
Koller, Tim, Goedhart, Marc & Wessels, David - Valuation: Measuring and Managing the Value of Companies, John Wiley & Sons, 2010, [Finance] Grade ★★★★★

On a basic level there are two competing mental models of stock values in the financial sector. The first is that the value of something is what someone is prepared to pay for that something. In the equity market this leads to statements such as “the valuation of a stock is low” if the current market pricing of the stock is historically low compared to, for example, the estimate of the near term future earnings. The other model is based on that a company has a fundamental intrinsic value that is separate from the market pricing of its equity. This book is about both how to estimate this intrinsic value and also on how to create it.

Out of all the books reviewed on this website Valuation is probably the one that sits on most shelves behind workstations of employees in the financial sector. The reason is that most of us have had it as a text book at university, but compared to all the other text books this one is also a handbook in corporate valuation that is used by practitioners. For those who use the concept of intrinsic value, cash flow valuation has become the standard methodology and Valuation is the standard source material. The book is mandatory reading for persons within corporate finance, venture capital and private equity who are slightly less close to the public stock market. It is less widely used by portfolio managers or sell side analysts who often look to shorter time horizons.

There are obviously competing text books on valuation such as Damodaran on Valuation. Where professor Aswath Damodaran's writing is academic and covers more ground with regards to different aspects of securities valuation, Valuation is a practical book that connects valuation to corporate strategy and value based management. Two of the authors of Valuation are employed by McKinsey and the main focus is on one specific method of valuation. This is a fifth edition. Over the years this book has become more and more of a practitioner's manual with consistent form, new sections on special situations and sector issues plus

solutions to all kinds of practical problems in a DFC-valuation. More academic issues such as if CAPM is really a good model to use for estimating the WACC, when it has become more and more obvious that beta doesn't work, is toned down as this would only subtract from the practical value of the book. Damodaran on Valuation is written by an academic, Valuation is written by consultants for daily use by CEOs and finance professionals.

The intrinsic value in a DCF is based on cash flows, the growth in cash flows and the risk that these future cash flows will not materialize. The cash flow in question differs; it might be dividends for stocks, coupons for bonds or after tax cash flows for businesses. The problem is that as the future is unknown the intrinsic value is unobservable. Any calculation of it is an act of faith. One strength of the DCF is that it is transparent. It requires a large number of assumptions of future performance. Each such input has a range of reasonable values and the choice of inputs can be examined and criticized. Paradoxically the construction also opens up for psychological biases. If each and one of the many inputs are tweaked in a slightly more optimistic or pessimistic direction the multiplier effect of all those small (but one by one reasonable) changes will bring huge swings in the calculated intrinsic value. The fact that a DCF could be made to show almost anything has created a mini revival for excess return valuations such as the Residual Income Model. These are close cousins to the DCF methodology, but use a) the capital base of the company and b) its ability to earn a return on capital that is higher than the cost of capital as the two main inputs. Using the capital as the base for the valuation makes it potentially less dependent on estimates of an unknowable future.

This book is unbeatable for the practitioner who needs the tools for valuing a company or must understand how other do just that. More philosophical issues are to be sought elsewhere.

Mats Larsson, February 22, 2012