***Valuation: Measuring and Managing the Value of Companies, Sixth Edition***

Chapter 1 Why Value Value?

Solutions

1. One benefit for companies that have a long-term perspective on value creation is that it leads them to engage only in activities that create value and not waste effort on activities that do not. Also, this perspective discourages them from engaging in activities that appear to have positive benefits in the short term but can be detrimental in the long term (e.g., focusing on growth while ignoring return). Such a misguided focus can lead to bubbles. With respect to the overall economy, evidence suggests that when firms focus on creating value, they tend to engage in a higher level of corporate responsibility, and there is a healthier economy with higher employment.
2. Managers know more than shareholders about the firm’s prospects and choices that have been or will be made with respect to firm operations. For instance, managers could slash crucial marketing expenses and claim that they are being more efficient. Investors won’t be able to tell with publicly available information that this could be problematic for long-term value creation. This disparity in information between managers and shareholders can lead to differences in the stock price in the short term versus long term.
3. The exclusive focus on corporate earnings neglects one of the two key components of long-term value creation: generating a return on capital that is greater than a firm’s cost of capital.
4. Examples of complementary interests include IBM’s free Web-based resources on business management; Novo Nordisk’s “triple bottom line” philosophy of social responsibility, environmental soundness, and economic viability; and Best Buy’s efforts to reduce attrition among female employees. Examples of conflicting interests include companies in mature, competitive industries deciding whether or not to keep open high-cost plants that lose money in order to keep employees working and to prevent suppliers from going bankrupt; and a firm’s decision about how much to compensate employees in pay and benefits. When interests conflict, managers should focus on long-term shareholder value creation, as this will not only benefit shareholders, but will also ensure efficient allocation of resources.
5. The most common feature of market crashes is the use of short-term debt to invest in long-term illiquid assets. This practice has usually been associated with placing more emphasis on growth and less emphasis on return.
6. No, getting bigger does not necessarily translate into creating value. Growth can harm value if the return on the growth is less than the cost of capital. Growth creates value if the return exceeds the cost of capital.
7. The board of directors and the shareholders could introduce incentive schemes where managers are rewarded for long-term value creation and a higher return to shareholders and where there are not rewards for short-term targets like earnings and earnings per share.