

Valuation Matters
A regular newsletter
from
Value Adviser
Associates
December 2010

Valuation Matters

Welcome to the December 2010 edition of *Valuation Matters*.

Another year has ticked by; there are many headlines that have captivated us over the past 12 months – mining disasters, change in governments, fleeting parity with the US dollar, sporting grand finals that were won, lost, drawn and played again!

This year has been another great year for Value Adviser Associates, demand for valuation and value-related services has continued to grow.

In this edition

- » Does your incentive compensation system add value?
- » The state of the global capital markets
- » Value Adviser Associates Unlisted Infrastructure Index
- » The state of global capital markets
- » Debt markets
- » ESG think tank
- » TIA Annual States' Taxation Conference
- » WACC workshop
- » An update from Tasmania, South Australia and Queensland
- » Meet a new member of the Value Adviser Associates team

Does your incentive compensation system add value?

Ideally, an incentive compensation system focuses the mind and actions around drivers of value and encourages and rewards value creation.

Many schemes we have reviewed either have challenges in meeting this objective or result in implementation challenges.

One scheme we recently reviewed had a component based on relative total shareholder return ("TSR") performance. TSR performance was defined to be relative to the performance of the companies ranked 201 to 300 in the ASX 300 Industrials Index. Our research showed that there were only 19 industrial companies in the 201 – 300 group of the ASX 300.

Further, most had experienced a significant downturn during the GFC so that the base earnings were either negative or very low. Consequently, the company, which had not experienced a significant downturn in earnings, would be unlikely to be able to match the growth of the corporate companies, which would likely experience a significant recovery of earnings. Thus the scheme had a negative rather than motivating effect.

Also, the financial press, shareholders, shareholder activist groups and ASIC are increasing scrutiny of these schemes and providing adverse publicity to those that appear to reward poor performance.

How does your scheme perform? Is it linked to value creation? Will it be seen to be paying for poor business performance or not paying for strong performance?

Criteria that can be used to inform this judgment evolve from the features of a 'good' incentive scheme. Key criteria that Value Adviser Associates considers in designing and evaluating an incentive scheme include:

1. Ensuring alignment between managers and shareholders and encouraging a value creating culture; and closely linked to this is;
2. Improving motivation and productivity;
3. Being simple, transparent and easy to explain to management and shareholders;
4. Encouraging retention of good management and attracting the right people; and
5. Having a payout that is a 'reasonable' cost to shareholders as well as having low administration effort and cost.

Taking each of these in turn:

1. Ensuring alignment between managers and shareholders and encouraging a value creating culture

A challenge here is to establish a starting point. If there is acceptance by the Board that a primary objective of the business is to create and deliver value for shareholders, then this is the starting point. It is certainly the one we endorse.

It is essential to recognise that shareholder value has a long term focus [contrary to some opinions]. This means the scheme requires a long term focus. We note that many schemes have short-term and long-term components. This is not a problem provided the short term measures and targets are consistent with a long term view (e.g. they are derived from the first years of a long term plan). For example, while not necessarily advocating EPS growth as a measure or focus, one plan we valued derived its EPS growth target from its long term financial plan, which had been valued and reflected the long term strategy of the business. This makes good sense.

Linking the scheme to creating and delivering long term shareholder value can be achieved in a number of ways. These include:

- » Issuing shares (including Phantom Shares) and/or options to management so that they experience the gains and losses that shareholders experience;
- » Relating the performance bonus to either absolute or relative TSR performance. Typically the relative performance assessment is based on that of peers;
- » Using financial measures that are plan-based targets, where the plan reflects business strategy, has been valued and has been established as the best alternative;
- » Measuring economic profit or EVA® year-on-year improvement against a predetermined pattern, perhaps derived from the current market value;
- » Ranking against peers on financial measures such as earnings or EPS growth, although we prefer ranking against the plan;
- » Using activity measures that link through to key value drivers.

These are listed in order of the directness of the link to shareholder value. Given the challenge in establishing the most direct (and controllable) link between decision responsibility and change in business value, the mix of incentive plan performance measures often changes from the CEO through the GM of BUs and below. CEO measures will comprise overall business performance measures like TSR whereas activity drivers are more likely further down the hierarchy.

Clearly, unlisted companies and BUs are denied the capital market measurement of TSR so a substitute is required which means moving further down the list. For example, the GM of a BU may have targets like Economic Profit, Return on Investment or Return on Equity for the Business Unit, in addition to Total Shareholder Return if the overall business is listed. Central to the design, regardless of the incentive mechanism chosen, is reinforcement of

the planning and performance measurement regime in place in the organisation – on the assumption that these processes are the most appropriate.

Often we find that a performance measurement regime is not appropriate because it focuses on growth / size rather than on value creation. Sometimes value creation requires reducing size rather than growing.

2. Improving motivation and productivity

This is perhaps obvious (and closely linked to point 1), but improving motivation and productivity means setting attainable targets that at least provide 'at market' compensation for solid performance. Note our recent experience with a scheme that unintentionally set unattainable Earnings per Share growth targets (see text box above).

People are marvellously inventive and do focus on 'what gets measured gets done'. This creates some interesting challenges with schemes that limit both the downside and upside of incentive payments. A plan can be de-motivating once the upside cap is hit and can encourage 'warehousing' performance for next year in these circumstances. On the other hand, if there is little chance of performance targets being hit this year, there is an incentive to apply the 'big bath' treatment by throwing all downside into this year to clear the way for next year or to simply reduce effort – even unconsciously.

3. Being simple, transparent and easy to explain to management and shareholders

An incentive plan will not motivate if it is not understood. A black-box generally creates suspicion. Nor will it overcome shareholder skepticism if it appears overly complicated and not easily explainable by Board members and business managers.

This can be a challenge – particularly because value and the value drivers for a business are not always well understood. Education and reinforcement can assist for both shareholders and management / employees. While there can be considerable complexities in business valuations, the basic principles can be expressed simply.

We argue, however, that it is essential for employees to see how their efforts impact value drivers. This can usually be achieved by having activities drivers linked to the financial drivers.

4. Encouraging retention of good management and attracting the right people

There are very high costs of changing management, mostly indirect. Consequently it is most desirable that the incentive scheme attracts and works to retain good management.

There is some balancing here. It is desirable for management, particularly senior management, to feel the gain and pain of shareholders. However many have mortgages, school fees etc. to meet. Consequently one challenge is to establish the 'best' mix between base and incentive pay. This will vary across individuals. Our focus here is on the incentive component.

Ideally, the incentive component is set so that the expected outcome meets the expected outcome of a 'sensible' market-assessed remuneration scheme. There tends to be less of an issue with retention when firm performance is better than the target than in the reverse case.

Consequently there needs to be some focus on the latter case – how to minimise retention risk in business downturns.

One mechanism is a performance bank. A performance bank can be established to help deal with retention and also to promote a long term focus.

A performance bank is a vehicle into which the annual reward is paid. Of the balance in the bank, one part, say one third, is paid in cash or shares to the executive. The other part remains in the bank until the same process is followed the next year. This encourages retention as it will take a number of years to access the bonus for a particular year. Usually the executive will generally forfeit the balance upon departure. The bank also provides a buffer in downturns when a negative bonus can kick in e.g. when shareholder returns have been below the cost of capital.

Other retention components include designing a scheme that is based on long term performance (e.g. a series of plans of say three years) and invoking vesting periods for shares or options.

Clearly an issue may arise if 'good' management experiences, or foresees several years of negative bonuses. Ideally, the expected bonus trigger point is not revised in these circumstances because the link between shareholder and manager pain would then be broken. However, there may be some circumstances where this could be considered.

5. Having a payout that is a 'reasonable' cost to shareholders as well as having low administration effort and cost

While this objective is relatively self-evident, shareholder concern about cost usually arises from poor alignment rather than the absolute cost. Nevertheless, concern is expressed that upside in incentive plans should be invoked to limit the cost. However, the other side of the argument is that, if the plan is linked to value creation, then unlimited upside is simply a sharing that is highly correlated with shareholders' experiences – both management and shareholders are 'winning'.

Concluding comments

We encourage the remuneration committee to agree upon, document and prioritise the overall objectives of the executive incentive plan. In our view, this provides the best starting point to revisit actual plans to ensure they are meeting these objectives.

Naturally we would be delighted to explore these thoughts further with you and your Board. 



Dr Steve Bishop

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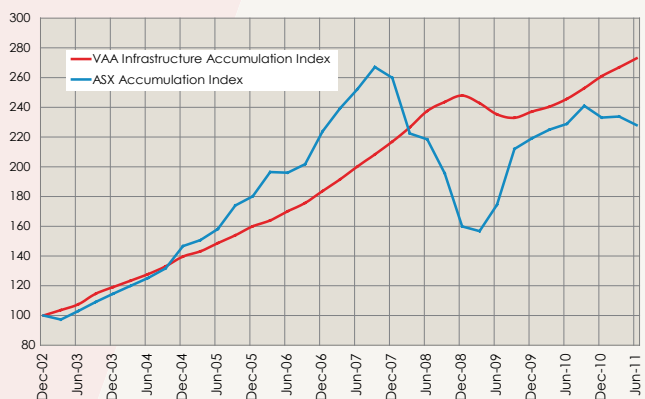
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UII® – Value Adviser Associates Unlisted Infrastructure Index

Why should I invest in unlisted infrastructure? This is a question often posed by superannuation fund trustees and investors when considering portfolio asset allocations. A major concern is that there is often a lack of crucial evidence to support the case – in the form of total shareholder returns, equity beta, asset beta, historical alpha and duration.

Value Adviser Associates has developed an exciting new product for infrastructure investors – the Unlisted Infrastructure Index or "UII®". UII® will help direct investors in unlisted infrastructure to better understand the risks and total shareholder returns available from this class of assets its the sub-sectors such as energy networks, transport, social infrastructure and water utilities. UII® will provide information on total shareholder returns by infrastructure sub-sector so that investors can benchmark the performance of their assets and make better-informed decisions when investing in the future.

Value Adviser Associates plans to offer UII® on a subscription basis to investors in direct unlisted infrastructure, advisers in the sector and anyone else interested in the performance of this asset class.



Our initial meetings with potential subscribers and suppliers of data have demonstrated a high level of support for and interest in UII. We are currently in the process of undertaking further consultations to explain how UII® would operate, to receive feedback on how the index can be developed to meet the requirements of data providers and to learn what features UII subscribers would like to see included.

If you would like to know more about UII®, please contact **Michael Churchill** or **Mark Gemmola** on 03 9626 4300 or email m.churchill@vaassociates.com.au or m.gemmola@vaassociates.com.au 

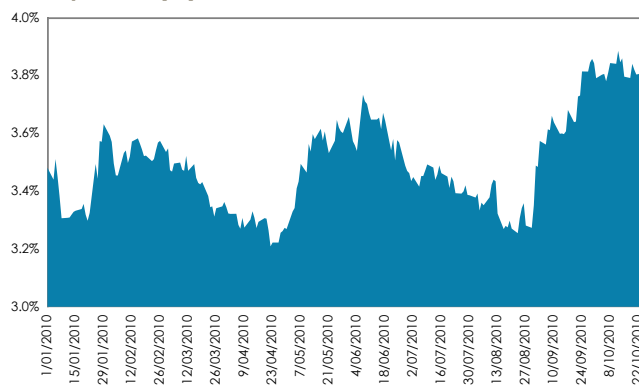
The state of global capital markets

Whilst the GFC seems to be fading from our collective domestic memory, global financial and capital markets continue to behave in a volatile manner. It is fair to say that most economies continue to suffer slow growth, high unemployment and the aftermath of the end of fiscal stimulus (the Bernanke helicopter cash drop).

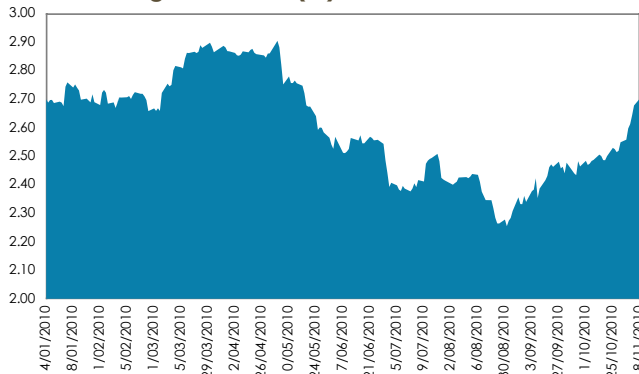
Whereas capital markets have tended to revert fairly quickly and consistently after past recessions or capital market collapses, a number of markets continue to be dislocated. The headlines can be read off the charts below and can be summarised as follow:

1. Interest rates have gapped-out to GFC levels with BBB-rated debt at 380 basis points over swap rates – the highest we've seen in Australia at any time in 2010
2. The domestic inflationary outlook is running at 2.7%
3. The ASX300 has been stuck in a channel of around 4300-4800 all year, largely mirroring the US market

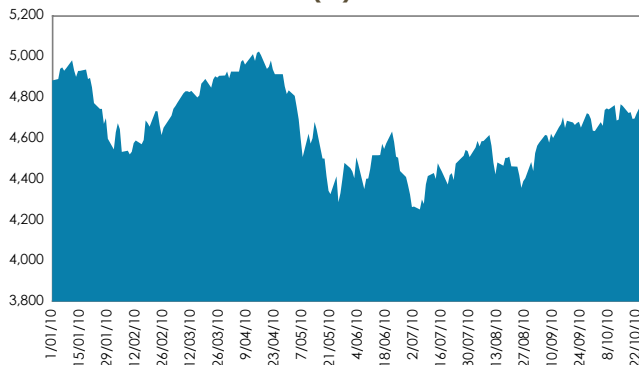
BBB Spreads (%)



Inflation Long-Run Index (%)




ASX300 Share Price Index (%)



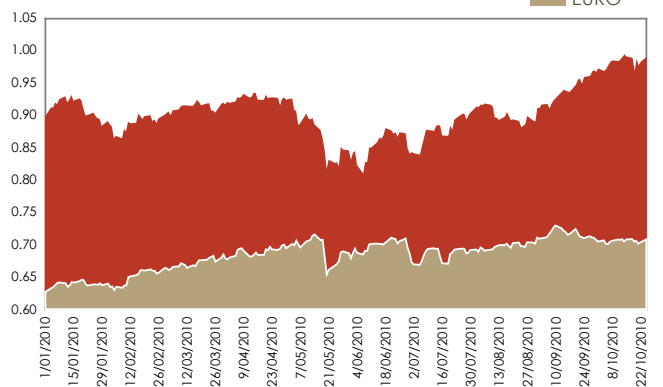
4. The AUD is the strongest against the EUR and USD since the float of the AUD in 1985
5. Equity market volatility remains about 50% over the long-run average at 20%
6. The European debt crisis is epitomised by Greece where the long run bond rate is "junk" with a double-digit yield. That compares with the Australian bond rate at around 5.5% (which is high compared to US, UK and Japanese rates).

What does this mean for domestic investment returns?

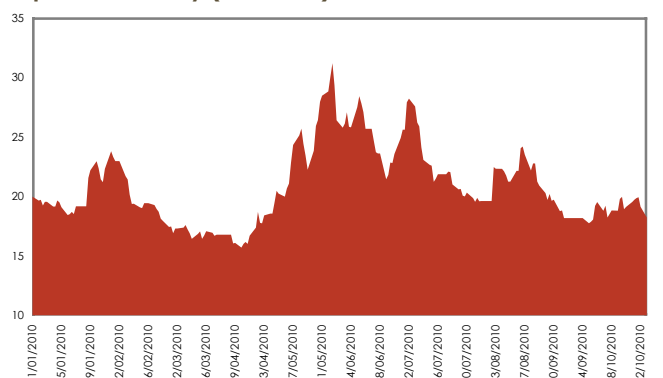
In short, the short-run required returns from equity markets is around 4% higher than the long-run average at 10%. The equities market as a whole is expected to return around 15.5% compared with a long-run expectation of around 11.5%.

This higher expected return comes with a price: risk that returns will be significantly lower than the long-run average. 

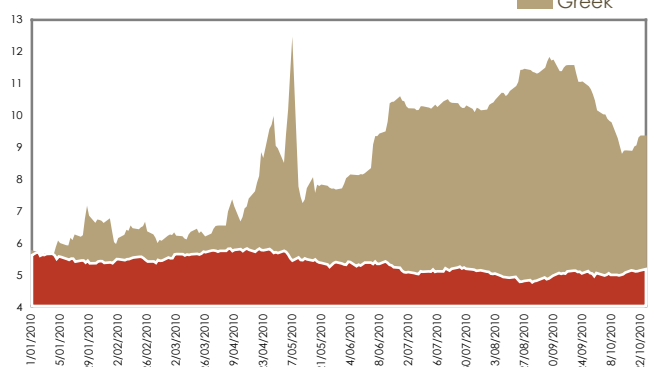
AUD/USD and AUD/EUR



Equities Volatility (Australia)



Greek and Australian Bond Rates



Debt markets



Whilst Value Adviser Associates has always advised on debt markets, Mark Day joining the team as Value Adviser Associates' representative in Adelaide brings a new dimension to the team's expertise. Mark has had a career in debt capital markets, originally working in the banking sector and then – since the early '90s – in consulting. Combined with multiple directorships, Mark brings a unique perspective to a corporation's debt/capital markets needs.

One core activity is analysing a company's debt and transaction banking facilities and benchmarking these against best practice. Terms sheets are benchmarked using bottom-up credit analysis, affording the company an understanding of the terms and conditions it should be expecting given its "shadow" credit rating. Armed with the credit analysis, a company can determine the extent to which existing facilities are overpriced, over secured or are deficient in terms of covenants or funding commitment.

According to Mark "the GFC has thrown a cat amongst the pigeons: companies now have little idea of what pricing, terms and conditions their credit should command and are hesitant to test the market. The upshot is that banks are being opportunistic and funding costs have blown out, often past appropriate levels."


We are working with many different companies, from SMEs to top 200 listed companies. "Savings are sometimes extraordinary and I am consistently surprised by the way some banks treat what are fundamentally sound companies - not just in terms of pricing, but also in relation to what we would consider inappropriate structuring and products."

There is no doubt that pricing has moved up as a result of the GFC, but some banks have gone for the jugular with opportunistic pricing on effectively uncommitted facilities. For instance, one of the banks has changed its corporate terms sheet to reflect the fact that it can alter its debt pricing – at notice. Whilst they may provide a two or three year commitment to funding, this loophole effectively allows them to ramp up pricing to a point where continued funding from that bank would be problematic. Other banks have employed different measures to capitalise on the vagaries of the current market.

Transaction banking is all about benchmarking product volumes against best practise and negotiating bankers to those levels. On occasions there may be efficiencies in migrating to alternative payment or receivables processes. The first step is undertaking benchmarking to ascertain the sorts of savings that may be achieved. If there are material savings [usually] the next step is either bilateral negotiations with bankers or going to tender.

Depending on the relationship, the overall banking proposition and the extent of savings possible, tendering and the competitive tension it creates is the preferred method of achieving desired outcomes [as with debt negotiations]. In most cases it is the incumbent bank that retains the relationship, but invariably at benchmark costs, terms and conditions.

The tender often works to refresh the relationship, which may have been taken for granted. With bankers knowing that the company may in future test the market again, there is also a tendency for future (attractive) pricing changes to be brought back to the company by bankers on a more proactive basis.

The tender also has other advantages. Firstly, it exposes the company to new relationships with external banks, thereby providing a direct route for the CFO to explore future finance and risk management alternatives. Secondly, we generally find that companies don't go down the best practice route of getting at least three prices whenever they undertake interest rate or foreign exchange transactions. However, because tendering banks undertake a full credit analysis as they determine their appetite for the debt, the natural extension is to use that analysis to establish unsecured treasury limits, thereby allowing them to participate whenever treasury transactions are required. 



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ESG think tank


Here at Value Adviser Associates we have been thinking about how to incorporate Environmental, Social and Governance ("ESG") factors into valuations for the following reasons:

- » Value Adviser Associates is a signatory to the United Nations Principles for Responsible Investing ("UNPRI");
- » Value Adviser Associates believes in a triple bottom line world where value is ubiquitous;
- » Value Adviser Associates has increasingly encountered ESG issues in valuations; and
- » Value Adviser Associates' clients (most of whom are also UNPRI signatories) are also working on how to incorporate ESG factors into their operations.

Value Adviser Associates started the process by focussing on the ways that ESG factors affect financial outcomes, both in the short term and the long term, with the focal point being how to incorporate ESG into valuations. Building on the work already done in the industry, Value Adviser Associates considered the ESG factors commonly identified in ESG overlays.

To determine which ESG factors were likely to have the greatest effect on value (defined as measurable, financial value) Value Adviser Associates held two industry think tanks. Think tanks were held in Melbourne and Sydney, with both attended by high calibre professionals experienced in ESG from all over the country, including company directors and representatives from fund managers and super funds.

During each think tank, Value Adviser Associates provided a list of factors considered by five different ESG ratings agencies, with a customised focus to unlisted infrastructure. Participants decided which factors they thought would have the most impact on value. The table below lists the factors the participants thought would have the greatest impact on financial value for each industry listed.

The next step is to conduct further research to test whether the factors identified in these think tanks can be incorporated into valuations. Once this testing is complete, Value Adviser Associates may hold another series of think tanks to refine views. The long term intention is to continue to work with other investment professionals across the industry to find better ways to incorporate ESG factors into valuations. To discuss ESG please contact **Megan Raynal** on 03 9626 4300 or m.raynal@vaassociates.com.au 

	Factors	Transport	Energy (non-renewable)	Energy (renewable)	Water	Social Infrastructure
Environmental Factors	» Environmental regulation and compliance	✓	✓	✓	✓	✓
	» Political	✓	✓	✓		
	» Energy use	✓	✓		✓	
	» GHG emissions	✓	✓			
	» Pollution levels	✓	✓			
	» Climate change	✓	✓		✓	✓
	» Site contamination		✓	✓		
	» Technical risks, e.g. carbon capture		✓	✓		
	» Energy availability & reliability			✓		
	» Water availability				✓	
Social Factors	» Stakeholder / community / regulatory relations	✓	✓	✓	✓	✓
	» Political	✓	✓	✓	✓	✓
	» OH&S	✓	✓	✓	✓	✓
	» Union disputes	✓	✓		✓	✓
	» Transparent reporting	✓			✓	✓
	» Human capital	✓	✓	✓	✓	✓
	» Staff retention			✓	✓	
	» Service provider mgmt					✓
Governance Factors	» Meet regulatory requirements	✓	✓	✓	✓	✓
	» Effective risk management systems	✓	✓	✓	✓	✓
	» Board skills	✓	✓	✓	✓	✓
	» Active shareholders	✓	✓	✓	✓	✓
	» Operational management	✓	✓	✓	✓	✓
	» Independence	✓	✓	✓	✓	✓

Value Adviser Associates update

TIA Conference wrap up

In the sunny setting of Brisbane the Tax Institute of Australia held its Tenth Annual States' Taxation Conference. Hosted at the Sofitel Brisbane delegates spent the 29th and 30th of July attending presentations and workshops on various topics including contemporary discussions on payroll tax and landholder/landrich duty. This year's conference included an in-depth technical discussion on aspects of the Henry review – the biggest review of Australia's tax system in more than 60 years.



For the third year in a row, Value Adviser Associates was the premiere sponsor of this event. Michael Churchill of Value Adviser Associates was asked to present to the delegation on Valuation of Land from an advisor's perspective.

Value Adviser Associates has been a proud sponsor of this event for the past three years and also support the 11th Annual States' Taxation Conference, to be held in Melbourne in 2011. For further details please contact **Kerrie Doherty** on 03 9626 4300 or k.doherty@vaassociates.com.au

WACC workshop

On the 27th of October, Value Adviser Associates joined forces with the Australian Centre for Financial Studies to host a WACC workshop.



The workshop was a sell-out, with over 70 delegates attending an intimate and interactive workshop.

This was a great opportunity for Dr Steve Bishop, Director of Value Adviser Associates and other leading experts to engage with their audience on highly relevant topics. The workshop was geared around the needs of the delegates and presented up to date and pertinent information. The delegates were given an opportunity to interact with structured practitioner panel on the commercial applications of the workshop content.

This event was received so well and the feedback was so positive that Value Adviser Associates will be holding a workshop in Sydney, Brisbane and Adelaide in February 2011. For more information on these up and coming events please contact **Kerrie Doherty** on 03 9626 4300 or k.doherty@vaassociates.com.au

Update on Tasmania

Nick Burrows joined the Value Adviser Associates team in June 2010, assuming responsibility for the Tasmanian market. Introductory meetings have been held with a range of businesses and institutions in order to introduce Nick and outline Value Adviser Associates' client service offering.

Value Adviser Associates has provided advice on financial forecast modelling and business valuation, cost of capital, impairment testing of intangible assets and valuation of multiple-hurdle share-based long term executive incentive schemes to the Tasmanian market.

Continuing the national program, Value Adviser Associates has hosted a number of highly successful Round Table Lunches, covering topics such as access to debt and equity capital, and the impact of the GFC on the cost of debt.

Update on South Australia

It's been a busy time for Value Adviser Associates in Adelaide. Projects have included: advising a client on the financial viability of an unlisted investment as they deliberated on whether to maintain/increase exposure; a shadow credit rating and analysis of the appropriateness of banking facilities for a mid-sized corporate; total shareholder return analysis and advice for the Board of an unlisted public company; and advising a Board on its foreign exchange risk management policy.

Value Adviser Associates has been short-listed as a primary supplier of valuation services for an institution with multiple unlisted infrastructure assets.

Value Adviser Associates has hosted numerous Round Table Lunches in Adelaide, allowing the team to catch up with many clients. Topics revolved around the post-GFC debt capital markets, valuation issues for unlisted infrastructure, the health of the equity markets, and the question "where to from here?".

Update on Queensland

Value Adviser Associates has hosted Round Table Lunches throughout the year, as part of its national program. Topics included uncertainty and impact on decision making, economic profit as a performance measure and debt markets, all of which were warmly embraced by the business community.

The Value Adviser Associates team in Queensland has been busy working with energy, water, resources, infrastructure, engineering, financial services, ICT, health, accounting and legal firms, as well as fund managers and state revenue offices. We have provided advice on: cost of capital and the valuation of shares; businesses and projects in relation to strategic planning; business cases; project development; mergers and acquisitions; restructuring; refinancing; impairment testing; intangible assets; executive remuneration; and litigation support and disputes. We have also built numerous best practice business models associated with the above projects.

Team profile: Introduction to Justin O'Brien

The Value Adviser Associates team continues to grow. The newest member of the team is Justin O'Brien.

Justin joins the team as a Corporate Adviser and has over ten years of experience in both domestic and international environments. Justin holds a Bachelor of Engineering, a Bachelor of Business and Masters of Applied Finance.

Justin is a great complement to an already high calibre Melbourne team. Justin was formerly a Vice President in Credit Suisse's HOLT Valuation and Advisory business in London, where he advised some of the world's largest long-only and hedge fund investors. Justin has also previously held a consulting role, where he advised to a range of Australian corporations and private equity funds on issues relating to strategic position assessment; market forecasting and strategic plan development; valuations; mergers and acquisitions; financial modelling; and support for significant reinvestment decisions. 



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Team Profile: Introduction to Kylmyn Cowburn-Cainer

Kylmyn (or Mini) joined the team as receptionist and PA in April after moving to Australia from the UK in late 2009. Since then Mini has become the voice of Value Adviser Associates and many of you will have been fascinated and beguiled by her Yorkshire accent on the phone!

Mini joined us with a background in event management and telesales and has taught us all a thing or two about organising great functions and events. She has also kept us all in stitches as she comes to grips with Aussie humour and colloquialisms!

Mini is keen to run a series of PA-only events in 2011 (mid-February), so keep a look-out for an invitation. 



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Thank you

On behalf of all the team at Value Adviser Associates, thank you for helping make 2010 a great year! The team wishes you and your family a Merry Christmas and a happy and safe New Year. 



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