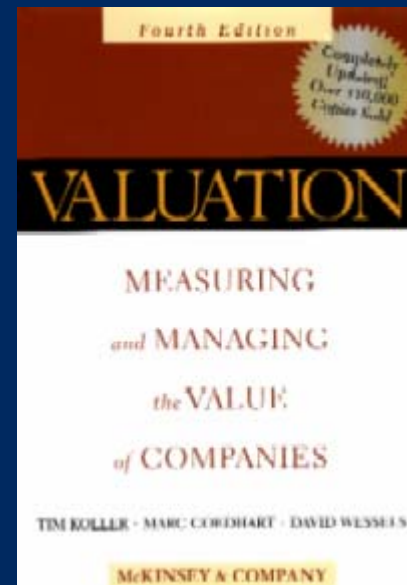


Valuation: Measuring and Managing the Value of Companies

Tim Koller

October 11, 2005



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TODAY'S DISCUSSION

- **Understanding value creation**
- **Balancing performance and health**

SIMILAR P/E

PE Ratio



21

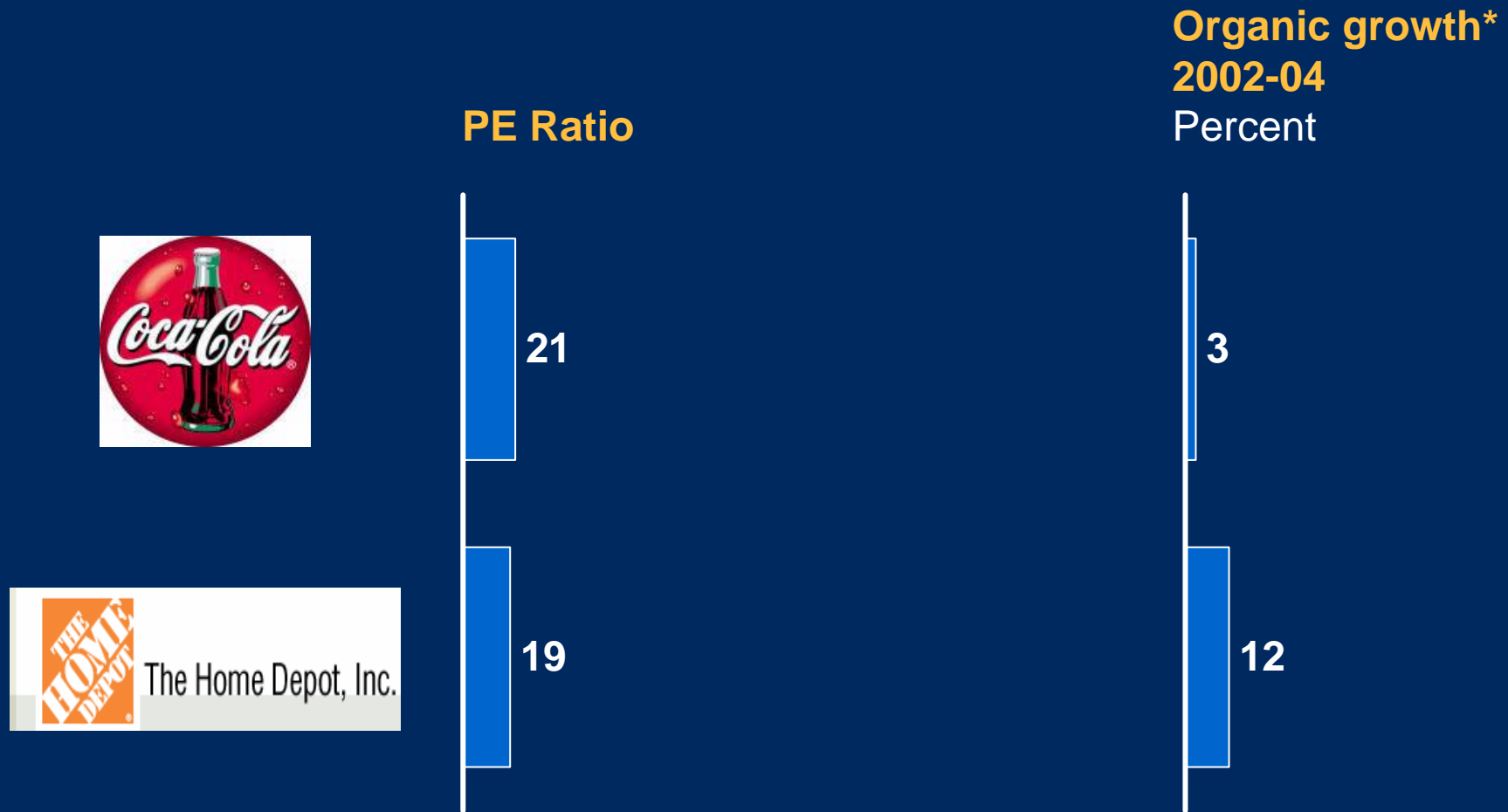


19

* Excluding acquisition, divestiture and foreign exchange impact

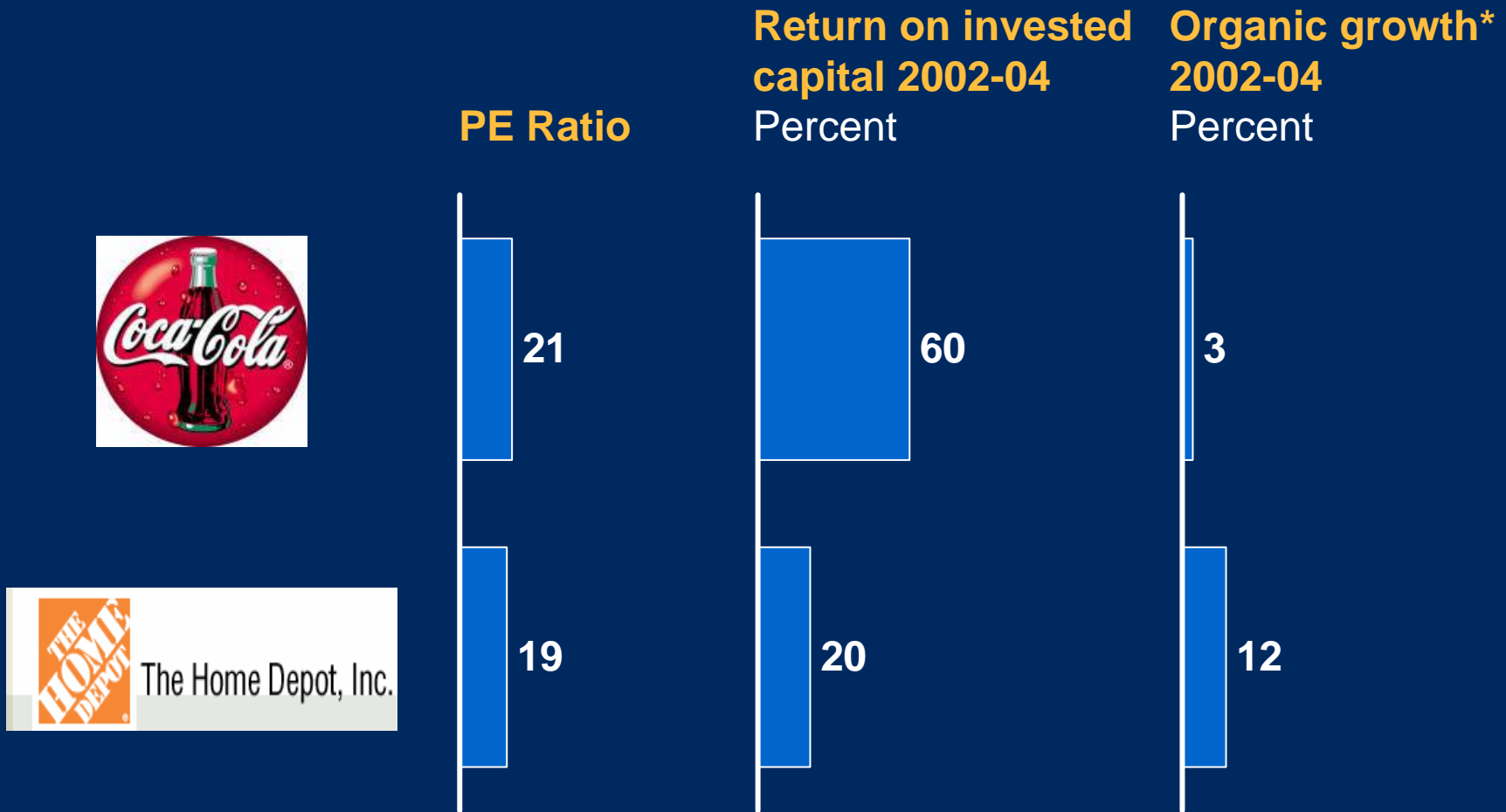
Source: Compustat; Zacks; McKinsey Corporate Performance Center

SIMILAR P/E, DIFFERENT GROWTH



* Excluding acquisition, divestiture and foreign exchange impact

SIMILAR P/E, DIFFERENT GROWTH



* Excluding acquisition, divestiture and foreign exchange impact

WHY ROIC MATTERS

Company A

g = 5%

ROIC = 10%

Earnings

Year 1

Year 2

100

105

Investment

(50)

(52)

Cash flow

50

53

Company B

g = 5%

ROIC = 20%

Earnings

100

105

Investment

(25)

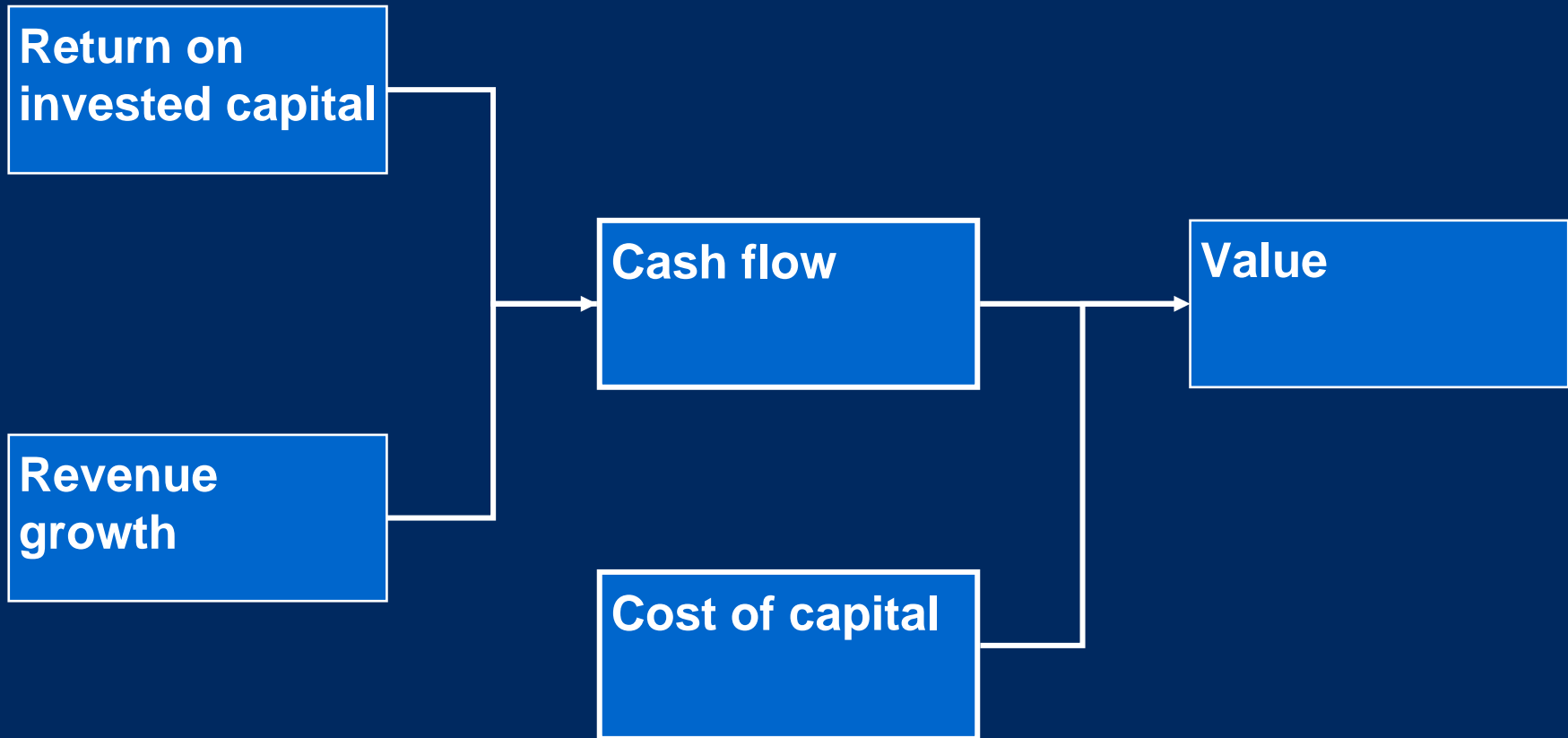
(26)

Cash flow

75

79

CORE DRIVERS OF VALUE



VALUE OF GROWTH AND ROIC

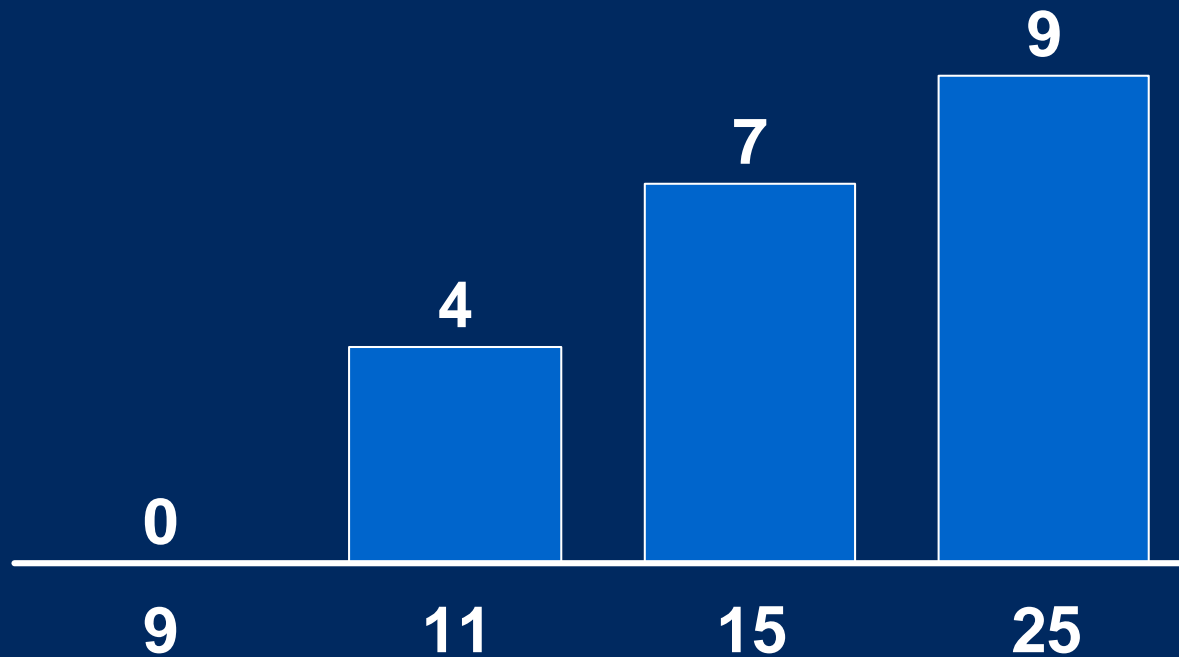
Implied PE ratios

Return on Invested Capital

		7%	9%	13%	25%
Growth	3%	8	11	14	16
	6%	6	11	16	21
	9%	4	11	19	27

VALUE OF GROWTH

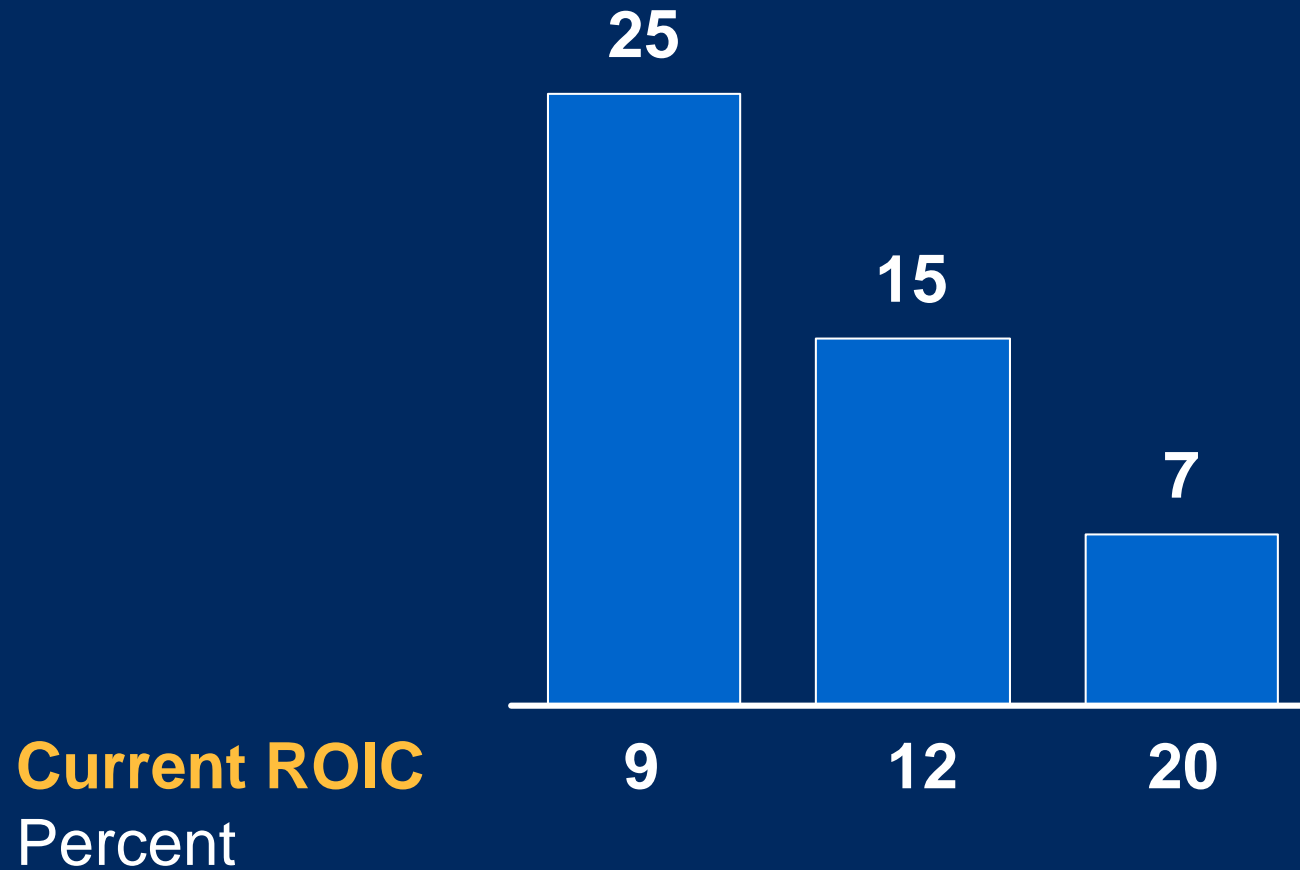
Increase in value due to 1% faster growth
Percent



ROIC
Percent

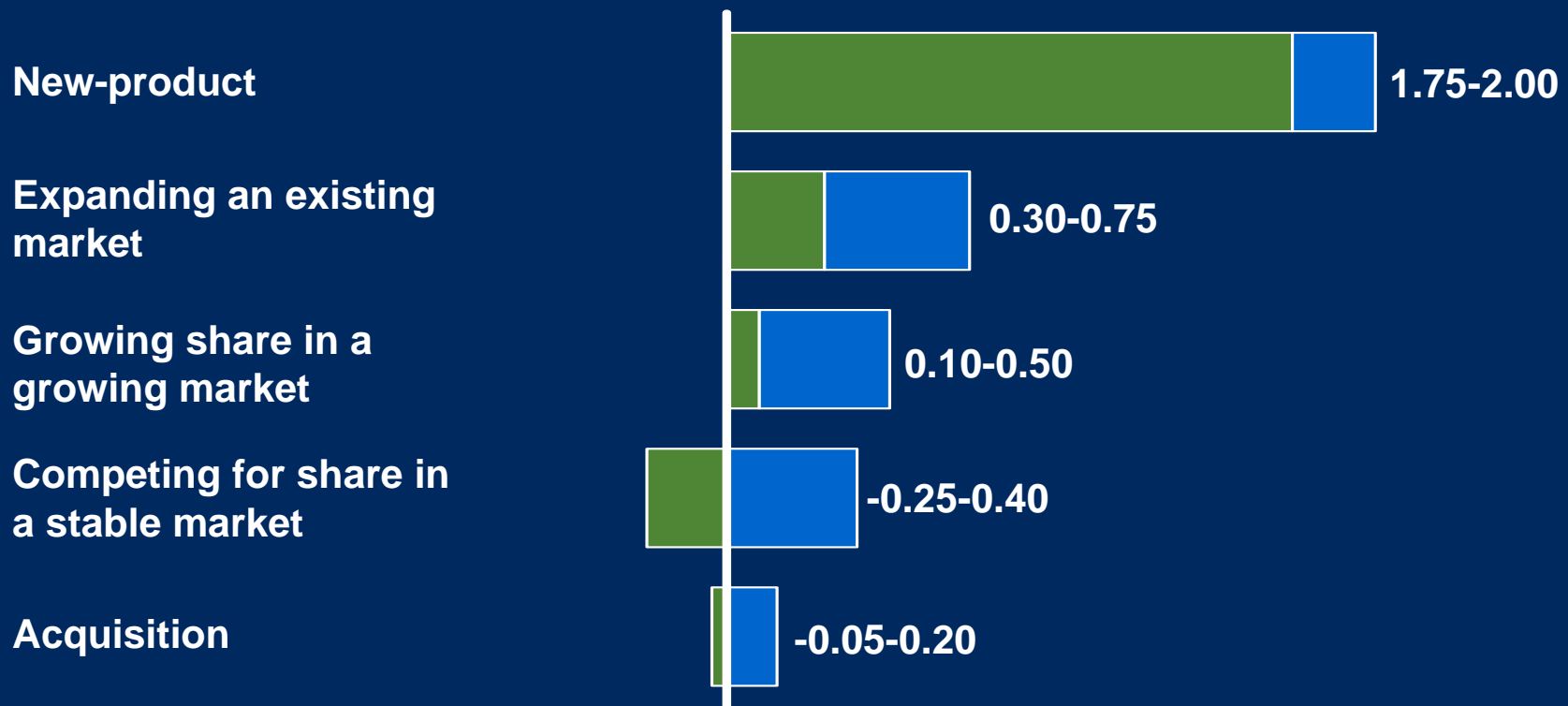
IMPACT OF IMPROVING ROIC

Impact of 1% higher ROIC
Percent



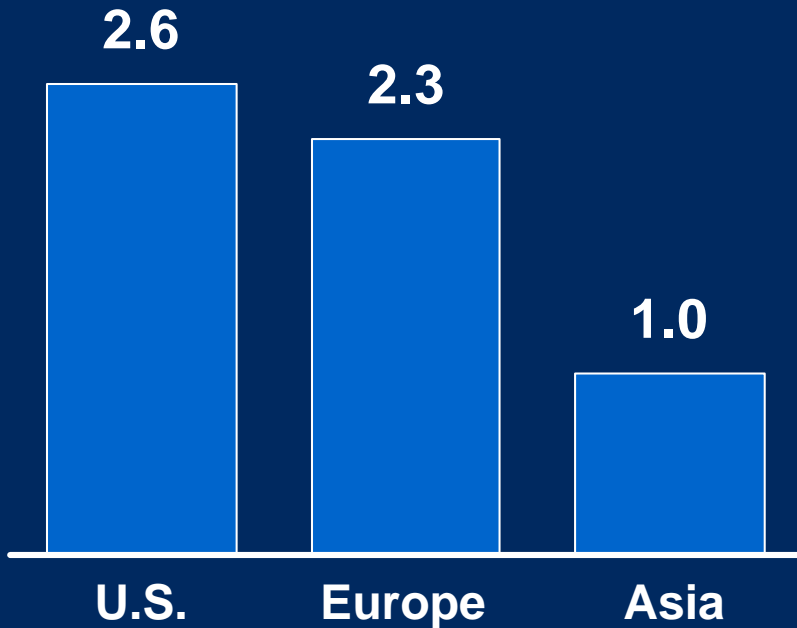
VALUE CREATION FROM GROWTH DEPENDS ON TYPE OF GROWTH

Shareholder value created for incremental \$1 of revenue

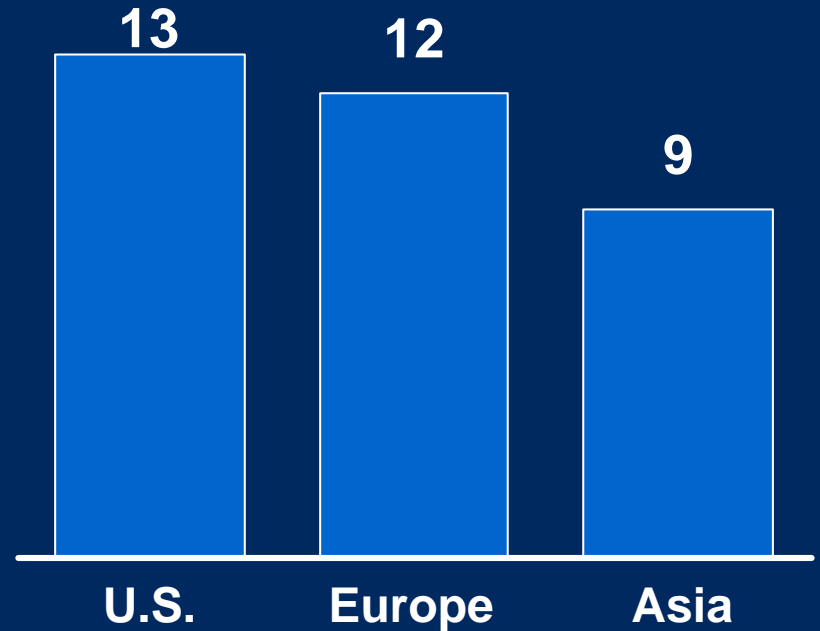


U.S. EARNS HIGHER VALUATIONS DUE TO HIGHER ROIC

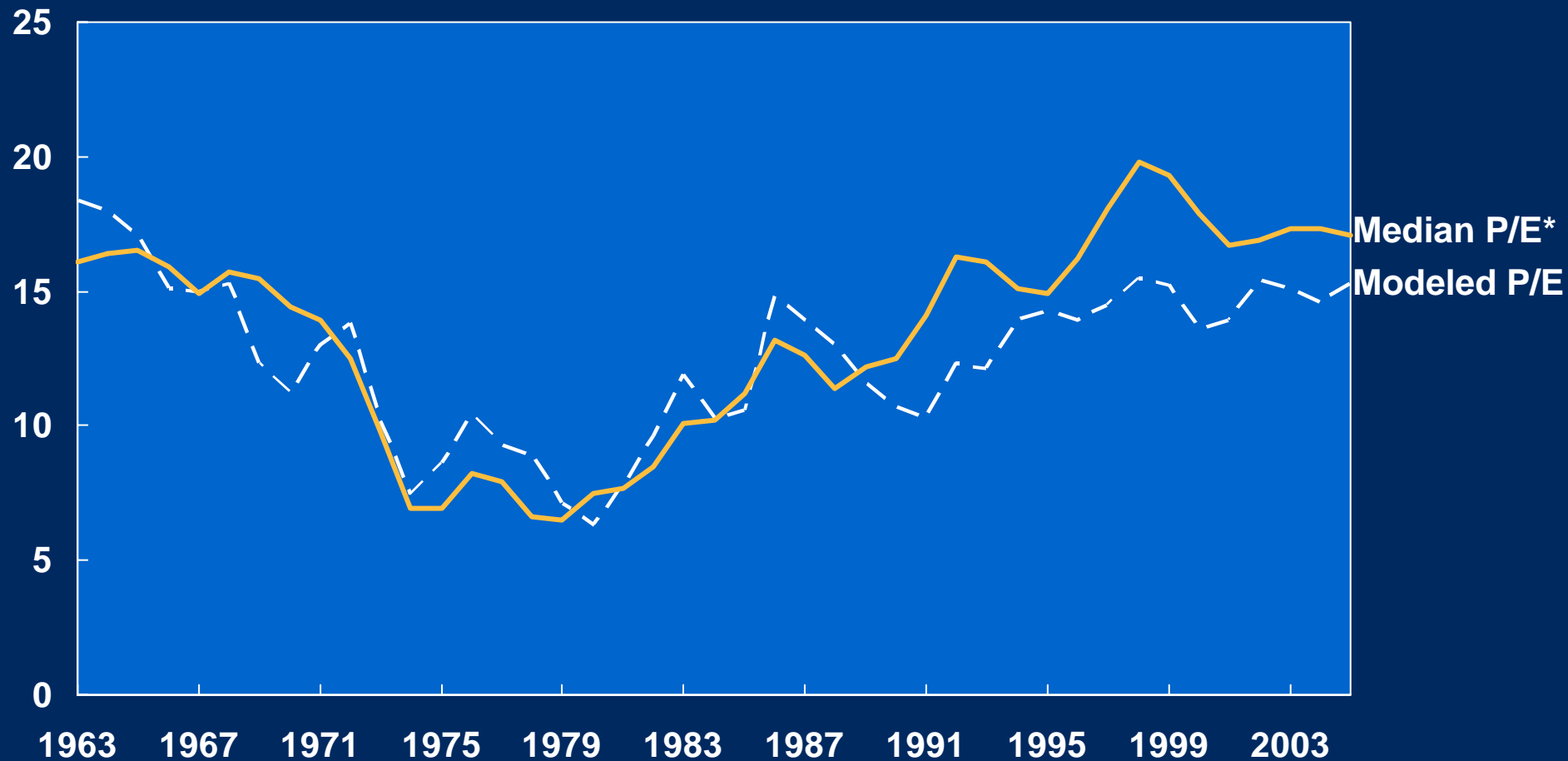
**Median Market-to-Book Ratio
2002-04**



**Median Return on Equity
2002-04**

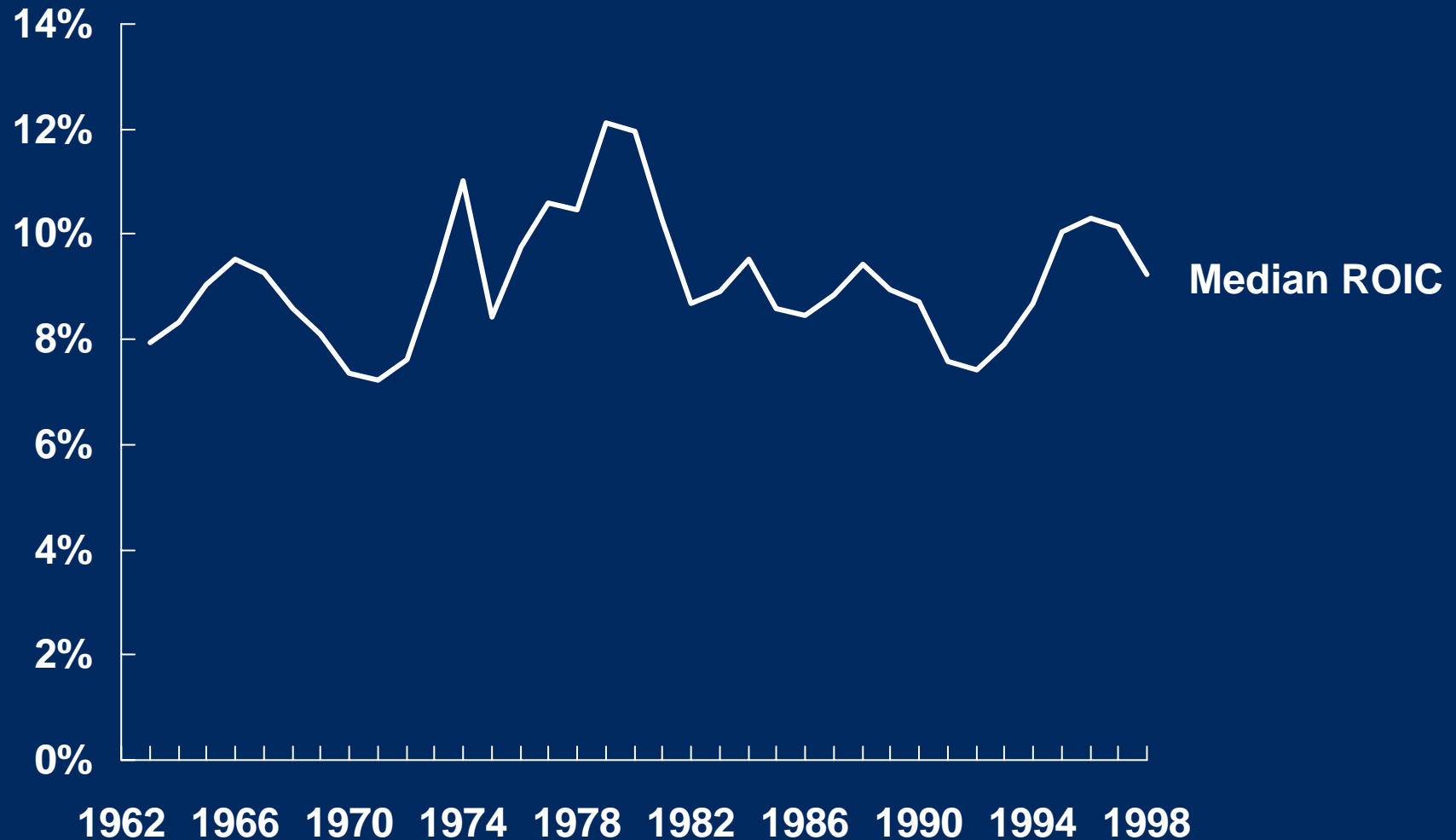


PREDICTED P/E TRACKS ACTUAL P/E

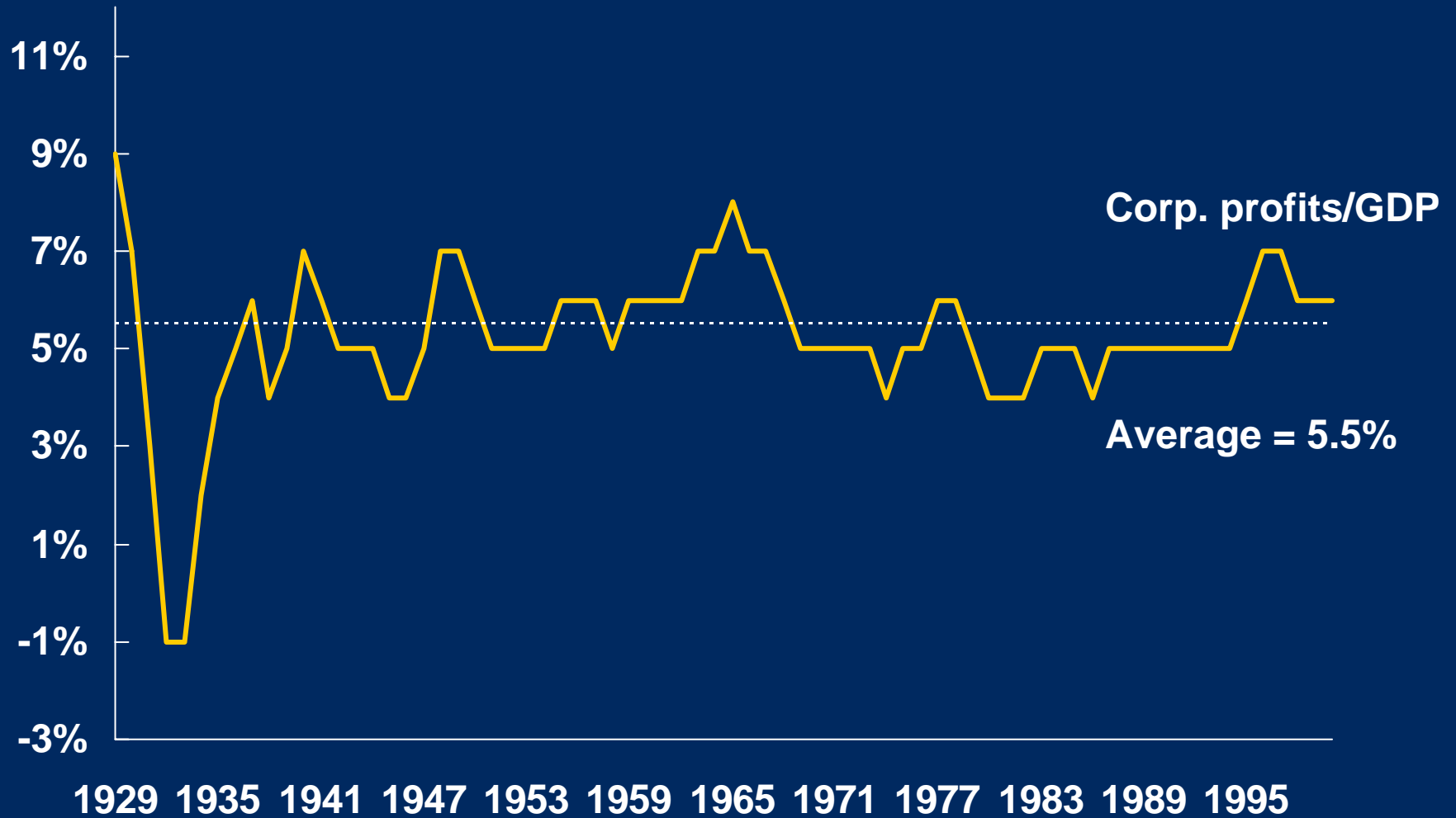


* Average of beginning and end of year S&P 500 median P/E

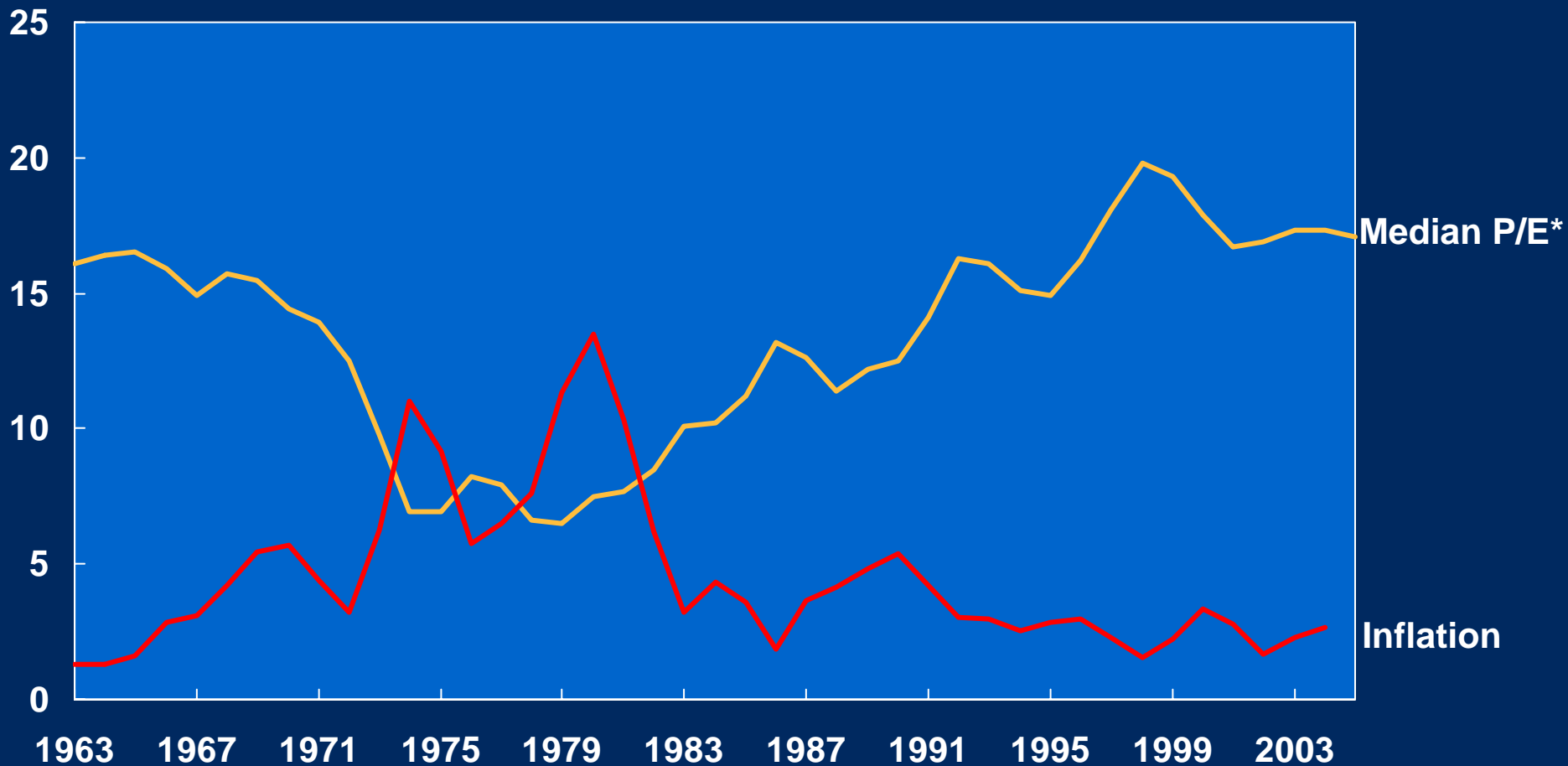
MEDIAN ROIC HAS BEEN STABLE



CORPORATE PROFITS CONSTANT PERCENTAGE OF GDP



INFLATION RATE DRIVES A MEDIAN P/E

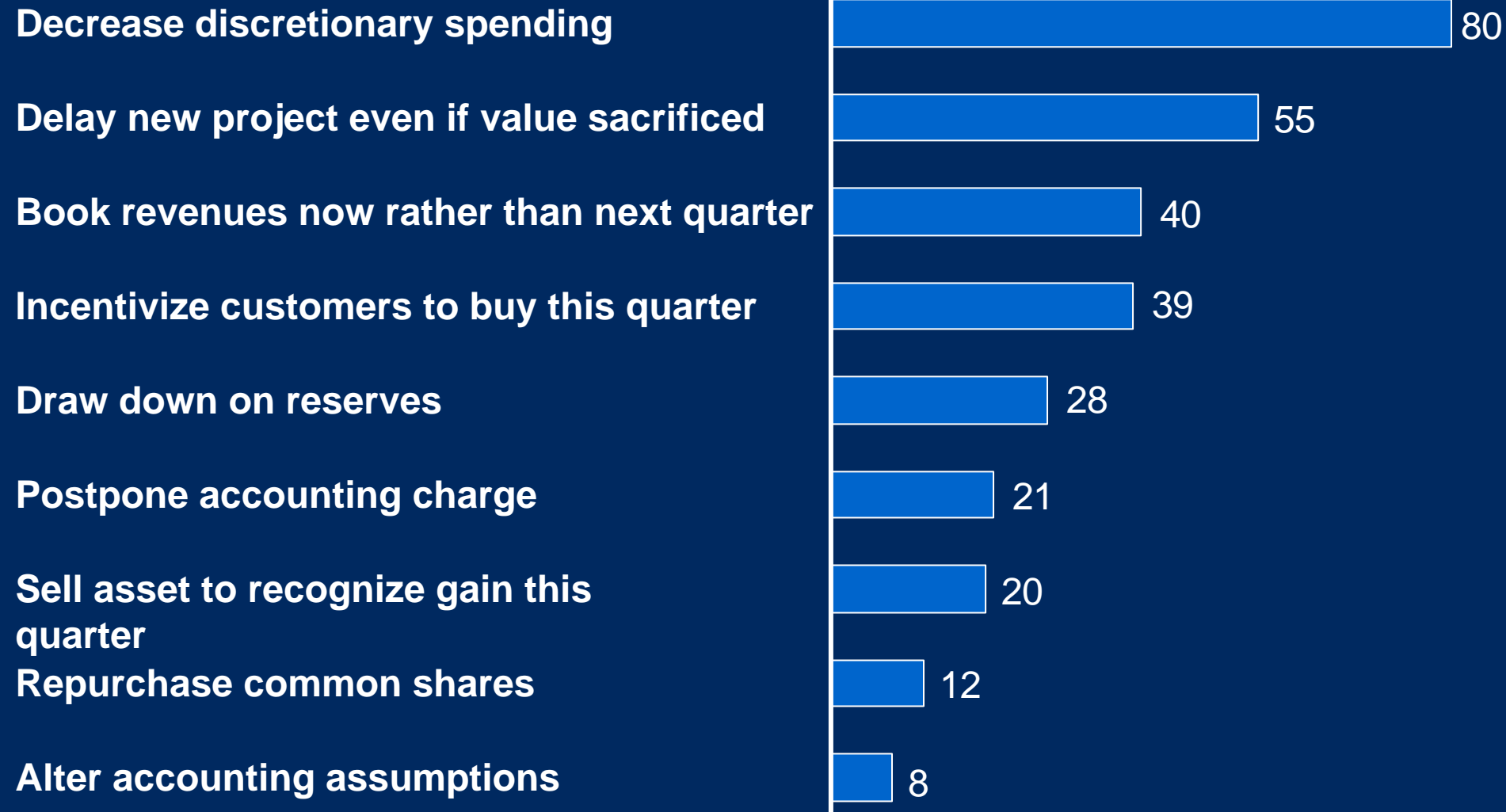


* Average of beginning and end of year S&P 500 median P/E

TODAY'S DISCUSSION

- Understanding value creation
- **Balancing performance and health**

CFOs DEFER INVESTMENT TO MEET EARNINGS TARGETS



NOT ALL EARNINGS ARE EQUAL

Consumer goods company

Percent growth

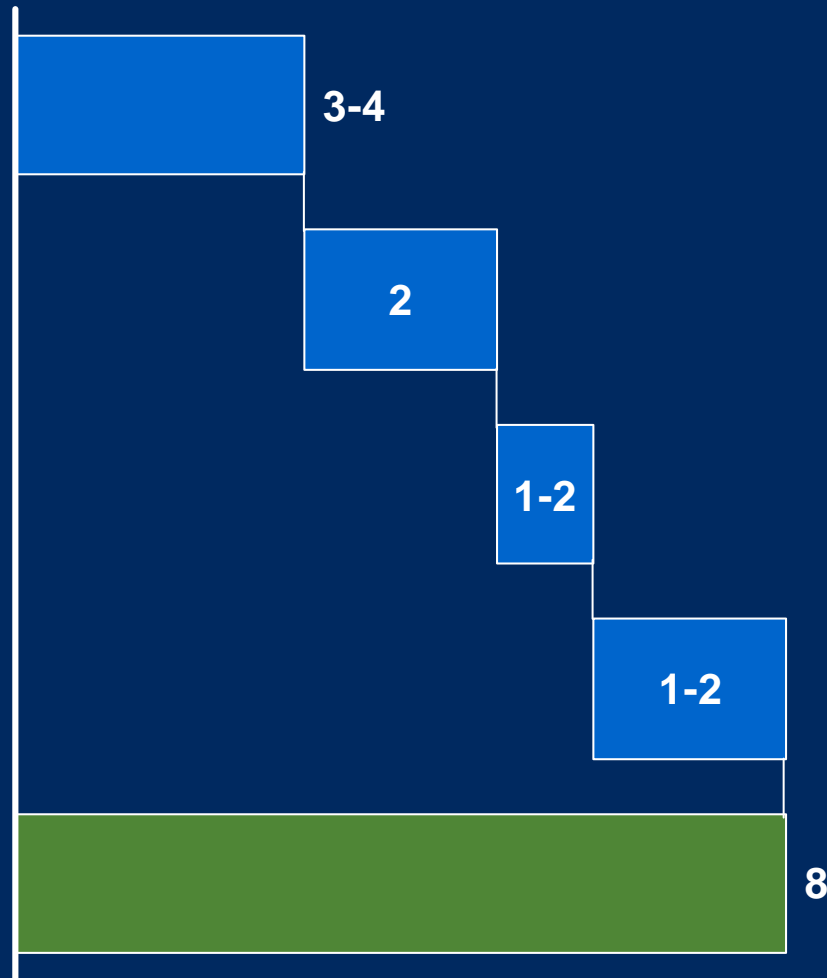
Volume

Pricing/mix

Cost reduction

Share repurchase

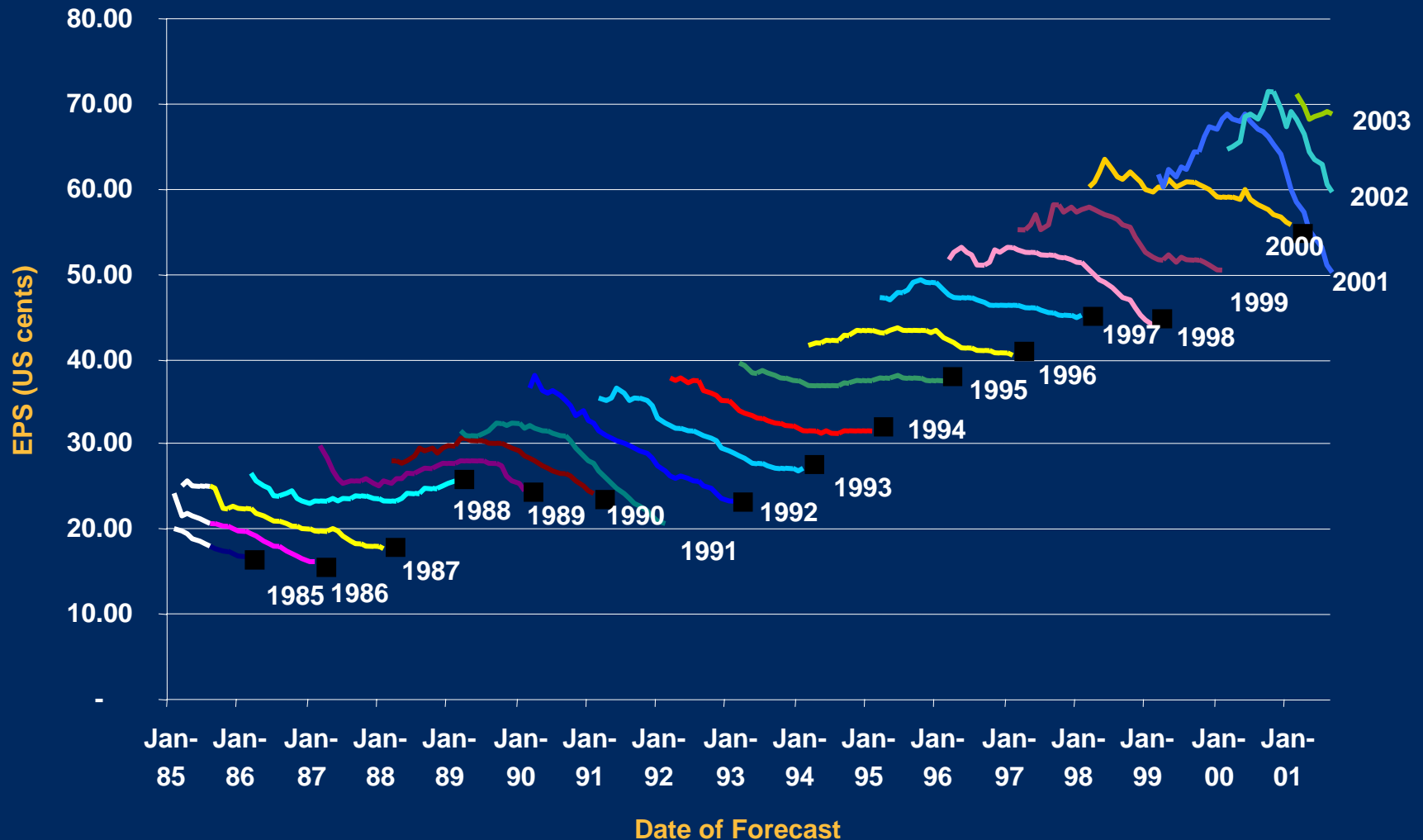
EPS growth target



MODEST GROWTH EXPECTATIONS FOR MAJOR COMPANIES



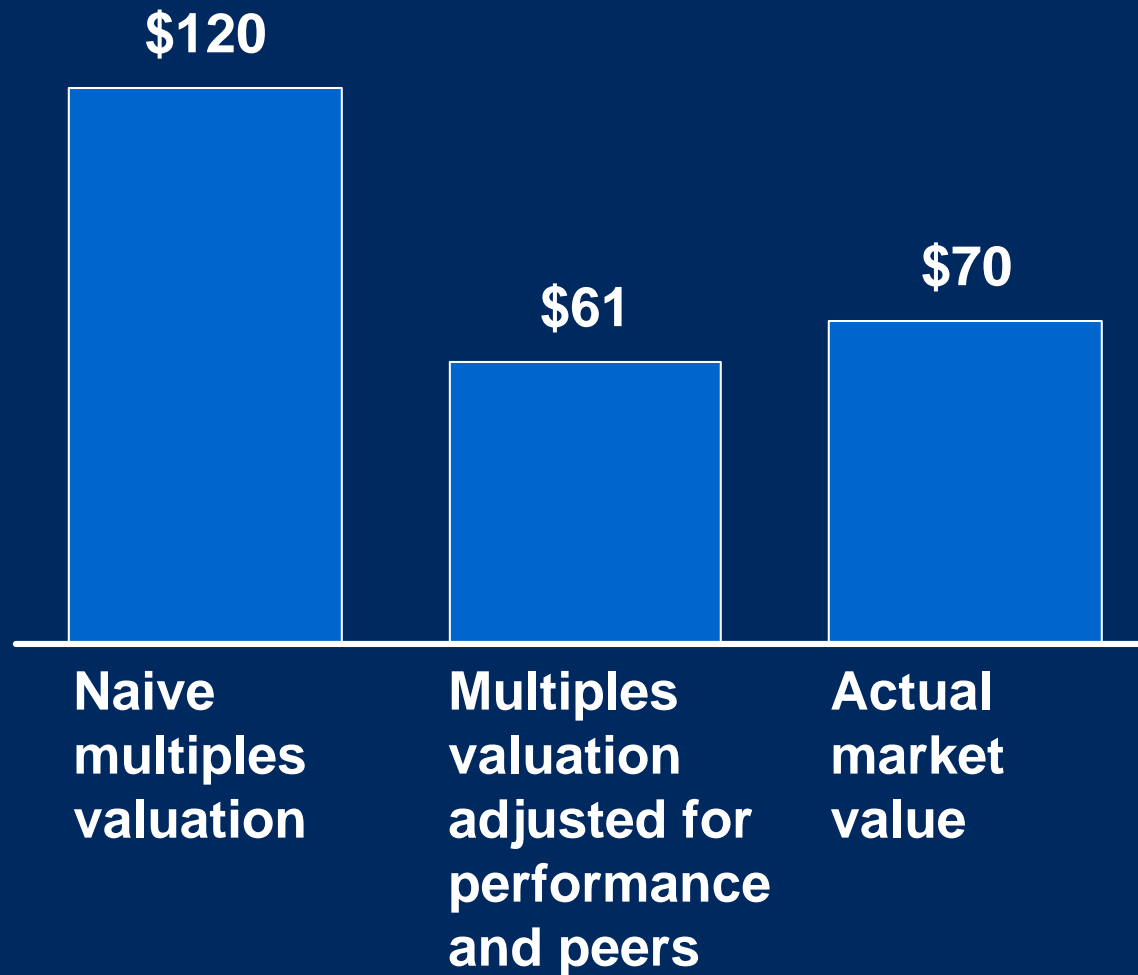
ANALYST EPS FORECAST CONSISTENTLY OVER-OPTIMISTIC



HIGH-TECH COMPANY – NAIVE VALUATION

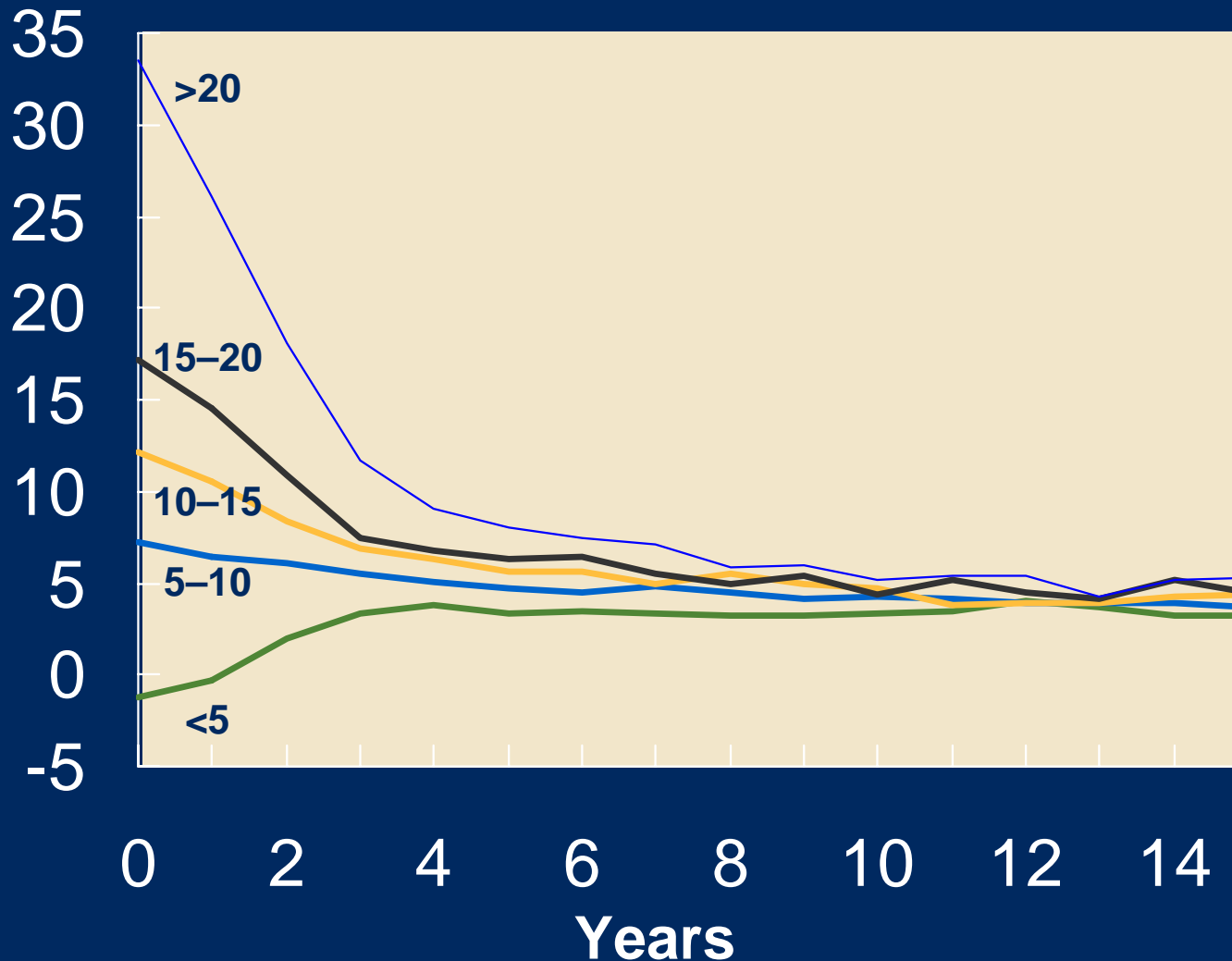
\$ per share

DISGUISED



GROWTH DECAYS VERY QUICKLY

Median real growth of cohorts
Percent



LONG-TERM PERFORMANCE EXPECTATIONS DRIVE SHARE PRICE

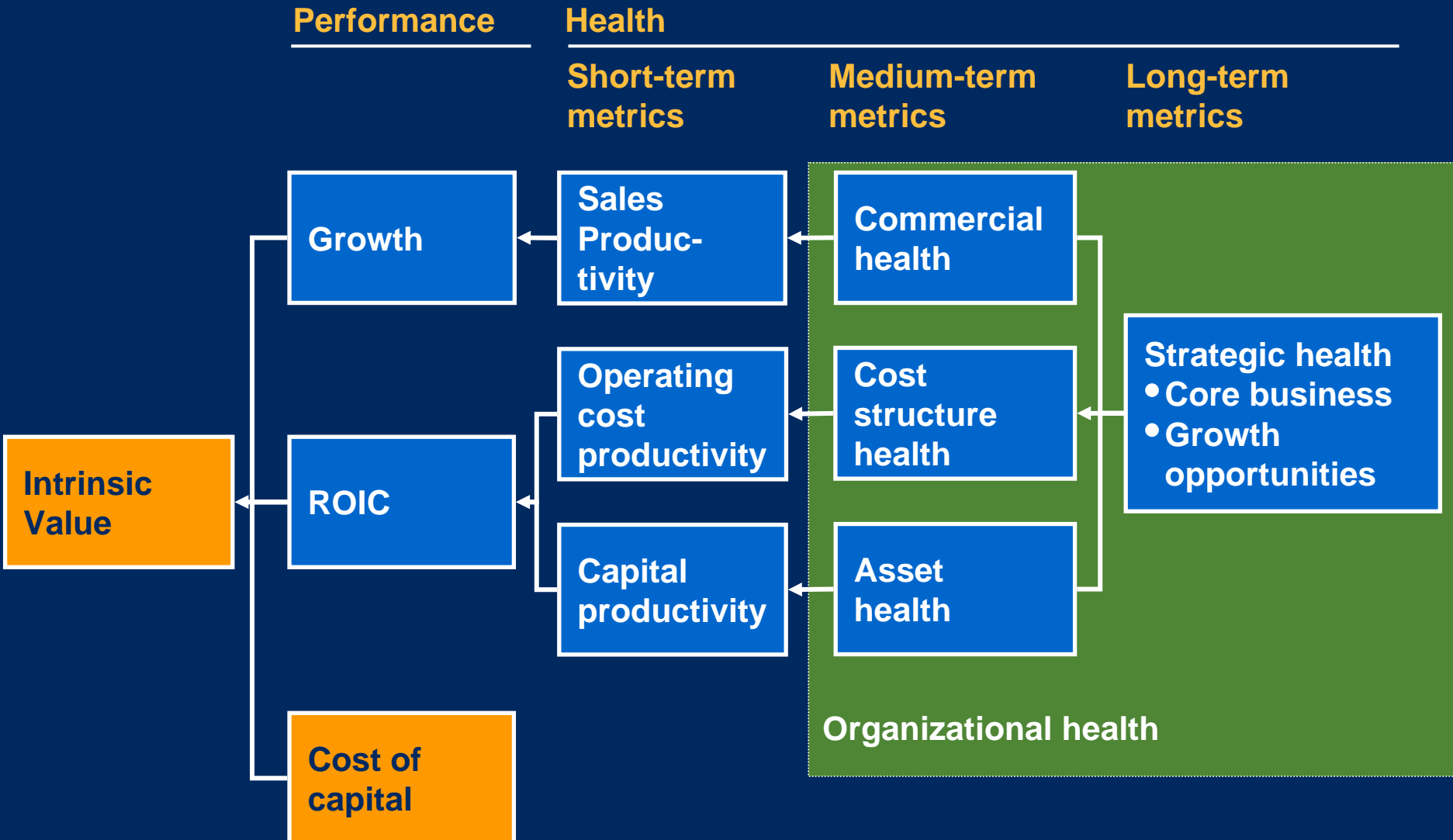
Abnormal return on 137 announcements of fiscal year earnings for 2002 by U.S. companies
Percent

Change in expected EPS for 2004 – “change in long-term expectations”

Positive	2.3	3.6
Negative	-4.1	1.0
	Lower	Higher

Actual EPS 2002 relative to expected EPS for 2002 – “short-term surprise”

PERFORMANCE AND HEALTH



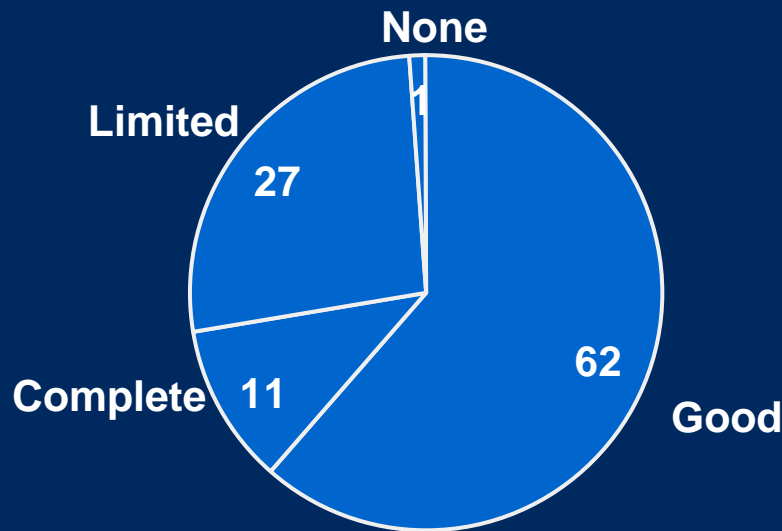
MANAGING PERFORMANCE AND HEALTH

- **Strategic initiatives across multiple time horizons**
- **Organizational processes focused on health**
- **New dialogue with investors and the Board**

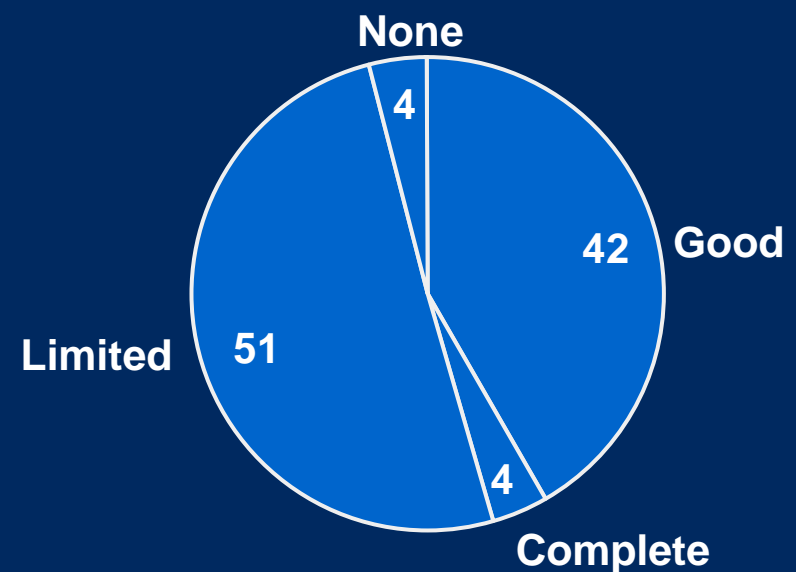
MANY DIRECTORS DON'T UNDERSTAND COMPANY'S STRATEGY AND INITIATIVES

1,016 respondents, percent

How would you describe your board's understanding of the company's current strategy?



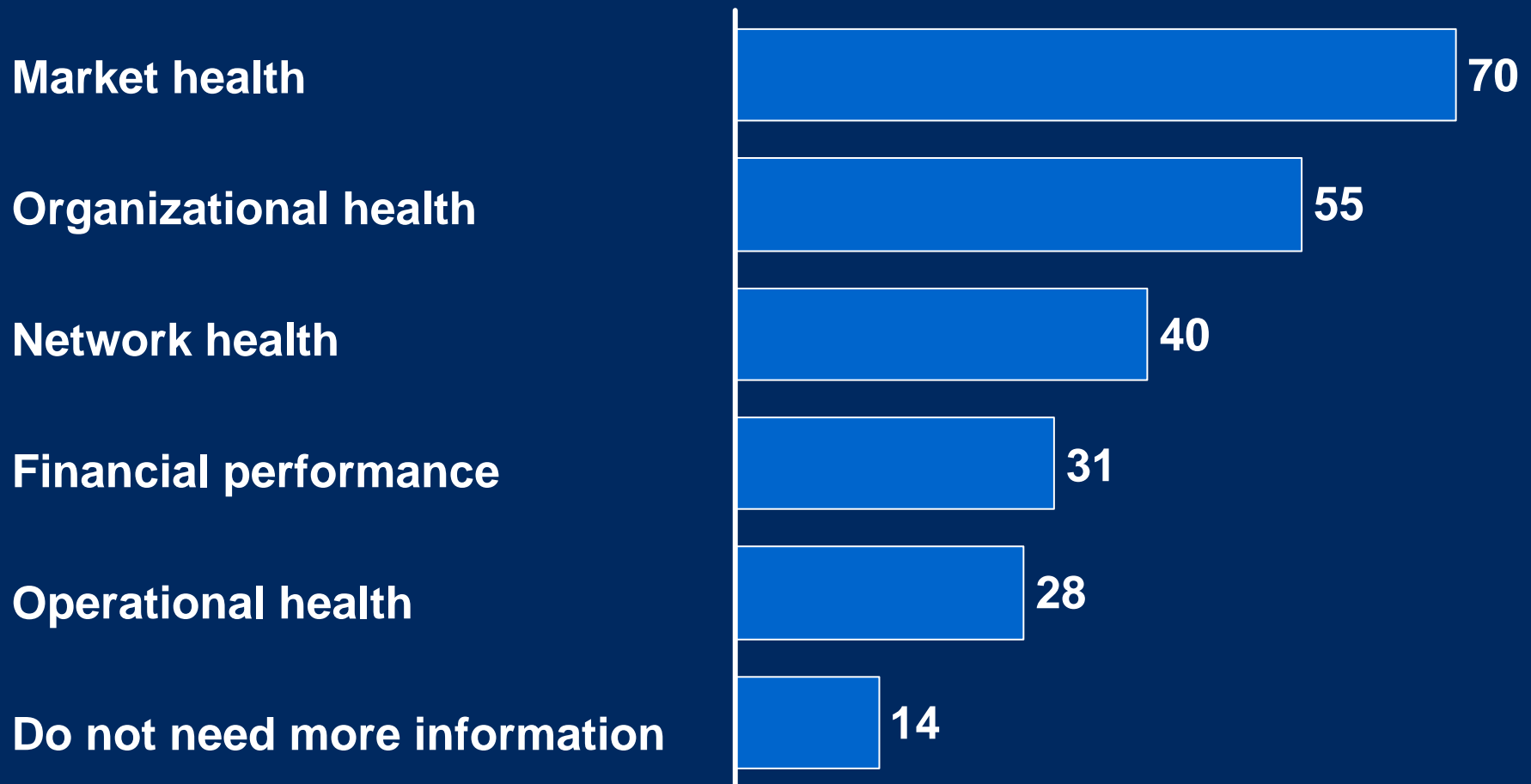
How would you describe your board's understanding of 5-10 key initiatives needed to achieve long-term objectives?



DIRECTORS WANT TO KNOW MORE

1,016 respondents, percent

As a director, I would like to know more about:



PERFORMANCE AND HEALTH

