



**Valuation Matters**  
 A regular newsletter from  
 Value Adviser Associates  
 June 2010

# Valuation Matters

Welcome to the June edition of *Valuation Matters*. The world continues to present exciting and compelling challenges for us all – the impact of the economic recovery, the shift in the balance of economic power, travel disruptions from volcanic ash, social cohesion issues in our melting pot of cultures and many other “big” issues.

At Value Adviser Associates we have been meeting the challenge of a significant up-tick in demand for valuation and value-related services over the last quarter – evidence that M&A activity, commercial disputes and capital raisings are on the boil.

## In this edition

- » Mergers & Acquisitions: strategies and processes
- » Market risk is still high – reflect it in the cost of capital
- » Value Adviser Associates becomes a signatory to the UNPRI
- » Meet two new team members of Value Adviser Associates
- » Value Adviser Associates Round Table Lunches
- » TIA Conference – the Tenth Annual States’ Taxation Conference (29–30 July 2010)

## Stop Press!

Fat-fingered Freddie, the Greek bail-out and the potential introduction of the so-called “super profits” tax on miners have all been headline news.

The consequences of these events have been:


- » high volatility in equities markets (the VIX volatility index has doubled from 20 to 40 in the last few weeks)

- » increases in debt spreads (and interbank rates)
- » a discernible reduction in the value of the miners most-affected by the proposed resources super profits tax

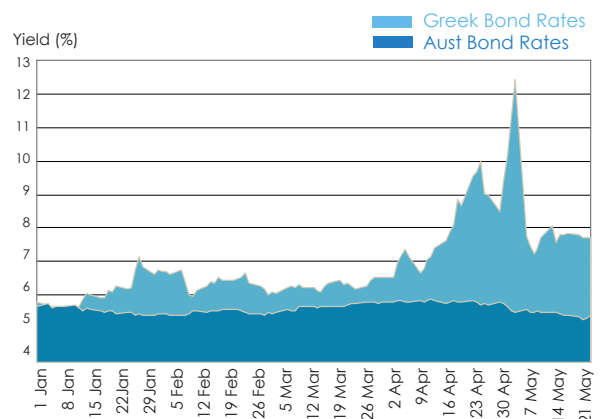
This brings back into focus the question of the pace and extent of economic recovery. Recent commentary from Bloomberg suggests that there are three themes to the recovery:

- » **Europe** – a long shallow L-shaped recovery
- » **Emerging markets** – a sharp V-shaped recovery
- » **US and other developed economies** – a sustained U-shaped recovery

Notwithstanding clear signs of recovery and the relative strength of the domestic economy, the increase in equity market volatility and debt market uncertainties have effectively increased the short-term cost of equity capital by virtue of:

- » higher forward-looking market risk premium - the reversion to the long-run mean has been pushed out by virtue of the renewed equity market volatility
- » lower short-term returns to equity as a consequence of higher debt costs – like equity markets, the reversion of debt spreads to the long-run mean has been pushed into the future. 

## AUSTRALIAN AND GREEK BOND RATES, 2010



**Melbourne**  
 Level 2  
 65 Southbank Boulevard  
 Southbank VIC 3006  
 Tel (61 3) 9626 4300  
 Fax (61 3) 9626 4301

**Brisbane**  
 Level 20, AMP Place  
 10 Eagle Street  
 Brisbane QLD 4000  
 Tel (61 7) 3221 4857  
 Fax (61 7) 3221 6152

**Adelaide**  
 Level 2  
 99 Frome Street  
 Adelaide SA 5000  
 Tel (61 8) 8111 4035  
 Fax (61 8) 8111 4098

[vaassociates.com.au](http://vaassociates.com.au)

Value Adviser Associates Pty Ltd  
 ABN 54 131 852 607

# Mergers & Acquisitions: Strategies & Processes – Part 2

by Michael Mileo

In the previous edition of Valuation Matters (December 2009), we provided an overview of how to create value in businesses. In this edition, we are going to cover strategies and processes for using acquisitions and divestments to enhance value creation objectives.

As advisers to companies over several years, it is always exciting and rewarding to embark on M&A engagements that may shape our client's company (and in the case of smaller businesses, our client's personal wealth) for many years to come. In this intimate client-adviser relationship, our objective is to support the longer-term wealth creation objectives of our clients. A central tenet of this philosophy is to take a strategic and value-centric view.

## The M&A process

The typical M&A process follows a relatively well-known path, regardless of whether you are involved on the buy or sell side of a transaction. Within this path, the phases of the process leading to an adviser setting the vendor expectations, or the provision of any formal offer, are critical.

The diagram below sets out the initial phases prior to the formal due diligence process. These phases can be applied for either an acquisition process or a divestment process, where the vendor is proactively seeking out the best available acquirer for their company.



## It's all about the strategy

Notwithstanding the well known path for a typical M&A process, it is not uncommon for the impetus of an M&A opportunity to be born from a chance meeting, a rumour around the traps or perhaps a casual discussion over a drink with a colleague/competitor. While many business opportunities 'happen', it is preferable that M&A opportunities are born from the disciplined execution of a sound strategy.

A key ingredient to realising value from any purchase or sale is to have viable alternatives to facilitate commercial negotiations. The question then becomes, what are the alternatives? To answer this question, we must address the principal question of "what is our strategy?" There are two elements to address in this question: the corporate strategy and the business unit strategy.

## Corporate strategy

The corporate strategy reflects the portfolio view of a company where there is more than one operating business. An example would be a retirement village and aged-care provider.

- » What businesses do we stay in, enter or exit?
- » How do we allocate resources across the existing businesses?
- » How can relationships be better managed across the existing businesses?

## Business unit strategy

The business unit strategy reflects the core competencies of a given business and may be concerned with, for example, issues of scale or adjacencies.

- » What segments do we stay in, enter or exit?
- » How do we allocate resources across the existing segments?
- » What products/services do we offer?
- » How do we price those products/services?
- » What is our cost/asset position?

An advanced position on these questions should be reached prior to setting the M&A wheels in motion.

## Are you the best owner of your asset?

It's a confrontational question, but one that should be asked periodically when evaluating business performance.

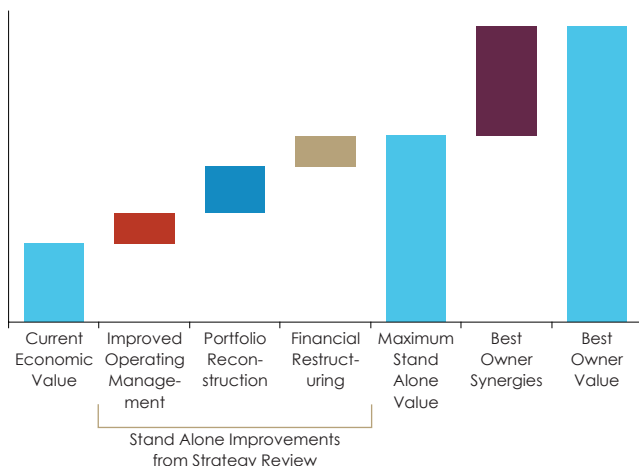
To answer this question of the 'best owner', we are examining which company has the characteristics/performance to create the most value from your business. It is unlikely we could readily identify exactly who could create the most value in an absolute sense, only who (across a given group of considered alternatives) is best placed to drive the greatest value.

A given company at different junctures in its life cycle will need different skills and focus to maximise value. For example, the natural owner/manager of a start up is likely to be entrepreneurial, while later in the business' life, the company may need a higher degree of explicit governance culture to excel. A consumer goods company with a single strong brand may be best managed by a larger corporate that excels in managing a diversified portfolio of brands.

This question may lead to thinking about the search and screening process in a new light. For example, the 'best owner' for a niche breakfast food manufacturer and marketer may not currently be operating in the breakfast food segment but may have the requisite marketing and distribution skills to maximise market share.

The following chart summarises the value analysis which is undertaken in the strategy and 'best owner' reviews required to support a sound M&A process.

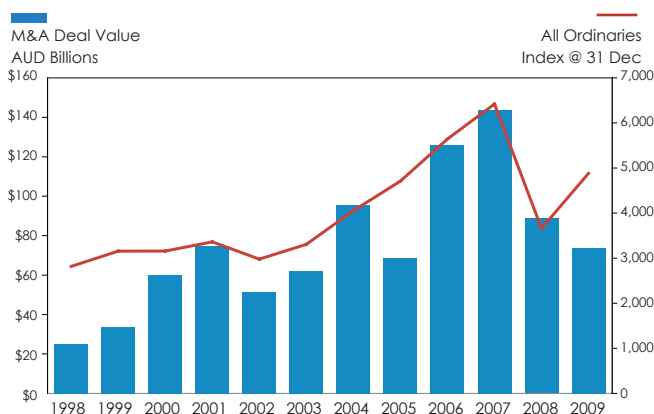
## STRATEGY REVIEW AND BEST OWNER ANALYSIS



## M&A and market cycles

An interesting indicator of psychology in M&A is the prevailing market conditions where activity is greatest. This is born out by the correlation of M&A announcements and market pricing/index levels the volume and value of deals announced are typically higher when the market is higher. The graph below illustrates the recent history in Australia for this.<sup>1</sup>

### AUSTRALIAN M&A DEAL VALUE VS ALL ORDINARIES INDEX



It's interesting then to ask why the drivers of M&A activity try to 'time' the market, particularly given the challenges most acquirers have in executing value-creating acquisitions (i.e. some acquirers pay too much).

From a buyer's perspective, it may be that acquirers are seeking to minimise risk by waiting for irrefutable signs of a market recovery. The problem with this, however, is that the primary issue in managing M&A risk is ensuring that any action is supported by a strong strategic imperative and this is not driven by market cycles.

With this strategic imperative in mind, it may be that buyers are better advised to consider a counter-cyclical approach to M&A, particularly given cycles can be short term in nature.<sup>2</sup>

The M&A and market cycle trends pose interesting challenges for potential vendors as well. Not only does the graph on M&A activity suggest that acquirers may be sitting on their hands during cyclical downturns, it may also infer that willing (but not anxious) vendors may also be inactive in cyclical downturns.

From a vendor's perspective, you might ask why would a seller let go of an asset in a cyclical downturn? In our experience, a considered search and screening process arising from the strategic review would uncover a range of viable alternatives; the supply of alternatives is typically not a problem. Typically, where the supply of buyers is not a problem, the price achieved on sale is solid.

In addition to the development of a range of viable buyer alternatives, another important consideration is how the sale proceeds are to be applied, e.g. to reinvest in the alternate business units, acquire a new business, retire debt or return funds to shareholders.

Selling in a down cycle does not always mean that value cannot be created, particularly if a strategic approach is taken to assess the best owner for an asset.

## Summing up

M&A leading to a binding agreement is challenging enough (and we haven't even considered banking the promised synergistic benefits!). To improve the chances of establishing these value creating opportunities through M&A, we need to start with a robust strategy evaluation.

A robust strategy evaluation typically brings into focus a wider potential range of targets that may not have previously been considered. For the courageous amongst us, an honest strategic review may lead to the conclusion that we are, in fact, not the best owner of the company/asset because another set of managers or shareholders can derive a higher value from it. Conversely, it may also mean that a proposed acquisition is not, in fact, a good idea.

Beyond a chance meeting, or response to a rumour, the process of establishing a wider range of targets helps to increase the odds of creating value because it enhances the negotiating position. Further, a robust strategy can act as the best risk mitigation policy, because it brings into focus the fundamentals rather than trying to time the market cycles.

For acquirers and vendors looking through the lens of long-term value creation, market cycles should not mask the underlying opportunities that can present when short-term pricing diverts from fundamental value.

Last, but not least, the M&A process for most is a milestone activity and one that requires sharp and uninterrupted focus. The CEO/CFO or owner/manager still has a business to run while the M&A process takes place. Over and above the provision of dedicated resources and expert support, engaging a trusted adviser is critical to help maintain discipline, through objectivity and impartiality, throughout the process.

For more information on M&A please contact Michael Mileo on 03 9626 4300 or [m.mileo@vaassociates.com.au](mailto:m.mileo@vaassociates.com.au)

<sup>1</sup> We expect the GFC impacts on the debt market had an impact on available capital for M&A activity in 2009.

<sup>2</sup> For those who do not subscribe to an efficient market at all times, market pricing could be viewed as having a bias towards current/short term economic conditions i.e. prices can be inflated in strong cyclical periods and fall well below fundamental value in challenging cyclical periods.

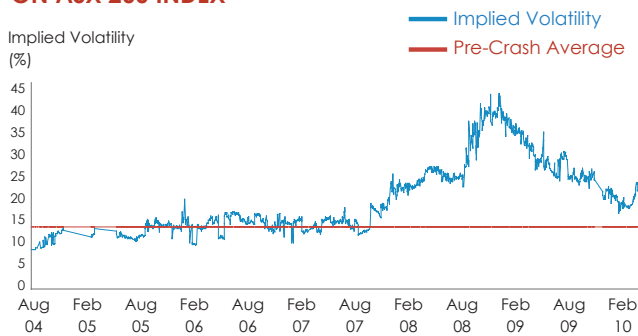
## Market Risk is still high - reflect it in the cost of capital

by Dr Steve Bishop

Just when the market volatility appeared to be returning to 'normal' recent events have led to another jump. Figure 1 below shows this jump. It plots a forward view of overall market risk since mid 2004. This forward view is captured in the implied volatility of one year options on the market index.

Value Adviser Associates uses the implied volatility to estimate a forward view of the market risk premium (MRP) on equity in the cost of capital used in its business valuations. With a required return related to risk, we would expect the behaviour of risk premiums on financial instruments to follow a similar pattern to this volatility. Certainly we would expect the risk premium on equity to be more volatile and higher than that on debt, since equity is the residual risk bearing instrument.

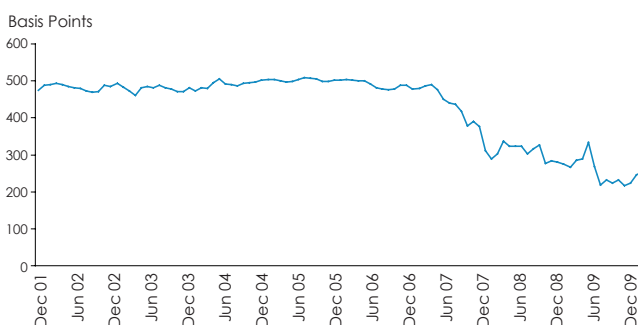
**FIGURE 1: IMPLIED VOLATILITY OF 12 MONTH OPTIONS ON ASX 200 INDEX**



The risk of debt is also high, as reflected in debt spreads over 10 year Commonwealth Bonds. The spread on BBB debt at the end of April was circa 350 basis points compared with a longer term average pre-GFC of circa 120 basis points.

These phenomena lead to an interesting challenge when estimating a weighted average cost of capital for project or business valuations. Standard practice is to use a spot rate for the cost of debt, reflecting the current market risk premium, but a long-run average for the risk premium on equity, usually 6%. Under current market conditions this practice leads to the situation depicted in Figure 2. Here the risk spread between debt and equity is clearly decreasing - when the opposite would be expected.

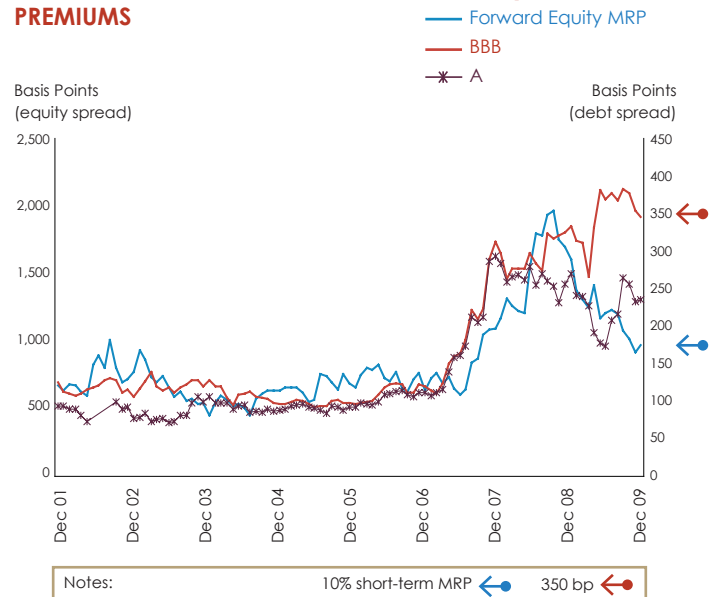
**FIGURE 2: DIFFERENCE BETWEEN BBB DEBT RISK SPREAD AND A CONSTANT EQUITY MRP**



To overcome this 'ridiculous' situation, Value Adviser Associates estimates annual forward-looking equity MRPs using the forward-looking implied volatility data shown in Figure 1. By multiplying a constant premium per unit risk by this implied volatility, we obtain a view of the forward-looking annual equity MRP. This gives a result which we believe to be more reflective of current conditions. The outcome is shown in Figure 3, which also superimposes the premiums for A-rated and BBB-rated debt over the 10 year Commonwealth bond rate, which are also forward-looking.

This provides a better match between the risk spreads on debt and equity than does the practice of using a constant 6% MRP for equity. It will also provide more realistic valuations arising from discounted cash flow analysis.

**FIGURE 3: FORWARD LOOKING DEBT AND EQUITY RISK PREMIUMS**




The equity MRP derived in this way is a one year forward view. We estimate this to be currently circa 10% p.a. but it is not expected to stay at the current level forever.

We have estimated that, if history is to be repeated, the equity MRP will return to the long-run average over 3-5 years from the date it moved above the average. Since the initial 'jump' in volatility occurred in late July 2007, it might be expected that reversion will occur between a few months and 2+ years from now. Given the recent uplift in volatility, it is more likely to be a longer rather than a shorter time to recovery.

This means that when estimating the cost of equity valuers can use an MRP profile that reflects current conditions but reverts to 'normality' over time. This will put debt and equity on a more sensible footing when estimating a WACC. What might this profile look like?

Officer and Bishop, in submissions to the Australian Energy Regulator, argue that the long-term MRP (incorporating a return on imputation tax benefits) should be 7%, although 6% is widely used in practice. The long-term MRP is used to determine the premium per unit risk, and therefore the size of the current premium, in addition to the rate at which the MRP is expected to revert.

Consequently, we present a range of MRP profiles in the accompanying table. The table shows a number of 'reversion' profiles that you may choose from when estimating a cost of equity. Our preferred position – the longer profile reverting to 7% - is in the first row. 

### EQUITY MARKET RISK PROFILES

Decline Scenario	2010	2011	2012	2013
Decline over 3 years to 7%	9.7%	8.8%	7.9%	7.0%
Decline over 3 years to 6%	8.4%	7.6%	6.8%	6.0%
Decline over 1 year to 7%	9.7%	7.0%	7.0%	7.0%
Decline over 1 year to 6%	8.4%	6.0%	6.0%	6.0%

## Value Adviser Associates update


We are delighted to welcome Nick Burrows and Mark Day to the Value Adviser Associates team.



Nick Burrows (left) recently retired from his long-serving role as CFO of ASX-listed agribusiness Tassal and is carving out a new life as a company director and strategic adviser. Nick will be responsible for the Tasmanian market and he can be contacted on 0419 591 616 and email: [n.burrows@vaassociates.com.au](mailto:n.burrows@vaassociates.com.au)

Mark Day (right) is a director of Australian Central Credit Union and chair of Electricity Industries Super Scheme as well as an accomplished debt-markets adviser. Mark is responsible for the South Australian market and can be contacted on 08 8111 4035 and [m.day@vaassociates.com.au](mailto:m.day@vaassociates.com.au)



Value Adviser Associates has had a long association with the Tasmanian and South Australian business communities - working with organisations such as Tassal and FEA in Tasmania and ETSA and Envestra in South Australia. 

## Signatory to the UNPRI

As part of our vision-setting, we have set a goal of "living in a triple bottom-line world where value is ubiquitous".

This manifests in the placing of value-based measures at the core of all decisions and the incorporation of ESG (environmental, social and governance) considerations.



Led by our ESG champion, Megan Raynal, Value Adviser Associates has recently become a Professional Services Partner signatory to the UNPRI (UN Principles for Responsible Investing).


Signatories to the UNPRI are required to:

1. incorporate ESG issues into investment analysis and decision-making processes
2. be active owners and incorporate ESG issues into our ownership policies and practices
3. seek appropriate disclosure on ESG issues by the entities in which we invest
4. promote acceptance and implementation of the Principles within the investment industry
5. work together to enhance our effectiveness in implementing the Principles
6. report on our activities and progress towards implementing the Principles

More details on the UNPRI can be found at [www.unpri.org](http://www.unpri.org)

One of the most significant challenges confronting the investment industry in implementing the UNPRI (and ESG policies more generally) is the absence of an established framework for measurement of the impact of ESG policies on risk and return.

Megan Raynal will be hosting an ESG think-tank in July as an important step in the development of the measurement framework for our direct-investing clients.

If you would like to participate in the ESG think-tank please contact Megan on 03 9626 4300 or email [m.raynal@vaassociates.com.au](mailto:m.raynal@vaassociates.com.au) 

## Value Adviser Associates Round Table Lunches

This year has seen the launch of a series of lunches hosted by Value Adviser Associates.



A combination of business and pleasure the Round Table Lunches are set in a calm and comfortable environment. Guests experience impeccable food and service as well as relevant and up to date conversation topics.

Guests are encouraged to 'leave their worries at the door' and enjoy a couple of hours in the company of like minded professionals discussing issues that are common place regardless of industry.

The Round Table Lunches have been warmly embraced by the business community all around Australia. Brisbane and Adelaide Round Table Lunches were a great success and the next instalment in the series of Value Adviser Associates Round Table Lunches will be hosted in Tasmania, followed by a repeat performance in Adelaide.

Previous topics covered at the Round Table Lunches have been:

- » Uncertainty and the impact that this has on decision making
- » Economic profit as a performance measure
- » Debt markets, pre and post GFC

For further information on the Value Adviser Associates Round Table Lunches please contact Kerrie Doherty on 03 9626 4300 or email [k.doherty@vaassociates.com.au](mailto:k.doherty@vaassociates.com.au)

## TIA Conference – save the date

Value Adviser Associates is proud to be the sole Executive Partner Sponsor of the Tenth Annual States' Taxation Conference to be held at the luxurious Sofitel in Brisbane. The dates for the event are Thursday 29 – Friday 30 July 2010.



This is the only conference hosted in conjunction with State Revenue Offices covering all State and Territory tax matters in one program. If you are a private tax practitioner or if your business services State and/or Territory tax matters then this is an opportunity not to be missed! All State and Territory Revenue Commissioners, State Revenue Office teams plus other State Tax professionals will be there.

As well as contemporary discussions on payroll tax and landholder/land rich duty, this year's conference will involve an in-depth discussion on aspects of the Henry review. High calibre speakers will provide invaluable insight into the biggest review of Australia's tax system in more than 60 years.

For further information please go to the Taxation Institute of Australia website [www.taxinstitute.com.au](http://www.taxinstitute.com.au) or call 1300 733 842.