

Preface

Why This Book?

We wrote this book because we saw a void between the abstract theoretical treatment of equity valuation and the practical problem of valuing an actual company using real world data. We give serious treatment to the underlying theory of financial analysis and valuation, but our main goal is to be able to arrive at a pragmatic answer to the all-important question, “What is this company really worth?” To answer this question, we adopt a very different approach from other textbooks. The key differences can be summarized as follows:

1. Our overriding focus is on generating good financial statement forecasts.
2. We provide detailed practical guidance on how to obtain and analyze relevant real-world data.
3. We demystify the mechanics of equity valuation.

We believe that good forecasts of the future financial statements are the key input to a good valuation. Most other aspects of the valuation process are mechanical and can be programmed into a computer. In fact, this text is supplied with eVal, an Excel-based computer program that takes care of these mechanical tasks. As with many other textbooks, we discuss topics like business strategy analysis, accounting quality analysis, financial ratio analysis, etc. However, we always do so with a clear view to how these analyses help us to generate better financial forecasts.

We also provide plenty of advice on where to go to obtain the most relevant raw data. eVal is supplied with historical financial statement data for over 8,000 companies and you can use eVal to access these companies’ SEC filings, investor relations websites, analysts forecasts and new releases. Armed with such a rich source of data, we are able to provide you with plenty of practical examples on how to generate good forecasts using real world data and sound financial analysis.

A final goal of this book is to demystify the valuation process. In the past, we have seen students become lost in a sea of valuation formulas and inconsistent spreadsheet models. For example, students get confused as to whether they should use the DDM, DCF or RIM valuation formula and whether they need to compute a WACC or just a simple cost of equity capital. They become obsessed with learning acronyms and formulas, but flounder when asked to determine a plausible valuation for an actual company. Using eVal, we demonstrate that these different formulas are easily reconciled and refocus students on developing the best set of financial forecasts to plug into them. This reinforces our main point that the key to good valuations is good forecasts.

The eVal Software

We wrote the software because we realized that students were spending way too much time building and debugging their valuation spreadsheets and, consequently, way too little time thinking about the forecasts that they put into their spreadsheets. The tail was definitely wagging the dog. They also couldn't talk to one another because each student tackled the spreadsheet problem differently—it could take hours just to figure out why Jill's value estimate differed from Jack's value estimate. By building one “mother-of-all-spreadsheet valuation models” and making it completely transparent and completely general, we turned our students' attention back to the real problem at hand, which is forecasting the future financial statements. Thus, eVal was born. As we used the early version of the program with students, we discovered that we could use eVal to organize the entire historical analysis, forecasting and valuation process. All the pieces of the puzzle could finally be kept in one place. Later we realized that if we loaded the program with tons of company data and provided web links to even more data, eVal could become the final one-stop-shop for valuation analysis. We also found that once we had familiarized students with eVal, we could effectively teach complex valuation cases that would otherwise become bogged down in the details of the spreadsheet model.

The eVal software helps in doing valuation and it helps in *learning* valuation. There are many software products and web services today that take a few forecast inputs from you and then spit out a valuation, as if by magic, but how they arrived at the results is hidden in a black box. In contrast, this book and the eVal software that accompanies it are designed to be completely transparent at every stage of the valuation process. The software displays the valuation implications of your forecasts in both discounted cash flow models and residual income models, and it shows exactly how the flows of value from these models are linked to your financial statement forecasts.

Why Is This a Good Idea?

Besides the practical value of focusing our book in this way, we think that students find financial analysis and forecasting much more compelling when the theory of valuation is closely linked to real world applications. The abstract theory of financial statements, ratios and valuation formulas can be covered in one or two very boring lectures. What makes this topic exciting is seeing how an organized approach to studying a real company leaves you so much better informed about the firm's future. Is Dell really the highly efficient manufacturer of computers that everyone claims? The answer is yes, as you can see in their turnover statistics. Royal Caribbean Cruises wants to build six more cruise ships in the next three years but can they generate enough cash from the existing ships to pay for the new ones? A careful study of their cashflows shows that they will almost certainly be borrowing lots of money to buy these boats. Salton Inc., maker of the George Foreman grill, toils away in the very unexciting small appliance industry, but has

been generating stellar earnings. With a price-to-earnings ratio of only five, are they undervalued? The answer is probably not, because their most popular products have just peaked and their earnings quality is suspect. Financial statements, accounting rules, financial ratios and valuation models are all pretty dull beasts on their own, but if we can use them to answer questions like this, then their usefulness becomes clear. By blending the theory of equity analysis with practical application we feel that students learn both better.

As a working example, the retail department store chain Kohl's is used throughout the book. It is also the default company in eVal, so you can readily see how the theory translates into real forecasts and valuation implications. Because eVal comes preloaded with data for over 8000 public companies, you can also compare Kohl's to Saks, Target, and Sears with just a few mouse-clicks.

Cases and the Website

We have posted a number of cases on the eVal website (www.mhhe.com/eval), and have included short descriptions of each at the end of the relevant chapter. Most of the cases come with data input files for eVal, and most of the cases are based on real companies. These cases are “freeware;” instructors should feel free to modify them as they wish. For most cases, we have also included the PowerPoint slides from the lecture where we used the case in our MBA class. The website also includes other tidbits, such as installation instructions, notices about any changes in the URLs reference in the book or the software, and FAQs.

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