

Preface

The Dark Side of Valuation – Second Edition

The first edition of the Dark Side of Valuation is showing its age and its origins. The idea for that book was born at the end of 1999, towards the end of the Dot-com boom and was triggered by two phenomena; the seeming inability of traditional valuation models to explain stratospheric stock prices for technology (especially new technology) companies and the willingness of analysts to abandon traditional valuation metrics and go over to the “dark side” of valuation, where prices were justified using a mix of new metrics and story telling. The publication of the first edition coincided with the bursting of that bubble.

As markets have evolved and changed, the focus has shifted. The bubble and the concurrent rationalization using new paradigms and models has shifted to new groups of stocks (Chinese and Indian equities) and into new classes of assets (sub-prime mortgages). I have come to the realization that the dark side of valuation beckons any time analysts have trouble fitting companies into traditional models and metrics. The second edition of the book will reflect that broader perspective. Rather than focus on just young, high-tech (internet) companies as I did in the first edition, I want to look at companies that are difficult to value across the spectrum.

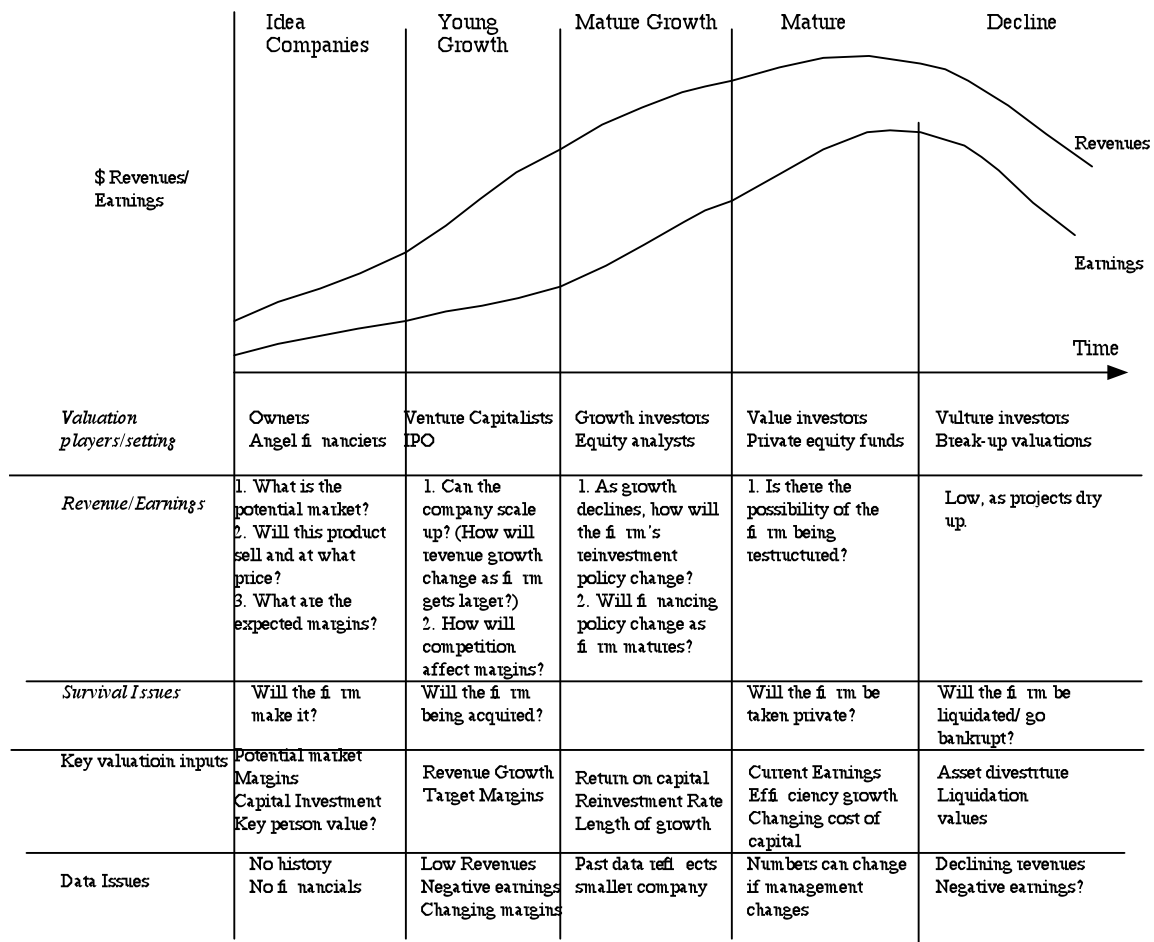
The first part of the book will review the basic tools that you have available in valuation. In particular, it will provide, in compressed format, a summary of conventional discounted cash flow models, probabilistic models (simulations, decision trees etc), relative valuation models and real options. Much of what will be included in this section has already been said in my other books on valuation.

The second part of the book will examine some of the estimation questions and issues surrounding macro inputs that affect all inputs. The first chapter in this section looks at the riskfree rate, the building block for all other inputs, and challenges the notion that government bond rates are always good estimates of riskfree rates. The second chapter expands the discussion to look at equity risk premiums, another number that is often taken as a given in valuation, primarily because risk premiums in mature markets have been stable for long periods. In shifting and volatile markets, risk premiums can change significantly over short periods and failing to recognize this reality will create

skewed valuations. The third chapter examines other macro economic assumptions that are often implicit in valuations about growth in the real economy, exchange rates and inflation and how inconsistencies in these valuations affect the conclusions that we draw.

The third part of the book will look at valuation challenges across a firm's life cycle. In pictorial format, these are the challenges:

A Life Cycle View of Valuation



The first chapter in this section will review the valuation challenges faced in valuing young and “idea” businesses, where there an interesting idea for a product or service but no tangible commercial product yet. It will also consider the baby steps involved as the idea evolves into a commercial product, albeit with very limited revenues and evidence of market success. In effect, this chapter is designed to look at the challenges faced in the very first stages of entrepreneurial valuation. It is the challenge that venture capitalists have faced for decades when providing “angel financing” to small companies. The second chapter will climb the life cycle ladder to look at young growth companies, whose

products and services have found a market and where revenues are growing fast. This chapter will also examine the valuation implications of going public as opposed to staying private and the sustainability of growth. The second chapter will look at the growth companies that have survived the venture capital cycle and gone public. These companies have a well-established track record of growth, but the size of the company is working against it. The third chapter will look at “mature companies”, where growth is in the past, and the efforts that they go to increase value including acquisitions, operating restructuring and financial restructuring. In the process, we will also consider how a private equity investor may view value in a “mature” company in the context of a leveraged buyout and the value of control in this company. In the closing chapter in this section, we will consider firms in decline, where growth can be negative, and the potential for distress and bankruptcy may be substantial.

The final part of the book will look at specific types of firms that have proved difficult to value for a variety of reasons. We will begin by looking at two broad classes of firms – commodity companies (oil, gold etc) and cyclical companies – where volatile earnings driven by external factors (commodity prices, state of the economy) have made projections difficult to do. The special challenges associated with financial service firms – banks, insurance companies and investment banks – are examined in the subsequent chapter, with an emphasis on how regulatory changes can affect value. We will follow up by looking at companies that are heavily dependent on intangible assets: patents, technological prowess and human capital. The nature of the assets in these firms combined with flaws in the accounting standards that cover them make them challenging from a valuation perspective. The next chapter looks at companies that operate in volatile and young economies (emerging markets) and how best to estimate value. The final chapter looks at companies in multiple businesses that operate in many countries and how best to deal with the interactions between the different pieces within these companies.

In summary, I hope to make the second edition of the Dark Side of Valuation a broader book directed at dark practices and flawed methods in valuation across the spectrum and not just in young technology companies. Hopefully, the potential audience will be larger as a consequence.

Chapter Outline

Chapter *Topic*

1 The Dark Side of Valuation

Enlightenment: The Tools

2 Intrinsic Valuation

3 Probabilistic Valuation: Scenario Analysis, Decision Trees & Simulations

4 Relative Valuation

5 Option Valuation

The Dark Side of Macro Inputs

6 A Shaky Base: A Risky Risk free Rate

7 Risky Ventures: Assessing the Price of Risk

8 Macro Matters: The Real Economy

The Dark Side across the Life Cycle

9 Baby Steps - Valuing young and start-up companies

10 Shooting Stars - Valuing growth companies

11 Not so staid - Valuing mature companies

12 The inevitable end - Valuing companies in distress and decline

The Dark Side across company types

13 Ups and Down: Valuing Cyclical and Commodity companies

14 Mark to Market: Valuing Financial Service companies

15 Invisible Investments: Valuing firms with intangible assets

16 Volatility Rules: Valuing Emerging Market companies

17 The Octopus: Valuing Multi-business, global companies

The Finale

18 Lighting the Way: Vanquishing the Dark Side