

Value

The Four Cornerstones of Corporate Finance

Tim Koller, Richard Dobbs, and Bill Huyett. Wiley, 2010.

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Book Overview

Value is McKinsey's short, nontechnical companion to Valuation, the firm's long-running corporate finance textbook. It is written for CEOs, board members, and line executives rather than finance specialists. The authors argue that the principles of value creation are simple but are routinely forgotten in boom times, and that the financial crisis that began in 2007 was the latest result.

The book is built on four principles the authors call cornerstones. The core of value holds that companies create value by growing and earning a return on capital above their cost of capital. The conservation of value holds that anything that does not increase cash flows does not create value. The expectations treadmill holds that share price movements reflect changes in expectations, not just performance. The best owner principle holds that a business has no inherent value, only a value to a particular owner.

Part One explains the four cornerstones. Part Two applies them to the stock market, covering who sets prices, how markets relate to the real economy, bubbles, and earnings management. Part Three applies them to management decisions, including return on capital, growth, the business portfolio, acquisitions, risk, capital structure, investor communications, and managing for value. Two appendices cover the math of value and the use of earnings multiples.

A company creates value only by investing capital at returns above its cost and growing those investments, so every major decision, from acquisitions to buybacks to pay, should be tested against its effect on long-term cash flow rather than on earnings or the share price.

Chapter Summaries

Chapter 1: Why Value Value?

The opening chapter introduces the four cornerstones and argues that forgetting them has caused repeated waves of value destruction.

- The authors argue that value is the right measure of corporate performance because it captures the long-term cash flows that serve investors, employees, and customers.
- In their related McKinsey excerpt, the authors use mortgage securitization as an example of what happens when the cornerstones are ignored. Securitization did not increase the cash flows of home loans, so it created no value. It only passed the risk to other owners.
- The challenge for executives is resisting the pressure of financial engineering, excessive leverage, and the boom-time belief that the rules of economics no longer apply.

Chapter 2: The Core of Value

The first cornerstone relates growth, return on invested capital, and cash flow. It is the central idea of the book.

- Value comes from future cash flows. Cash flow depends on how fast a company grows and how much return it earns on the capital it invests to grow.
- Growth creates value only when return on invested capital exceeds the cost of capital. When it does not, faster growth destroys value.
- The managerial implication is that growth and return must be considered together. The right trade-off depends on where the company's return on capital stands today.

Chapter 3: The Conservation of Value

The second cornerstone says that how the financial pie is sliced does not change its size. Only better cash flows create value.

- Share repurchases, changes in capital structure, and accounting choices change who owns the cash flows or how they are reported. They do not change the cash flows themselves.

- Acquisitions create value only when the combined cash flows exceed what the two companies would have produced apart.
- The authors use the principle as a reality check on any proposal that claims to create value without changing operations.

Chapter 4: The Expectations Treadmill

The third cornerstone explains why total returns to shareholders can diverge from a company's actual performance.

- Share prices reflect the market's expectations of future performance. Shareholder returns come from performance against those expectations, not from performance alone.
- A company that beats low expectations earns high returns and raises expectations for new shareholders. It must then improve ever faster to keep up, like a runner on a treadmill that keeps getting faster.
- Extraordinary managers can therefore deliver only ordinary shareholder returns, and ordinary managers can deliver strong returns for a time.

Chapter 5: The Best Owner

The fourth cornerstone holds that a business is worth different amounts to different owners, depending on how they would run it.

- Owners add value through unique links with other businesses, distinctive skills, better governance, better insight into the market, or relationships with key stakeholders.
- The best owner changes over the life cycle of a business. The company that invented something may not be the one best able to scale it, and a long-time owner in a mature industry may no longer be the best owner.
- The implication is that executives should regularly ask whether they are still the best owner of each business they hold.

Chapter 6: Who Is the Stock Market?

Part Two opens by challenging the conventional view of the stock market as a mass of short-term investors.

- The authors divide investors into groups by strategy, including intrinsic investors who study fundamentals, traders who seek short-term gains, and mechanical investors such as index funds.
- They argue that intrinsic investors, though a minority, drive valuation levels over time. Communications and strategy should be aimed at them.

Chapter 7: The Stock Market and the Real Economy

The chapter shows that over long periods the stock market tracks the real economy, through returns on capital, growth, interest rates, and inflation.

- Using a century of shareholder returns and a review of market eras from 1960 to 2009, the authors argue that market valuation levels can be explained by economic fundamentals.
- Short-term swings are harder to explain, but the authors argue that fundamentals reassert themselves over time.

Chapter 8: Stock Market Bubbles

Bubbles happen, but the authors argue that marketwide bubbles are rarer than commonly believed.

- Bubbles arise when prices detach from fundamentals, often when investors and executives convince themselves that the rules of value creation no longer apply.
- Sector and company bubbles are more common than marketwide ones. Financial crises tend to start in credit markets, where excessive leverage and illiquid assets combine.
- The authors argue that bubbles strengthen the case for managing for long-term value, because prices eventually return to fundamentals.

Chapter 9: Earnings Management

The chapter argues that much of the effort companies spend managing earnings is wasted.

- Meeting or missing consensus estimates by small amounts matters less than executives believe. Investors look past the headline number to the drivers of long-term cash flow.

- Some earnings volatility is inevitable. Trying to smooth it can lead to decisions that destroy value.
- Accounting treatment that changes reported earnings without changing cash flow does not change underlying value.

Chapter 10: Return on Capital

Part Three applies the cornerstones to management decisions, starting with what drives return on capital.

- Return on capital is driven by industry structure and by competitive advantage, which shows up either as a price premium or as a cost and capital efficiency advantage.
- The authors examine how sustainable returns are, how they have trended across industries, and why return on capital remains relevant in an economy shaped by intangible assets.

Chapter 11: Growth

Different kinds of growth create very different amounts of value. The chapter ranks them and shows how hard growth is to sustain.

- Growth that comes from creating or expanding markets with new products generally creates more value than growth from taking share in mature markets, where competitors respond.
- High growth rates tend to decay quickly as markets mature. Sustaining growth requires a continual search for new markets.
- Acquisitions add revenue, but whether they add value depends on the price paid relative to the improvements achieved.

Chapter 12: The Business Portfolio

The chapter applies the best owner principle to which businesses a company should own.

- Owning a business makes sense only when the parent adds value to it. The authors call this corporate value added.

- In their excerpt, the authors cite research showing that the market consistently reacts positively to divestiture announcements. They also report that spun-off businesses tend to raise profit margins by one-third in the three years after separation.
- Diversification on its own does not create value. Size matters to capital markets only for very small firms, with some evidence that companies under \$500 million in market value face slightly higher costs of capital.

Chapter 13: Mergers and Acquisitions

The chapter explains how to measure value creation from acquisitions and which acquisition strategies tend to work.

- In the authors' worked example, Company A pays \$1.3 billion for Company B, a 30 percent premium. It expects improvements that make B worth \$1.4 billion to A, creating \$100 million of value for A's shareholders. An acquirer creates value only when the improvements exceed the premium.
- The authors report that most empirical research shows only about half of acquirers create value for their own shareholders. Most of the value goes to the sellers.
- Value-creating archetypes include improving the target's performance, removing excess capacity, accelerating market access for products, and acquiring skills or technology faster than building them.
- The authors find no empirical link between expected earnings-per-share accretion or dilution and whether a deal creates value.

Chapter 14: Risk

Risk affects companies and investors differently, because investors can diversify and companies often cannot.

- Companies should retain some risks that are part of their business. Financial markets are of limited help in reducing underlying economic risk.
- In the authors' excerpt, a utility weighs a \$15 billion nuclear plant with an 80 percent chance of success and an expected value of \$7.4 billion. Because failure would wipe out the company's equity, the authors argue it should not proceed. Their rule is not to take a risk that endangers the rest of the company.

- The chapter closes on building a risk culture in which managers can discuss failure, not only degrees of success.

Chapter 15: Capital Structure

The chapter covers the mix of debt and equity, financial engineering, and returning cash to shareholders.

- Capital structure should support the company's strategy and avoid financial distress. It is rarely a major source of value on its own.
- Complex financial structures and financial engineering usually shift value or risk rather than create it.
- Dividends and share repurchases return cash to shareholders. They create value only when the company has no better use for the cash.

Chapter 16: Investor Communications

The chapter explains how a public company should communicate with investors, and with which ones.

- The goal is to close any gap between the company's intrinsic value and its market value, not to push the share price above intrinsic value.
- Communications should be aimed at intrinsic investors. The authors are skeptical of precise earnings guidance and recommend listening to investors as well as talking to them.

Chapter 17: Managing for Value

The closing chapter covers the management systems that make value creation routine.

- Organizing for value means measuring performance on the drivers of long-term value, including health metrics, not only on short-term earnings.
- In their excerpt, the authors argue that compensation should reward growth, return on capital, and total shareholder returns relative to peers rather than against an absolute target.
- Strategic planning should be separated from budgeting so long-term choices are not crowded out by next year's numbers. Boards need the information and time to test

management's choices.

About the Authors

Tim Koller, Richard Dobbs, and Bill Huyett were senior McKinsey and Company consultants in corporate finance and strategy when the book was published. Koller, then a principal in the New York office and head of the firm's Corporate Performance Center, is a longtime coauthor of *Valuation: Measuring and Managing the Value of Companies*. Dobbs was a director in the Seoul office and a director of the McKinsey Global Institute. Huyett was a director in the Boston office.

Their authority comes from McKinsey's corporate finance practice and research base, which the book draws on throughout. That base is built mostly on large public companies. Applying the principles to private and owner-managed businesses requires some translation.

Key Takeaways

1) Value comes from growth at returns above the cost of capital.

The core of value is the book's foundation. Cash flow depends on growth and return on invested capital. Growth creates value only when returns exceed the cost of capital. Below that line, faster growth destroys value.

- Growth and return must be judged together.
- Return on capital is driven by industry structure and competitive advantage.
- Companies sustain high growth and high returns only with a real competitive advantage.

2) Rearranging claims on cash flow does not create value.

The conservation of value rules out most financial engineering. Repurchases, leverage, accounting changes, and securitization change who owns the cash flows or how they look, not how large they are. The authors use it as a test for any proposal that promises value without operational change.

- Securitization passed mortgage risk around without reducing it.

- Leverage increases risk to equity without increasing cash flow.
- Accounting choices change reported earnings, not underlying value.

3) Share price returns measure performance against expectations.

The expectations treadmill explains why shareholder returns can diverge sharply from company performance. Beating low expectations raises them, so a strong company must keep accelerating to keep up. This makes total shareholder returns a poor measure of management performance over short periods.

- Extraordinary managers can deliver ordinary returns.
- Compensation should compare returns with peers, not absolute targets.
- Intrinsic investors drive valuation levels over time.

4) A business is worth what it is worth to a particular owner.

The best owner principle says value depends on who runs the business and how. Unique links, distinctive skills, better governance, and better insight make one owner worth more than another, and the best owner changes over the life of a business.

- Divestitures tend to be received well by markets.
- Diversification does not create value on its own.
- Executives should regularly ask whether they are still the best owner.

5) Most acquisitions create value for sellers, not buyers.

An acquirer creates value only when the improvements it delivers exceed the premium it pays. The authors report that only about half of acquirers create value for their own shareholders, and they find no empirical link between expected earnings-per-share accretion and value creation.

- Improvement must exceed the premium paid.
- Proven archetypes include improving performance and removing excess capacity.
- Earnings-per-share effects tell nothing about value.

6) Never take a risk that endangers the whole company.

Finance theory says to accept any project with positive expected value. The authors add a caveat. If the downside would endanger the rest of the company's cash flows, the project should be rejected regardless of its expected value. Investors can diversify, but the company cannot.

- Sophisticated models can hide downside risk.
- Some business risks should be kept rather than hedged.
- A healthy risk culture allows discussion of failure.

7) Managing for value is a system, not a slogan.

The final chapters argue that value creation depends on performance measures, compensation, planning, and board oversight aligned with long-term cash flows. Earnings management and precise guidance waste effort. Measuring value drivers and organizational health is what keeps decisions on track.

- Separate strategic planning from budgeting.
- Measure health metrics alongside short-term results.
- Communicate with the investors who study fundamentals.

Strengths And Limits

The book's strength is that it compresses McKinsey's corporate finance framework into a few principles a nonfinancial executive can apply. The four cornerstones give a consistent test for acquisitions, divestitures, buybacks, project risk, and compensation, and the authors back them with large-sample research. The acquisition and divestiture findings in the authors' own excerpt are directly usable in deal discussions. The Growth chapter's question of when to favor growth over returns is developed in a related McKinsey article by Bin Jiang and Tim Koller. They found that for companies with high returns on capital, faster growth produced higher shareholder returns than further return improvements. For companies with low returns, improving returns mattered more than growth.

The limits come from the audience. The research base is large public companies, and much of Part Two, on the stock market, earnings guidance, and investor communications, has little direct use for a private company. The book assumes that maximizing long-term shareholder value is the right objective, a premise Roger Martin and others contest. Return on invested capital is harder to measure in businesses whose main investments, such as software, brand, and people, are expensed rather than capitalized. The predictable failure is treating the cornerstones as abstract truths and continuing to judge deals and pay on earnings, because the book offers principles more than operating mechanisms.

Bruce's Take

The diagnosis holds, and it matters more for growth companies than the public company framing suggests. Founder-CEOs in the five-to-fifty-million range regularly chase revenue at returns that do not cover their cost of capital, buy companies on the strength of a revenue multiple, and assume bigger is automatically worth more. The core of value and the conservation of value are the two ideas I most want a founder to absorb before a growth plan or an acquisition.

The four cornerstones play differently in a private company. The core of value and the best owner principle apply directly. The best owner principle in particular is the clearest way to understand why a strategic buyer can pay more than a financial one and why the founder may not be the best owner at a certain stage. The expectations treadmill applies mostly after private equity investment, when a sponsor's return target becomes the expectation the company has to beat. Part Two on the stock market can be skimmed by most private company leaders.

The most credible outside objection comes from Roger Martin in *Fixing the Game*. Martin argues that tying executives to shareholder value pulls them into what he calls the expectations market, the market for shares, and away from the real market of customers and products. The authors would answer that they argue for intrinsic value, not share price, and for compensation relative to peers. I think Martin is right that the language of shareholder value gets used to justify short-term moves, even when the book itself argues against them. For a private company the fix is simple. Measure value on cash flow and returns, not on the latest multiple a banker quotes.

What the book leaves incomplete is practice. It explains what creates value but says little about how a CEO actually allocates capital year after year. William Thorndike's *The Outsiders* fills that gap with eight CEOs who applied the same principles, often against convention, through buybacks, disciplined acquisitions, and decentralized operations.

Discussion Questions

For CEOs

- What is our return on invested capital, and how does it compare with our cost of capital?
- Given that return, should our next dollar go to growth or to improving returns?
- Which of our growth initiatives would destroy value if they hit their revenue targets at current margins?
- Are we the best owner of every business line we have, and which ones would be worth more to someone else?
- For our last acquisition, did the improvements we achieved exceed the premium we paid?
- Which proposed projects have a downside that could endanger the rest of the company?
- Does our leadership compensation reward value creation, or revenue and earnings alone?
- Who would be the best owner of this company at exit, and what would make us more valuable to them?

For Teams

- How much capital does our part of the business tie up, and what return does it earn?
- Which of our products or customers earn returns above our cost of capital, and which do not?
- What source of competitive advantage, price premium or cost advantage, drives our returns?

- Where are we pursuing growth that comes mainly from taking share in a mature market?
- Which proposals we have made recently promised value without changing operations or cash flow?
- What business risks should we keep rather than try to hedge or avoid?
- Where do we spend effort smoothing or managing reported numbers rather than improving cash flow?
- What health metrics would warn us that next year's results are at risk?

Practical Tools

1. Growth Versus Return Map

The core of value says growth creates value only above the cost of capital, and the right trade-off depends on current returns. Mapping each business line by return and growth shows where to push growth and where to fix returns first. Run it before the annual strategic plan and before any major growth investment.

How it works:

- Calculate return on invested capital for each business line, product group, or service line.
- Estimate the company's cost of capital, using a conservative rate if there is no market benchmark.
- Plot each line by return and growth rate against the cost of capital.
- For lines above the cost of capital, identify how to grow without eroding returns. For lines below it, identify how to raise returns before investing in growth.
- Reallocate capital and leadership attention to match.

Leaders stop funding growth that destroys value. Investment shifts toward the lines where growth creates value.

2. Conservation of Value Test

The second cornerstone says only better cash flows create value. Applying it to every proposal that claims to create value catches financial engineering before it consumes time or money. Use it on recapitalizations, distributions, pricing schemes, accounting changes, and deal structures.

How it works:

- State in one sentence how the proposal is supposed to create value.
- Identify exactly which future cash flows would increase, and by how much.
- Check whether the proposal only shifts risk or ownership of existing cash flows.
- If no cash flow increases, reclassify it as a financing or reporting decision and judge it on those terms.
- Record the result so the reasoning is available for future proposals.

The leadership team can tell real value creation from rearrangement. Proposals that only move risk or claims get discussed as what they are.

3. Acquisition Premium Check

The authors show that an acquirer creates value only when improvements exceed the premium paid, and that earnings-per-share effects tell nothing about value. This check applies that logic to any acquisition before a letter of intent. Use it for every acquisition and for each bolt-on in a roll-up strategy.

How it works:

- Estimate the target's stand-alone value based on its own cash flows.
- Calculate the premium implied by the proposed price.
- Estimate the value of specific, realistic improvements and synergies, with a timeline and an owner for each.
- Subtract integration costs and the price from the stand-alone value plus improvements.
- Proceed only if the remaining value is positive under a conservative improvement case.

Deals are approved on cash flow and improvement plans, not on revenue or earnings accretion. The team walks away from targets where the premium exceeds what it can deliver.

4. Best Owner Review

The best owner principle says a business has no inherent value, only a value to a particular owner, and that the best owner changes over time. Asking the question regularly keeps a portfolio honest and prepares the founder for exit. Run it annually for each business line and before starting a sale process.

How it works:

- List each business line and the specific ways the company adds value to it.
- Identify potential owners who could add more, through links, skills, governance, or insight.
- Estimate what each business line would be worth to those owners.
- Decide for each line whether to keep, fix, or prepare it for sale.
- For the company as a whole, identify which buyers would be the best owners and what would make the company more valuable to them.

Business lines that would be worth more to someone else get an exit plan. The founder sees which buyer types the company should be built for.

5. Downside Risk Screen

The authors argue that a company should not take a risk that endangers the rest of its cash flows, whatever the expected value. This screen adds that test to project review. Apply it to large capital projects, major hires, new markets, and long-term contracts.

How it works:

- Describe the realistic downside case for the proposal, not only the base case.
- Estimate the cash loss in the downside case, including effects on lenders and customers.
- Compare that loss with the company's cash, credit capacity, and covenants.

- Reject or restructure any proposal whose downside would put the company at risk.
- For proposals that pass, accept the possibility of loss in exchange for the potential gain.

Large bets are sized so that failure would hurt but not sink the company. Teams discuss downside cases openly rather than presenting only degrees of success.

6. Value Driver Scorecard

The closing chapter calls for measuring the drivers of long-term value and organizational health, not only short-term earnings. A scorecard built on growth, return on capital, and health metrics keeps reviews focused on value. Build it once return on capital by business line is known, and review it quarterly.

How it works:

- Break return on invested capital into margin and capital turnover for each business line.
- Add revenue growth and the main operating drivers behind margin and turnover.
- Add health metrics that predict future performance, such as customer retention, pipeline, and talent.
- Set targets relative to peers or prior periods rather than absolute figures alone.
- Use the scorecard in quarterly reviews and in setting leadership incentives.

Reviews and incentives reward the drivers of value, not only revenue and earnings. Leaders spot health problems before they reach the income statement.

Further Research

- The authors' own excerpt, The CEO's Guide to Corporate Finance, applying the four cornerstones to acquisitions, divestitures, risk, and compensation. ([link](#))
- Bin Jiang and Tim Koller on how to choose between growth and return on invested capital. ([link](#))

- McKinsey's Why Value Value?, on how forgetting the principles of value creation leads to crises. ([link](#))
- Tim Koller's interactive tutorial on the four cornerstones. ([link](#))
- Roger Martin on Fixing the Game, the leading critique of managing to shareholder value. ([link](#))

Related Books

- **Valuation, Seventh Edition**, Tim Koller, Marc Goedhart, and David Wessels. The full McKinsey textbook behind Value, with the methods for measuring return on capital and valuing a company.
 - **The Outsiders**, William N. Thorndike. Eight CEOs who put the cornerstones into practice through disciplined capital allocation.
 - **Fixing the Game**, Roger L. Martin. The strongest argument that managing to shareholder value distorts executive behavior.
 - **Financial Intelligence for Entrepreneurs**, Karen Berman and Joe Knight. The statement literacy needed to calculate return on capital and judge investments.
 - **Capital Returns**, Edward Chancellor. Marathon Asset Management's capital cycle approach, showing how industry supply decisions shape returns on capital.
 - **The Essays of Warren Buffett**, Warren E. Buffett, edited by Lawrence A. Cunningham. Buffett's letters on intrinsic value, owner earnings, acquisitions, and buybacks.
 - **Playing to Win**, A. G. Lafley and Roger L. Martin. The strategy choices that create the competitive advantage behind high returns on capital.
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These summaries present Bruce Eckfeldt's analysis of business and leadership books for founder-CEOs and leadership-team members of growth companies. Each one identifies the ideas most relevant to decision quality, strategy, and leadership capacity, notes where the evidence is weak, and suggests practical ways to test what is worth testing. All ideas, stories, and quotations belong to the original author and to the people they cite. The assessments and recommendations are Bruce's. It is a companion to the book, not a substitute for reading it.

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