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and communicating value

Valuation Matters

A regular newsletter from
Value Adviser Associates

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Valuation Matters

Welcome to Value Adviser Associates' inaugural newsletter designed to canvas a range of issues dealing with business valuations.

In this edition the articles cover:

- » Expanding the budget process to enable a sum-of-the-parts portfolio analysis and valuation;
- » A proposed regulatory decision on the cost of capital which has already had a substantive impact on business values;
- » The overarching approach to valuing non, or thinly traded, assets in a time of economic uncertainty – an issue currently facing alternative fund managers.

We hope you find the articles informative. If you would like to discuss any issues covered in Valuation Matters, please contact our office.

Expanding the budget process to enable portfolio analysis and valuation

The current economic climate has witnessed fundamental changes to expectations of economic activity, both globally and within Australia. Business models and projections which were previously robust, may now be redundant with a greater probability of demand downturn, commodity price decreases and exchange rate movements.

As a result we anticipate that Boards and Executives will reconsider the primary strategic focus and longer term performance of business units or segments, which will ultimately lead to a complete review of company strategy across the business portfolio.

This review can be a natural extension of the budget process. For many organisations, preparation of the 2009/10 budget is about to commence. It is sensible for organisations, particularly those with multiple business units, to expand the budget process into portfolio analysis and provide a platform for developing and evaluating alternative strategic options. These require an outlook beyond the budget.

There are five key steps to move to a portfolio review:

- 1. Expand business unit budgeting models** to accept a further four to five years of forecast data. Many Enterprise reporting packages will have a facility to permit forecasting beyond one year. Alternatively, financial models in spreadsheet-based software such as Excel, can be used to download budget data and incorporate this into the first year of a five year forecast.
- 2. Carry out a strategic review of the business units** to determine future industry trends and performance. Generally the budget process incorporates a high level review of the industry and competitors in order to validate the growth assumptions. Establishing longer term assumptions to drive the five year forecasts, requires careful analysis of the industry dynamics, addressing such matters as;
 - » trends in the key drivers of segment attractiveness including the position of the industry in its lifecycle;
 - » analysis of the business relative to its competitors; and
 - » statutory, legal, and capital market constraints.

3. **Develop long term assumptions:** Use the results of the strategic review, along with historical trends, to determine the key assumptions and possible scenarios which will underpin the five year forecasts for the current business strategy. These assumptions will include price and volume growth rates, raw material cost increases, capital expenditure needs and working capital requirements.
4. **Construct the "base case" projections** and valuation of the business unit. The long term financial view is established by applying the long term assumptions to current or budget data. The long term view should comprise income statements, balance sheets and cash flow projections. The business unit value is then established by applying an appropriate discount rate to the forecast cash flows. Sensitivity analysis can guide the areas where further supporting evidence may be required to 'sure-up' the projections.
5. **Consolidate business unit projections** to a total portfolio view. A total company view of projections and value can be obtained by consolidation of the various financial statements and valuations. This will provide a base for analysing and comparing expected business unit performance to demonstrate;
 - » relative business unit contribution to EBITDA, EBIT, NPAT and economic profit;
 - » returns on assets over the long term profile of the businesses;
 - » cash generation and debt needs over the long term; and
 - » relative contribution of the businesses to the overall value of the enterprise.

Most importantly, this approach provides a basis for assessing alternative strategies and encouraging a focus on business value throughout the organisation.

Ongoing portfolio analysis

Unlike the "single use" budget model, the portfolio analysis model will have a variety of uses for the Executive team and the Board on an ongoing basis. These include;

- » strategic analysis of business units to substantiate growth or divestment decisions;
- » a basis for intangible asset and goodwill impairment testing as required by A-IFRS each reporting period;
- » scenario testing for alternative strategy and capital expenditure options for business units;
- » assessment of future acquisitions including possible synergy outcomes; and
- » consolidated capital structure requirements, including debt and equity needs.

In our experience, this approach stimulates a long term view of the business and promotes the idea that the budget is really the first year of the longer term plan i.e. the plan precedes the budget.

The role of Value Adviser Associates

Our expertise and experience can be applied throughout the portfolio analysis and valuation process. We are highly experienced in project managing the entire process, or can assist the Executive team complete the analysis. From our experience, we can add significant value by being involved in:

- » the development of financial models and assisting management in their completion;
- » conducting strategy reviews of the business units or guiding the strategy development process;
- » testing the reasonableness of assumptions; and
- » communicating the findings to senior management and Boards. 🚩

Regulatory cost of capital decreased? What is the impact on valuation benchmarks?

The revenue of regulated electricity transmission and distribution businesses will fall, relative to prior regulatory determinations, if the proposed decision on the weighted average cost of capital ("WACC") becomes the final decision in the forthcoming months. This decision not only affects the immediate players involved, but could also impact on valuation benchmarks across all industries.

The Australian Energy Regulator ("AER") is currently conducting a review of the WACC parameters as input to the pricing determinations for Electricity Transmission and Distribution services. If the proposal becomes final then the decision will lead to a fall in the WACC by 96 basis points on a comparative basis – a substantive change.

Value Adviser Associates is delighted to have contributed to the review with several expert papers being submitted by Professor Bob Officer and Dr Steve Bishop.

The effect on the value of regulated businesses

The WACC is an essential input into the revenue of regulated businesses so the decrease in relative WACC means a decrease in expected revenue.

Interestingly the share prices of SP-AusNet Ltd and Spark Infrastructure Ltd, two firms affected by the decision, fell by 15% and 11.5% respectively around the release of the proposed decision (or 11.5% and 8.1% after adjusting for market movements).

The proposed revised WACC

The proposed decision is summarised below along with the previously adopted decision for the Transmission business and three of the State Distribution businesses.

Parameter	Previously Adopted	Proposed
Gearing	60%	60%
Nominal Risk Free Rate	10 year Commonwealth Government Securities ("CGS")	5 year CGS
Market Risk Premium ("MRP")	6.0%	6.0%
Equity beta	1.0	0.8
Credit rating	BBB+	A-
Gamma	0.5	0.65
Nominal 'vanilla' WACC	9.56%	8.60%

The most significant proposed changes are:

- » The change in the term of the risk free rate from 10 years to 5 years, without any corresponding change in the Market Risk Premium. The average difference in the risk free rate across these maturities is 20 basis points with the 5 year rate being lower;
- » The increase in gamma (which reflects the value ascribed to imputation tax credits). This is a significant change and if applied to valuing businesses in general would lead to a considerable uplift in DCF values. This is an area that many valuers 'ignore' in formal valuations;
- » The change in the debt spread (arising from a change in credit rating) which lowers the implied cost of debt; and
- » The reduction in the beta of equity.

There is a 'mountain' of research and argument debating the appropriate parameters to use. It is of extremely high quality and would be of great interest for keen students or advocates in the area – although daunting for the uninitiated! The papers can be found at: <http://www.aer.gov.au/content/index.phtml/itemId/722190>.


Our comments on the proposed WACC

Value Adviser Associates does not support the use of a 5 year risk free rate for valuing businesses with long term assets. Further, we argued that when the value of imputation tax credits is included in the measurement of the market return, the long term market risk premium is better treated as 7% than 6% (given an integer is to be used) particularly if imputation tax credits are valued at 65 cents in the dollar.

What is the link to valuations of other businesses?

It appears that many Valuation Practitioners look to these decisions, and the vast array of research presented at these hearings, for guidance on WACC parameter to apply to valuations of non related businesses. Further there are potential flow-on effects of the decision to other regulated business so the decision has high interest to all industry sectors.

If the changes represent a decrease in the cost of capital for your business then they would imply an uplift in DCF value relative to prior valuations. The changes would also mean a lower hurdle rate for investment projects. A lower cost of capital means a higher value (except for regulated businesses where the cost of capital determines revenue so a lower cost of capital means lower revenue).

Value Adviser Associates welcomes comments on the topic of cost of capital and naturally we would be delighted to talk about the research and the implications for your enterprise's cost of capital. 

Valuing non, or thinly traded assets in a time of economic uncertainty

Managers of investment and superannuation funds have a need to provide members with quarterly results and returns. One of the challenges facing fund managers at present is the value to ascribe to "tradeable" assets, when the market is illiquid and to non traded assets when the use of surrogate market data to determine value is at best unreliable and at worst misleading.

Valuing tradeable assets

Despite the global financial crisis, the general rule of "marking-to-market" tradeable assets remains, even if there is no material volume of buyers or sellers at the quoted prices. However with a number of investors selling assets because of debt rollover problems it is possible that transactions reflect a "fire-sale" scenario rather than a "well informed willing-buyer willing-seller" or "hold to maturity" situation.

Valuing non traded assets

For non traded assets, such as investments in infrastructure projects, the task of valuing has been complicated by comparatives, such as P/E multiples of like-for-like traded companies, being severely decreased. It has been further complicated by challenges in determining an appropriate WACC to apply to forecast cash flows as noted below.

A return to "going concern" valuations

In recognition of these issues, there have been moves by US accounting and regulatory bodies to allow entities to move away from traditional "marked to market" criteria and adopt a process of value determination by the entities themselves. This places the onus of value determination back on the entities but enables a long term "well informed willing buyer and willing seller notion" to be applied.

Valuation guidelines generally promote a going concern value and it is, in our view, reasonable to argue that most fund managers will not be willing sellers at "fire sale" prices. From initial discussions, our understanding is that this is also a view held by APRA. Clearly the fund managers would be keen to know both a "fire sale" price and the longer term view (i.e. under more 'normal' capital market conditions), however the primary driver of reported values should be a "going concern" value.

A discounted cash flow valuation is common to determine a "going concern" valuation, especially when valuing unlisted direct investments. In particular, the current state of the debt markets has created some interesting challenges for estimating the cost of capital. We raise the issues here and would be delighted to talk through both the issues and solutions with you.

Determination of WACC to apply to cash flows

Interestingly with the risk free rate falling and with no change in projected cash flows, a DCF valuation for these assets would rise. This appears to contradict intuition given the state of the capital market.

Further, if the long term view of MRP of 6–7% is used in the CAPM to obtain a cost of equity for low beta assets, it is possible to obtain a cost of equity lower than the cost of debt derived from current debt spreads. Mechanically applied, it certainly will narrow the spread between the cost of debt and cost of equity as traditionally estimated. Clearly a cost of debt greater than the cost of equity is nonsensical and should place a red-alert on such a mechanical application of the cost of capital.

Hence there are challenges in arriving at sensible cost of capital estimates when using DCF valuations to derive a "hold-to-maturity" or "willing buyer, willing seller" valuation.

Sensible approaches are available to resolve these apparent anomalies. 

Value Adviser Associates update

Value Adviser Associates is pleased to report a rapidly growing client base and a continuation of support from our existing clients. We interpret this as an appreciation of our independent viewpoint and our depth of experience and expertise. As the "Trusted Value Adviser" to our clients, we have undertaken engagements dealing with a wide variety of issues across several sectors including valuations and advice in the FMCG, agriculture and utilities sectors, infrastructure valuations for fund managers and due diligence reviews for SMEs.

Value Adviser Associates' website has recently been refreshed and we are working on growing our library of relevant valuations material.

Your "Trusted Value Adviser"

Value Adviser Associates' message to our clients remains simple and robust. As a "Trusted Value Adviser" we seek to provide quality, independent valuation related advice in the areas of:

- » managing for value creation (i.e. inculcating an explicit focus on value in the organisation);
- » compliance needs relating to A-IFRS and Federal and State tax support; and
- » transaction support from commercial due diligence through to synergy assessment and IERs.

Australia Day card

Value Adviser Associates continued its initiative of sending **Australia Day cards** to many clients and contacts. The feedback on this novelty has been very positive and this is planned to be a long running series.

This year's original theme was developed by the staff and contrasted the plight of Australia's cricket team over the summer with the effects the global financial crisis is having on the Australian economy. The card's message of "Battered and bruised...but facing the challenge" appears applicable to the Australian team's success in the test series recently held in South Africa and the continued improvement in the ASX All Ordinaries index. 



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