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Appendix A. Capital Asset Pricing Model (CAPM)

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Preface

Valuation Methods and shareholder value creation is a complete book about business valuation and value creation. The book explains the nuances of different valuation methods and provides the reader with the tools for analyzing and valuing any business, no matter how complex. With 300 pages divided into four parts, *Valuation and shareholder value creation* uses 140 diagrams, 211 tables, and more than 100 examples to help the reader absorb these concepts.

This book contains materials of the MBA and executive courses that I teach in IESE Business School. It also includes some material presented in courses and congresses in Spain, US, Austria, Mexico, Argentina, Peru, Colombia, UK, Italy, France and Germany. The chapters have been modified many times as a consequence of the suggestions of my students since 1988, my work in class, and my work as a consultant specialized in valuation and acquisitions. I want to thank all my students their comments on previous manuscripts and their questions. The book also has results of the research conducted in the International Center for Financial Research at IESE.

Part I – Basics of Valuation Methods and Shareholder Value Creation

The book begins with the definition of Shareholder Value Creation and with a description of the most popular valuation methods, with particular emphasis on Price Earnings Ratio, the relationship between market value and book value, dividends, and the impact of interest rates on valuation. Later chapters take an in-depth look at valuing a company by discounting a stream of potential future income back to the present. It lays out the differences between using net income or cash flow as the relevant stream. It offers various examples of valuations and explains real-life valuations. Chapter 11 tackles the question of which discount rate to use in discounting income streams. It shows the problems that may arise in measuring company betas and the difficulty of obtaining the market risk premium starting from historical data.

Part II – Shareholder Value Creation

The second part describes some of the tools used to measure value creation e.g., economic value-added and economic benefit, analyzing their limitations and applicability in various situations. Chapter 15 contains several valuations of RJR Nabisco and the value creation of each strategy. Chapter 16 analyzes the evolution of a number of Internet-related companies (Terra, Amazon, America Online, Microsoft, B2B companies, online brokers...), although the focus is the valuation of Amazon.

Part III – Rigorous Approaches To Discounted Cash Flow Valuation

The third part examines in greater depth discounted cash flow valuation and starts with the analysis of the eight most commonly used methods for valuing companies by cash flow discounting:

- Free cash flow discounted at the WACC;
- Equity cash flows discounted at the required return to equity;
- Capital cash flows discounted at the WACC before tax;
- APV (Adjusted Present Value);
- The business's risk-adjusted free cash flows discounted at the required return to assets;
- The business's risk-adjusted equity cash flows discounted at the required return to assets;
- Economic profit discounted at the required return to equity; and
- EVA discounted at the WACC.

It is shown how all eight methods always give the same value. This result is logical, since the methods analyze the same reality under the same hypotheses; they only differ in the cash flows taken as starting point for the valuation.

Chapter 18 is a revision of the financial literature about discounted cash flow valuation. We will analyze in greater detail the most important theories about value creation by leverage: Modigliani and Miller, Damodaran, Practitioners method, Harris and Pringle, Ruback, Myers, and Miles and Ezzell. Chapter 20 is the application of the theories studied in previous chapters to RJR Nabisco. Chapter 21 is a summarized compendium of all the methods and theories on company valuation using cash flow discounting presented in the previous chapters.

Part IV – Real options and brands

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The final portion of the book reviews the most important methods to value real options and shows the usefulness and limitations of option pricing theory for company valuation, clarifying the differences between financial options and real options. It also addresses the valuation of brands and intangible assets.

Some issues covered in *Valuation Methods and Shareholder Value Creation*:

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Shareholder value creation of 142 American companies in the period 1993-2000.

Valuation and shareholder value creation of Internet-related companies.

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