

Why Value Value?

The chief measures for judging a company are its ability to create value for its shareholders and the amount of total value it creates. Corporations that create value in the long term tend to increase the welfare of shareholders and employees as well as improve customer satisfaction; furthermore, they tend to behave more responsibly as corporate entities. Ignoring the importance of value creation not only hurts the company but leads to detrimental results such as market bubbles.

Value creation occurs when a company generates cash flows at rates of return that exceed the cost of capital. Accomplishing this goal usually requires that the company have a competitive advantage. Activities such as leverage and accounting changes do not create value. Frequently, managers shortsightedly emphasize earnings per share (EPS); in fact, a poll of managers found that most managers would reduce discretionary value-creating activities such as research and development (R&D) in order to meet short-term earnings targets. One method to meet earnings targets is to cut costs, which may have short-term benefits but can have long-run detrimental effects.

1. Data from both Europe and the United States found that companies that created the most shareholder value showed _____ employment growth.
2. The _____ in the late 1990s, and the _____ in 2007–08, arose largely because companies and banks focused on _____ over _____.
3. Maximizing current share price is not equivalent to maximizing long-term value because _____.
4. Discretionary expenses that managers can slash in order to pump up short-term profits include _____.

4 QUESTIONS

5. During the internet boom of the late 1990s, many firms lost sight of value creation principles by blindly pursuing _____ without _____.
6. Evidence that companies with a long strategic horizon create better total shareholder returns (TSR) than those run with a short-term mindset include(s):
 - I. Banks that forwent short-term profits during the real estate bubble of the 2000s earned much better TSR over the longer term.
 - II. Companies with a long-term focus tended to generate superior TSR.
 - III. Investments in research and development (R&D) have correlated powerfully with long-term TSR.
 - A. I and II only.
 - B. II and III only.
 - C. I and III only.
 - D. I, II, and III.
7. Paying attention to which of the following tends to lead to a company creating long-term value for shareholders?
 - I. Cash flow.
 - II. Earnings per share.
 - III. Growth.
 - IV. Return on invested capital.
 - A. I and II only.
 - B. II and III only.
 - C. II, III, and IV only.
 - D. I, III, and IV only.
8. A firm that grows rapidly will:
 - A. Always create value.
 - B. Create value if the return on invested capital (ROIC) is greater than the cost of obtaining funds.
 - C. Create value if the ROIC is less than the cost of obtaining funds.
 - D. Create value if the firm increases market share.
9. In order to create long-term value, companies must:
 - A. Focus on keeping costs at a minimum.
 - B. Find the optimal debt-to-equity ratio.
 - C. Seek and exploit new sources of competitive advantage.
 - D. Monitor and follow macroeconomic trends.
10. Focus on short-term results by banks was a contributing factor to the financial crisis of 2007–08.
 - A. True
 - B. False