financial distress.
STRUCTURE OF THE BOOK

In this fifth edition, we continue to expand the practical application of finance to real business problems, reflecting the economic events of the past decade, new developments in academic finance, and the authors’ own experiences. The edition is organized in six 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 despite the capital market turmoil of the past several years. We explain the two core principles of value creation: first, the idea that return on capital and growth drive cash flow, which in turn drives value, and second, the conservation of value principle, that 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 strategic principles and empirical insights.

Part Two, Core Valuation Techniques, is a self-contained handbook for using discounted cash flow (DCF) to value a company. A 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, Intrinsic Value and the Stock Market, presents the empirical evidence that share prices reflect the core principles of value creation and are not influenced by earnings management, accounting results, or institutional trading factors such as cross-listings. It also describes the rare circumstances under which share prices for individual companies or, very occasionally, the market in general may temporarily violate the core principles. The final chapter explains what makes stock markets efficient, which type of investors ultimately determine the trading range of a company’s share price, and the implications of their influence for managers.

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 create value through mergers, acquisitions, and divestitures; how to construct an appropriate capital structure; and how companies can improve their communications with the financial markets.

Part Five, Advanced Valuation Issues, explains how to analyze and incorporate in your valuation such complex issues as taxes, pensions, reserves, inflation, and foreign currency. Part Five also includes a comprehensive case valuing Heineken N.V., the Dutch brewer, illustrating how to apply both the core and advanced valuation techniques.

Part Six, Special Situations, is devoted to valuation in more complex contexts. We explore the challenges of valuing high-growth companies, companies in emerging markets, cyclical companies, and banks. In addition, we show how