

Valuation Matters

 Value Adviser Associates
creating, capturing and communicating value

A regular newsletter from
Value Adviser Associates

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Welcome to Valuation Matters, the second edition for 2011. Your opinion and feedback is most welcome. Enjoy!

Hot off the press – the importance of independence

by Michael Churchill

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The Australian legal system insists that independent experts remain independent of the engaging party and aid the courts in reaching a view on matters that are the province of the expert. The expert is effectively a servant of the court.



Value Adviser Associates provides independent expert evidence in a wide range of valuation-related disputes. The judgment in a recent case was handed down last week and stresses the importance of ensuring that the expert remains independent of the engaging parties following the withdrawal of a number of key experts.

In the judgement, Davies J reported that senior counsel “abandoned reliance on their expert witness, conceding that their experts lacked independence” and reiterated that the role of an expert witness is to provide independent assistance to the Court.

The judgement is available at: [BOSI Security Services Limited v Australia and New Zealand Banking Group Limited & Ors](#). Scroll to F: VALUATION. (f) Conclusion. Line 139

To discuss the importance of independence with an expert please contact Michael Churchill, CEO at Value Adviser Associates.



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Value Adviser Associates unlisted infrastructure investor update

Value Adviser Associates provides regular valuation services to a number of large investors in unlisted infrastructure and private equity investments. These investments are situated around Australia, in the UK and USA and cover the key sectors of Water, Energy, Transport and Social Infrastructure.

Value Adviser Associates provides a range of services to investors in unlisted assets – from regular ‘mark to market’ valuations to support on debt refinancing, origination, portfolio construction, cost of capital advice for regulated utilities and commercial due diligence.



We are delighted to welcome recent new clients Statewide Super and Infrastructure Capital Group – between these two clients alone we are regularly providing valuation advice with respect to more than 20 infrastructure and PE investments.



One of our Senior Corporate Advisers and Valuation Managers, Mark Gemmola, has recently returned from a site visit of UK investees, Inexus and Anglian Water, where he met with management and stakeholders as part of the regular valuation process for Colonial First State Global Asset Management and UniSuper.

Mark met with Inexus CFO, Darryl Corney, to learn first hand about the challenges imposed on the company by the recession in the UK which has seen the number of new home builds fall by about 30%. He was also given a tour of the Inexus “See The Light” facility, which showcases to developers the technological capabilities of a home connected to the fibre network.

right: Rutland Water Park, UK

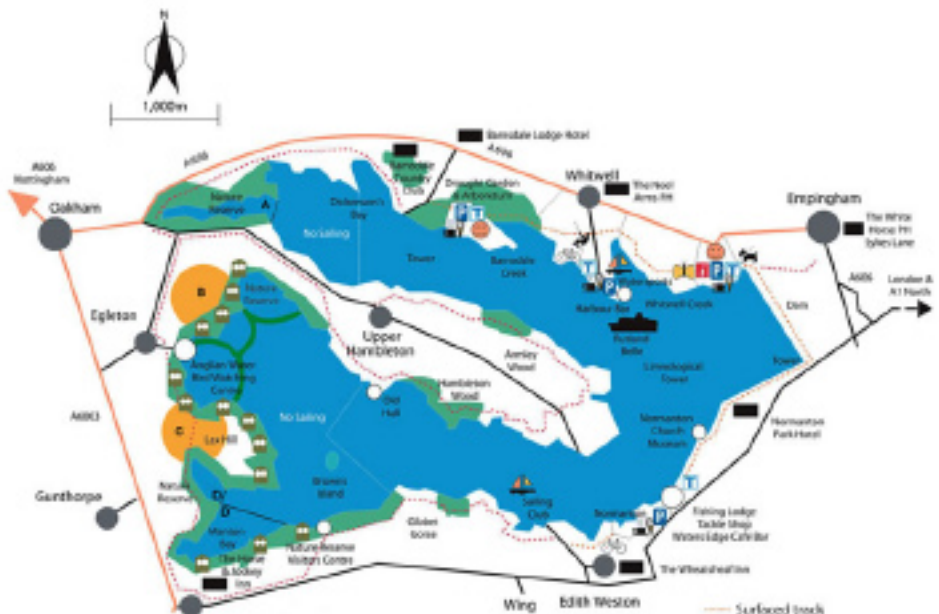
This facility has proved very effective in convincing developers of the merits of building an integrated fibre network throughout the home in new housing estates. Mark visited Anglian Water with two staff from CFGAM’s London office.

They were taken on a tour of the impressive new water treatment plant and then shown Anglian’s commitment to the environment with the construction of new wetlands adjacent to Rutland Reservoir. These new wetlands provide an alternative sanctuary for birds to live and breed when Anglian requires greater abstractions from the reservoir during times of drought. Mark also had meetings with Anglian Water Managing Director Peter Simpson and Group Finance Director Scott Longhurst.

These meetings provided insight into strategies Anglian is employing as a result of the tough regulatory allowances imposed by Ofwat in the recent determination. Mark was impressed with management’s focus on outperforming the regulatory allowances and their ability to deliver on the tough new targets. Overall, both trips proved very worthwhile and will be of great benefit to Value Adviser Associates when undertaking future valuations.



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Portfolio Valuation Project Manager and Senior Corporate Adviser, Megan Raynal, oversees the development of Value Adviser Associates' systems and processes to ensure efficient and timely delivery of regular valuations to the investors in unlisted assets. Megan is also responsible for our thought leadership in the application of Environmental, Social and Governance ["ESG"] policies in the valuation of unlisted assets – including her role as Value Adviser Associates' representative as a UNPRI signatory.

As part of our research we have found that infrastructure assets are regularly affected by environmental events (e.g. fire, flood, earthquake, etc). While the effects of these events are often mitigated by contracts or insurance, we have found many examples where the investors have had to bear at least some part of the cost associated with the event. This may affect investments even more in future as there are indications that environmental risk in Australia is being re-rated by re-insurers, so insurance will become more expensive or may not be available.



We have found that while many valuers take into account the effect of environmental events after the fact, they do not consider the risk of an event before it happens. This can result in an inaccurate assessment of the risks of the investment, and therefore of the potential value outcomes.

Investing in unlisted infrastructure and private equity has become prevalent among Australian and international investors over the last decade and is now a core component of most investment portfolios due to the risk/return characteristics and duration (time horizon) of the asset class.

Having worked in this area for several years, the team is able to provide clients with great insights into the unlisted investing universe across issues as diverse as:

1. The relative risks and returns of investments in listed and unlisted assets
2. The effect of gearing/leverage on relatively low-risk assets
3. Credit spreads and debt re-financing risks
4. Trends in regulatory pricing in the UK and its impact on Australian utilities.

When it comes to debt re-financing and benchmarking, the debt team (comprising Mark Day, Justin O'Brien, Mark Gemmola and Gareth Thompson) has been busy in recent months with assignments involving electricity distribution, port operations and telecoms.


One of the important developments emerging out of our work across the infrastructure sector is the Value Adviser Associates infrastructure map – in which every infrastructure asset located in Australian and owned by Australian investors offshore is listed by sector, location and investor. This is a powerful tool to support investors screen potential acquisition or investment opportunities in the Australian market.



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To discuss any of the Unlisted Infrastructure Investor projects in more depth please contact the relevant team member at Value Adviser Associates. 

Protecting Shareholder Value During M&A¹

Dr Steven Bishop, Executive Director

ACSI Annual Conference

Steve was invited to present at this year's ACSI (Australian Council of Super Investors) Annual Conference. Held at the Sofitel on Collins in Melbourne on 26th of May 2011 the theme for this year's conference was **'Reflections and Predictions – Governance in an uncertain world'**. Celebrating its 10th anniversary the year, the ACSI is a not for profit organisation that provides independent research and advice to superannuation funds on ESG risks in the companies in which they invest.

This was a great fit for Value Adviser Associates and cements the ongoing and increasing knowledge base that Value Adviser Associates has in ESG factors.

Amongst high calibre business and corporate executives Steve presented a session on protecting shareholder value during an M&A transaction. This session offered insights into how superannuation funds protect their long term interests during these types of transactions. The complete paper can be read below.

Introduction

"What can a Board of a potential acquiring company do from a governance perspective to maximise the chance of acquisitions creating value for shareholders?"

This is the question addressed in this paper.

The question is important because there is evidence that, while acquisition activity creates value overall, listed bidders, on average, erode shareholder value when they undertake an acquisition. It appears, again on average, that the target firm is paid the expected wealth created from the acquisition as well as some of the value of the bidder firm.

What aspects of governance might minimise the change of shareholder value erosion when acquisitions are contemplated or undertaken?

¹ This paper is the essence of a presentation given to the ACSI Annual Conference, "Reflections and Predictions: Governance in an Uncertain World". Thursday 26th May 2011. My thanks to Dan Dempsey and John Russel.



The activity of Private Equity ["PE"] firms provides some insight into 'good practice' from a governance perspective. This activity is of interest because:

- » there is evidence that, on average, PE acquisitions do not transfer wealth to target shareholders and that the top quartile PE firms do well from acquisitions; and most importantly;
- » PE acquisitions, by their nature, generally do not involve synergies. Consequently recovery of any premium paid plus generating value over and above this premium must come from governance changes as well as operational improvements.²

The term 'governance' is used here in the broadest sense.³ It is used in the context of a board having the right to:

- » Establish and monitor governance structures and management processes in the firm. These processes include strategic planning, resource allocation, performance management (KPIs, targets and reporting/monitoring) and risk management;
- » Hire, fire and set the level and structure of top management compensation;
- » Veto or ratify major strategic initiatives.

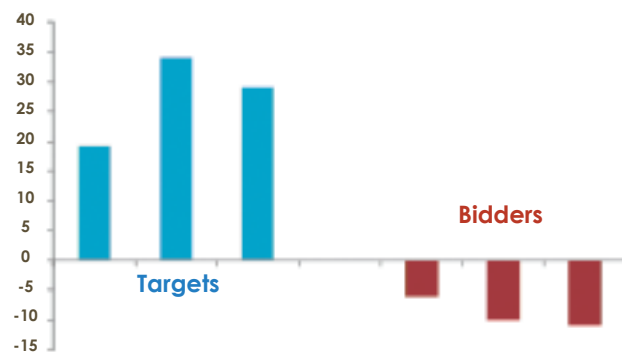
Value created / value eroded from acquisitions

There are some consistent themes arising from empirical research examining the market reaction to bid announcements and surrounding events.

1. The 'market' sees overall wealth increasing from acquisitions. Australian evidence from Bishop, Dodd & Officer⁴ estimate \$7.2 billion value created by takeover bids between 1974 and 1984. Using slightly different controls, Brown and da Silva Rosa⁵ identified total shareholder wealth increases of \$20 billion from takeovers between 1974 and 1985. US evidence reports an average of \$117M per tender offer bid⁶;
2. Target firm shareholders experience a value increase, on average. This is not surprising given most bids involve a premium over the prevailing market price. Figure 1 (right) shows the cumulative abnormal return target shareholders from announcement of a substantial shareholder notice through announcement of the offer to announcement of finalisation. From the Casey, Dodd and Dolan study⁷;
3. Bidding firm shareholders lose value, on average. This finding is common across time and geographies. For example, studies by Walter⁸ and by Casey, Dodd and Dolan report an average negative outcome for Australian Bidders. The cumulative abnormal return for Bidders of circa -10% from the Casey, Dodd and Dolan study also appears in Figure 1 (right). Bruner summarises US and wider studies;

4. Shareholders of PE funds earn around market returns net of fees but outperform gross of fees i.e. they cover management fees which are on average, 3%.⁹ The top quartile of PE firms in the US earn an IRR of 36% compared with 26% for the market¹⁰. The now Australian Centre for Financial Studies found from its review of research that there '... is a general consensus across different methodologies, measures and time periods regarding a key stylised fact: LBOs and especially MBOs enhance performance and have a salient effect of work practices.'¹¹

Figure 1: Cumulative abnormal return to targets and bidders in Australia (%)



Of interest for the current purpose is the consistent evidence that bidders, on average, transfer wealth to target shareholders. Why?

Explanation of the poor performance of the 'average' bidder

Obviously the price paid by bidders in wealth eroding takeovers is 'too high' relative to the benefits they expect to extract. There are numerous explanations with multiple reasons probably being applicable in individual circumstances. Being aware of these explanations enables the Board to be on guard when management is contemplating or conducting a bid.

- » Poor due diligence: missing some vital potential impacts on the attractiveness of the industry / segment and or the relative competitiveness of the target or not being adequately 'fact-based' i.e. an emphasis on financial and legal due diligence rather than commercial;
- » Rose coloured glasses on synergies and operational improvements and relatedly;
- » Synergies not based on the current business' core competence therefore making them hard to estimate and hard to deliver;
- » Hubris: bidder management not wishing to lose out on something they have started, not knowing when to stop pushing the offer price up;
- » Management compensation based on size not value creation thereby providing the wrong motivation;

- » Poor implementation of the changes required to deliver performance improvement and relatedly;
- » Under-estimation of the challenges in combining different cultures: this and underestimation of the challenges with meshing systems and processes may well be the single largest reason for challenges in success; and
- » Not on the front foot with corporate strategy. Ideally it is a well 'designed' corporate strategy that drives value growth. Often corporate strategy is reactive and overly influenced by 'brokers' selling transactions rather than value creation.

Which, if any, of these explanations dominate is challenging to discern ex post and each bid is likely to be circumstantial.

Interestingly there is evidence that institutional investors can have an influence on increasing the likelihood of value creation rather than value destruction. A recent US research paper found that concentrated holdings of a successful bidder by independent long-term institutional investors was positively related to positive post-merger performance and that the presence of these institutions makes the withdrawal of bad bids more likely.¹² The following quote from the Australian Financial Review is also interesting from the perspective of how institutional investors can affect decisions:

"Rare earth company Lynas Corporation has abandoned a contentious deal to sell two mineral deposits to a related party, Forge Resources, after heeding shareholder advice to concentrate on its core business.

... Lynas Chairman Nick Curtis, who is chairman of Forge, told the AFR it was ultimately feedback from the company's institutional investors that brought the deal undone. 'We reflected on the conversations we had with the major shareholders and good governance is about hearing and acting on shareholder conversations' he said." AFR 12 May 2011.

What do PE firms do around acquisitions?

PE firms' acquisitions are interesting from at least the perspective that they generally will not generate synergies. Consequently value creation will have to arise through improved operating performance and better governance. They make interesting case studies for this reason.

Following is a set of the activities PE firms engage in around acquisitions. This provides some insights into what governance activities a Board can focus on.¹³ All have a common theme of reducing agency costs through improved governance. There is growing evidence that 'good' governance generally (not just around acquisitions) leads to improved performance and value.¹⁴

1. Careful Due Diligence

PE firms either undertake or commission substantive research into the attractiveness of segments, the relative competitive position of the target in these segments and how these are likely to change over time. This fact base, in addition to usual financial and legal due diligence, often provides the most up-to-date view of the competitive environment and the relative status of the target available.

From this the PE firm can make an informed view of the strategic issues the business faces and therefore potential changes to strategy and operating performance that could create value. As noted below, this also forms a solid basis for strategic discussions with management.

In this regard Gadiesch and MacArthur note:



"The first thing that the best PE firms do is to develop a clear understanding of where and how a business makes money and why they'd want to own it. They conduct a rigorous and dispassionate due diligence, building an objective fact base of the business and its industry." P 28

This philosophy sits behind Value Adviser Associates' approach to strategy development.

2. Engage in Strategic Discussion with Management post acquisition

The fact base established in the due diligence phase provides a platform for subsequent updating and, more importantly, for engaging in detailed strategy discussions based on fact rather than opinion. The latter can be incredibly time wasting. The Board discussions post-acquisition are often more focussed on strategy than prior thus making the meetings more effective.

In this regard the following quote is appropriate:

"Strategy discussions often happen in corridors and at the time of unexpected events, like a takeover offer or opportunity. The strategic planning process is therefore really about establishing an agreed "fact base" so that on-going strategy discussions are constructive and on shared facts rather than based on intuition and opinions about the underlying competitive landscape that may well differ. Without a shared view of the fact base around the competitive environment then it is unlikely that there can be a shared view on the best strategy and path forward."¹⁵

3. Smaller and changed Board

There is evidence that PE firms both reduce the size of the Board and reconstruct the members to ensure the 'best' mix of skills. Wruck¹⁶ notes that the typical board of a PE controlled company has relatively few members (5 – 8) with only one executive director. These include individuals with strong management experience or industry expertise and financiers. Perhaps most importantly she notes that the Board has considerable equity based incentives.

Reducing the size often means less compromise, faster and 'harder' decisions.

Typically a non-executive and independent Chairman is appointed to maximise the 'ratify and monitor' responsibility of the Board. This tends to be less of a necessity in Australia than the US as it is more common to have the CEO as Chairman in the US thereby giving rise to a conflict of interest.

4. Clarification of decision rights / organisational responsibilities and improved governance processes

Often decision rights are 'decentralised' to the area where relative knowledge is greatest. When accompanied by a streamlined hierarchy, this can lead to more informed and 'faster' decision making.

Interestingly, the management team is often not changed however a tension develops between managements' strategy development/implementation and the 'oversight' / input by the Board. Where one stops and the other starts can get blurred and often requires frank discussion to get the mix 'right'. Clearly the objective is not to have two management teams – the Board and management.

Introducing a 'competitive' market for capital is another outcome whereby business units prepare high quality requests for capital carefully linked to supporting the approved strategy. This assists in creating a culture whereby capital is viewed as 'expensive' but readily available if the case is strong.

Similarly a culture of judicious cost management often results from scrutiny of plans and budgets.

One CFO of a firm that had been through a PE 'experience' commented on how the culture changed post PE acquisition to one whereby every dollar (albeit capital or operating cost) mattered and was scrutinised. He noted that this had stayed with him post re-listing.

Allied to this is another cultural change to a 'results' matter culture thereby increasing the focus of management to what does really matter in the end.

Value Adviser Associates encourages adoption of a set of management process that are not only linked together but also linked to a valuation of the business. Ideally strategy development is not only based on the fact base mentioned earlier but also pushed into forecasts of the likely financial outcomes enabling a

valuation of alternative strategies and selection of the best among alternatives i.e. that which has the greatest expected value creation. This latter activity enables a closer linkage between decisions and the likely impact on a goal of creating value.

The linkage of processes follows from strategy development to resource allocation to performance management to incentive compensation and to investor communications.

The strategy development process should define the capital and resources required to implement it over time thereby guiding the resource allocation process. A value creating strategy should attract the capital required to implement it. The first year of the strategic plan provides the basis of the budget which, in turn, feeds the targets for KPIs and performance monitoring. This process, in turn, feeds the KPIs and targets for rewarding executives for delivering or exceeding the Board approved strategic plan. A detailed understanding of the plan, and how it creates value, helps the business create and deliver an effective investor communication strategy (for listed firms).



5. Changed incentive compensation

"It's not how much you pay, but how" is the catchy but revealing title of an article by Michael Jensen and Kevin Murphy.¹⁷

Typically PE firms will restructure senior executive remuneration in a number of ways to reflect the sentiments of this title:

- » Increase the (long term) incentive component relative to base;
- » Ensure the performance hurdles are related to shareholder value drivers, including cash flow;
- » Increase the equity holdings to a level that can have a significant impact on executive wealth, thereby providing strong motivation for value enhancement (and retention).

Incentive schemes based on the drivers of value that management control provide powerful motivation to improve performance.

6. Short time horizon for implementation of change

PE firms usually have a 2–5 year horizon for investments. This means creating a sense of urgency to improve performance is an essential part of the changes made. Typically there is a 100 day and 3 year plan to bring about the change. This fits with the anecdotal statement that any synergies or performance improvement initiatives not implemented within the first two years after an acquisition will not be achieved.

7. Delisting

Several PE firms explicitly stated that one of the real benefits of a PE acquisition and delisting is that change can be implemented without worrying about quarterly earnings reports – that the longer term beneficial changes can occur 'below the horizon'.

Often changes will dilute EPS in the short term but with longer term increases. To the extent that the changes can be made without management worrying about the time and energy required to deal with analysts is a bonus. Certainly analyst 'road-shows' are expensive in terms of CEO and CFO time, let alone the distraction from achieving improved outcomes.

Delisting not only saves management time and assists with its focus but it also saves listing fees (usually a minimum of \$1M) and the quite significant compliance costs. If capital requirements and liquidity of shareholdings are not issues then it is appropriate to ask why a firm is listed.

8. High leverage?

Many PE acquisitions are associated with high leverage. While this adds to equity risk it has additional motivational / governance benefits.

- » The leverage often enable management to own a 'significant' share of the firm thereby providing enhanced motivation for value improvement;
- » The high interest payments enhance a focus on careful cash flow management to ensure they can be met. This, in turn, assists to create a cash flow culture in the business.

Wruck goes as far as to argue that leverage, per se, is a secondary driver of PE returns relative to the motivational / governance effects outlined.¹⁸

Implications for a Board of an Acquiring Firm

The setting for this paper was around what a Board member of an acquiring company can do to maximise the chance of an acquisition being value creating, especially given the poor record of the average acquiring company.

Examining the reasons for poor performance and looking to the actions of PE firms to improve governance provides a number of guidelines. One set of guidelines arising from such consideration is listed right.

1. Be on the front foot with corporate strategy – be pro-active in developing a value growth strategy that may or may not include acquisitions and don't be re-active to 'opportunistic' deals;
2. 'Demand' careful due diligence around a fact base for both the bidder and the target – ideally the bidder fact base is part of corporate strategy development process that precedes any acquisition activity;
3. Value the bidder and target on a stand-alone basis, assess the likely value enhancement from stand-alone improvements of the target as well as from synergies;
4. Ensure a maximum price is set from valuations and that the bidding process does not breach it. Walk away if necessary;
5. Ensure establishment of 100 day and longer term implementation and integration plan - and monitor progress;
6. Establish sense of urgency around improvements (100 day plan) – if most not there in 12 – 18 months they won't eventuate;
7. Ensure incentive based compensation linked to the drivers of value (and successful implementation);
8. Seek external valuation assistance to verify and challenge assumptions.

For more information on protecting shareholder value during M&A please contact Dr Steve Bishop at Value Adviser Associates on 03 9626 4300 or email s.bishop@vaassociates.com.au 

Notes:

2. The market for PE funds is becoming increasingly competitive making it difficult to simply buy at 'bargain' prices or below 'fair value'.
3. Fama E & M Jensen, "Separation of Ownership and Control", Journal of Law and Economics, 22 1983 provided a useful distinction between decision management, decision control and residual risk bearing. Decision management (initiate and implement) is the role of management, decision control (ratify and monitor) is the role of the Board and shareholders focus on diversifying to minimise risk. See also, Brickley, Smith and Zimmerman "Designing Organisations to Create Value" McGraw Hill 2003, Ch 12.
4. Bishop S, P Dodd & R Officer, "Australian Takeovers: The Empirical Evidence", CIS 1987.
5. Brown P & R da Silva Rosa, "Takeovers: who wins", JASSA, Summer 1997.
6. See R Bruner, "Applied Mergers & Acquisitions", Wiley, 2004, Ch 3 for a detailed summary of the empirical research.
7. Casey R, P Dolan & P Dodd, "Takeovers and Corporate Raiders: Empirical Evidence from Extended Event Studies", The Australian Journal of Management, December 1987.
8. T Walter, Australian Takeovers: capital market efficiency and shareholder risk and return", The Australian Journal of Management, 1987, 9.
9. Kaplan S & A Schoar, "Private Equity Performance: returns, Persistence and Capital Flows", Journal of Finance, August 2005.
10. Gadiesch O & H MacArthur, "Memo to the CEO: Lessons from Private Equity any Company Can Use", Harvard Business Press, 2008.
11. Melbourne Centre for Financial Studies, "Public Companies being taken private:" A research report into private equity", Study commissioned for the Australian Council of Super Investors, August 2009.
12. Chen X, J Harford & L Kai, "Monitoring: Which institutions matter?", Journal of Financial Economics, 86, 2007.
13. The list has been derived from various sources including discussions with PE firms, and articles including Gadiesch O & H MacArthur, op cit; K Wruck, "Private Equity, Corporate Governance, and the Reinvention of the Market for Corporate Control", Journal of Applied Corporate Finance, Summer 2008, "The Future of Private Equity" An interview with Steve Kaplan, Journal of Applied Corporate Finance, Summer 2009, ACFs op. cit. and Bruner op. cit.
14. See Bruner op. cit. Ch 26 for a discussion of some of this evidence.
15. Unfortunately I've lost the exact source but I recall the sentiments being attributed to Henry Mintzberg. See Kaplan S & Beinhocker, "The Real Value of Strategic Planning", MIT Sloan Management Review, Winter 2003.
16. Wruck op cit p 11.
17. Jensen M & K Murphy, Harvard Business Review, May-June 1990
18. Wruck, op. cit.

Revisiting Incentive Compensation Packages?

"What is measured gets managed" is a common but realistic statement related to considering the design of incentive compensation systems. Value Adviser Associates primarily designs packages that have performance measures that link to the drivers of shareholder value (see [Valuation Matters, December 2010](#)). Similarly we recognise that performance plans need to be expensed under AASB 2. Consequently this is another important consideration when designing a package – how easy is it to value it?



We are just completing a review of a sample of 70 listed companies including 50 of the top 100 companies across industry sectors and around 20 small to mid-size companies, to update our understanding of practices in the structure of incentive compensation packages and the type of performance measures used for top executives. We would be happy to share this with you. Some highlights are:

- » An analysis of the make-up of executive remuneration by base, short-term incentive ("STI") and long-term incentive ("LTI") components across industries, showing significant variation in remuneration structure employed;
- » Short-term measures used by companies included both financial and non-financial measures, but the type of measures employed varied significantly, with around 35% using an economic based measure such as EVA, cash flow or ROI. In addition, the use of traditional accounting measures such as NPAT and EPS is still strong;
- » Short-term incentives are mostly structured as a cash reward;
- » The majority (70%) of long-term incentives included a market component, usually a measure of relative total shareholder return ("TSR") versus a select peer group;
- » However, a significant proportion (43%) included both a market measure (such as TSR) and an internal measure of performance such as NPAT or EPS;
- » Long-term incentives are mostly structured as performance rights following changes to the taxing of options in 2009;

» In addition, a growing proportion of companies have minimum shareholding requirements to maximise the "wealth leverage" of senior executives to shareholder value. 

For further information please contact Corporate Adviser Justin O'Brien at Value Adviser Associates.



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11th Annual States' Taxation Conference




For the 4th consecutive year Value Adviser Associates is the executive sponsor of The Tax Institute's 11th Annual States' Taxation Conference. Held on the banks of the Yarra River at the Crown Conference Centre in Melbourne the Tax Institute will host over 150 delegates on Thursday 28th July and Friday 29th of July 2011.

As in previous years all state and territory revenue commissioners will be there with representatives from their respective offices. The hot topics for this conference will be anti-avoidance provisions, private and public rulings and appeals to tribunals. The program will also include an update on the reforms to the various landholder/landrich models.

This year sees an exciting addition with Value Adviser Associates hosting a CPD lunch session – the session will cover Valuations in Stamp Duty: including land, non-land and identifiable intangibles.

There are only 56 places available at the lunch. If you want to guarantee yourself a spot, you must register to attend the conference, and then contact The Tax Institute's National Events team on nationalevents@taxinstitute.com.au to indicate you wish to attend the Value Adviser Associates lunch.

The link for the event registration is <http://www.taxinstitute.com.au/events-and-education/upcoming-cpd-events/EVENTID/1110707M1> 

Value Adviser Associates update



Round Table Lunches

Are you an investor in unlisted investments?

If the answer is yes, you will be interested to know that our upcoming Sydney and Melbourne Round Table Lunch series will be focussed on the role of 'alpha' or discount rate adjustments for non-systematic risk.

Frequently used as a catch-all for (often) unquantifiable risks, alpha is both the source of returns for most managers and the subject of extensive debate amongst investors and valuers.

Watch your inbox for an invitation to a Round Table Lunch soon or contact Kylmyn Cowburn-Cainer on 1800 912 226 or k.cainer@vaassociates.com.au for more details.

CPA Australia's National Valuation of Equity and Other Securities Forum panel



In June Michael Churchill was invited by CPA Australia to be the key Victorian contact for the CPA Australia's National Valuation of Equity and Other Securities Forum panel. Phillip Mann of Value Adviser Associates is already a member, representing South Australia.

The purpose of this national panel is to coordinate forums and webinars to direct and guide contemporary points of discussion for experts in valuation today. Recent topics of interest have been Calculation of Beta post GFC, Family Controlled Business Valuation and Carbon Investing; the impact on valuation.

This panel is perfectly aligned with Michael Churchill's skill set and Michael is very keen to be a part of this initiative from CPA Australia.



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As seen in JASSA, Adjusting the MRP to reflect the GFC

Dr Steven Bishop, Michael Fitzsimmons and Prof Bob Officer prepared an article published in JASSA, the FINIA journal of Applied Finance examining how to deal with the increase in stock market risk arising from the global financial crisis when estimating the cost of capital.

JASSA is a quarterly publication that provides subscribers current, relevant and up to date articles in the financial services industry. This publication offers peer reviewed technical analysis research in the financial services industry. In its 41st year of publication it is a great honour to see Dr Steve as well as his esteemed collaborators publish a peer reviewed relevant article pertinent to what is happening right now.

[To read the full article please click here.](#)

ADJUSTING THE MARKET RISK PREMIUM TO REFLECT THE GLOBAL FINANCIAL CRISIS

Because of the substantial increase in stock market risk arising from the global financial crisis, it is not appropriate to use a constant market risk premium (MRP) when estimating the cost of equity. This is particularly so when estimates of the weighted average cost of capital include the current high risk premiums on debt but this is not reflected in the equity MRP. We propose a method for adjusting the MRP to reflect unusual risk situations.



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The global financial crisis (GFC) has had a significant impact on the capital market. The stock market return for 2008 was negative 40 per cent, the lowest in the 126-year recorded history of market returns. The most recent available data (as at early December 2010) show that market risk as defined by the variance of the market index, although declining from its peak, is still over 60 per cent above our estimate of the long-term average level of market risk.

There is an obvious link between the increase in market risk and the decrease in equity values. We argue that the market risk premium has risen to reflect this increased risk, and we suggest a method which reflects this increased risk in the cost of equity used for business valuations.

The increase in risk is very apparent in debt markets. Debt margins on BBB-rated corporate bonds are around 400 basis points (bps) above the 10-year Commonwealth Treasury bond rate compared with an average of around 120 bps prior to the GFC. While this is apparent in debt markets, estimating a weighted average cost of capital (WACC) also requires an estimate of the cost of equity capital. If we were to follow the common practice of using a 6 per cent market risk premium (MRP) in the Capital Asset Pricing Model (CAPM), which is used under more 'normal circumstances', then the outcome would be a substantial narrowing of the difference between the risk premium on equity relative to debt. However, we argue that this could be misleading since the risk premium on equity would be expected to rise, at least commensurately with the risk premium on debt.

As we have indicated above, the cost of equity can be estimated using the CAPM. The CAPM defines the cost of equity as a risk-free rate plus a premium for risk, where risk is a market risk premium multiplied by beta (a measure of the risk of an asset relative to market risk). Since beta is a relative measure of risk, the impact of the GFC on the overall market return is unlikely to be reflected in changes in beta (the market beta will still be one). The overall market adjustment must be reflected in the MRP.

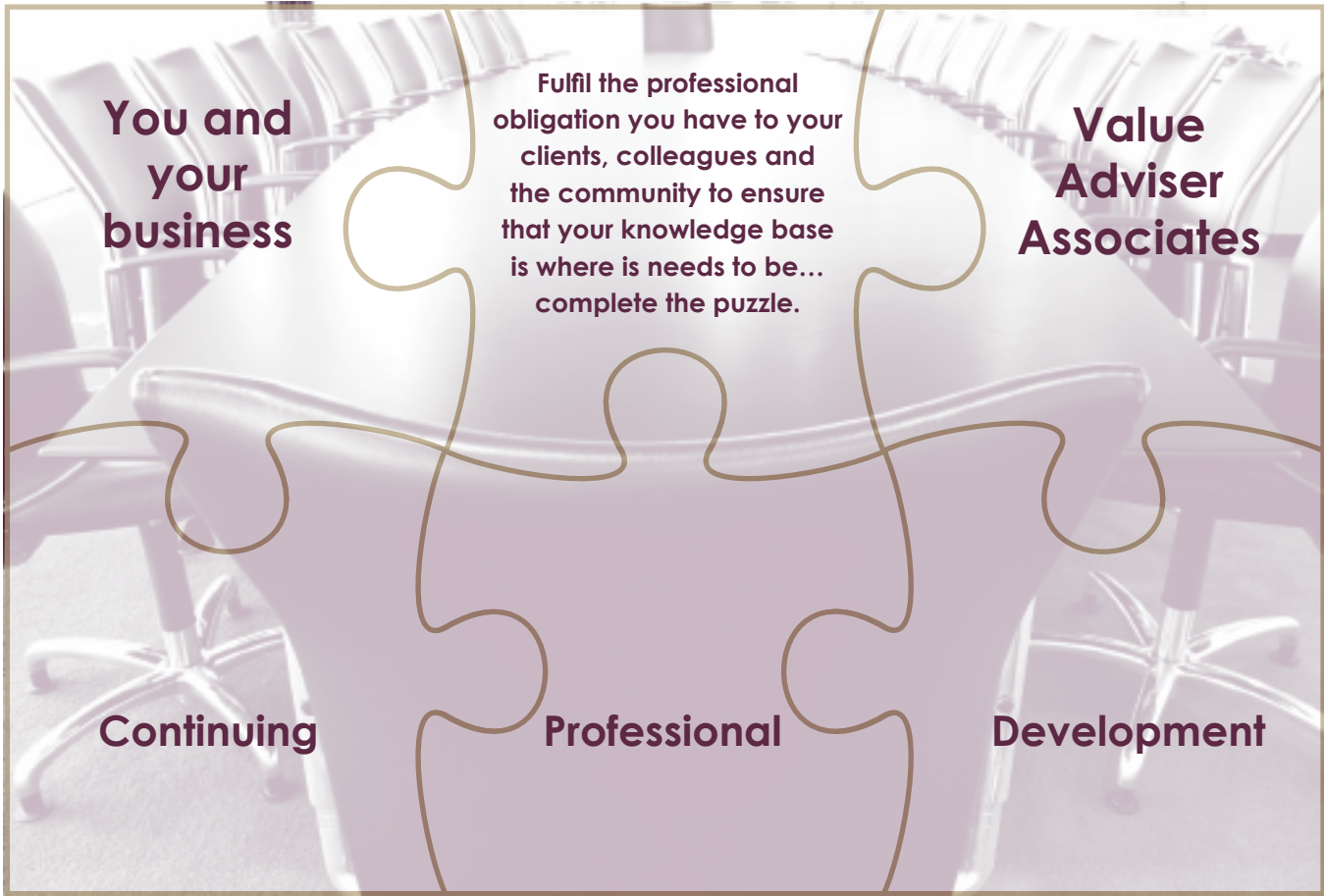
The MRP is a forward-looking risk premium and will change over time to reflect the changing view of risk and attitudes to risk on the part of risk-averse investors who require a positive risk premium relative to a risk-free asset. We would expect the MRP to vary within an average range of, say, 5 per cent to 7 per cent.

The method we use to estimate the current forward view of the annual MRP is to assume a constant required premium per unit of risk, implying increasing risk would increase the risk premium (the expected, or required, MRP), and conversely for

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Completing the CPD puzzle – CPD sessions

This year Value Adviser Associates has launched a great way for clients to sharpen skills and increase their confidence and ability to commercially apply knowledge.

In an increasing time poor working environment wouldn't it be great to have an expert come to you and give you and your colleagues a 45 minute session to give you the competitive edge?

Value Adviser Associates offer valuation and advisory services to meet decision management, compliance and transaction advisory needs across a wide range of industries and to both public and private businesses.

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Valuations in commercial and regulator disputes

- » Measurement issues
- » Methodology vs. application
- » Briefing the expert
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- » Recent 'land rich' issues
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Value Adviser Associates welcomes the opportunity to develop a CPD session that is specifically designed to meet your requirements.

Sessions include:

- » 45 minute session that is sharp and to the point
- » We come to you
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- » Supporting material provided for future reference
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Here is what some CPD session participants have said:

"We found it very comprehensive and would be useful if we needed to get a valuation of a business done."

"The feedback after your session was very positive. Everyone enjoyed your presentation style...and found the content valuable and relevant."

Contact Kylmyn Cowburn-Cainer on 1800 912 226 or k.cainer@vaassociates.com.au to find out more about Value Adviser Associates CPD sessions. 

WACC workshops

In March and April this year Value Adviser Associates ran another three WACC workshops in conjunction with the ACFS (Australian Centre for Financial Studies).

The brainchild of Value Adviser Associates and riding on the coat tails of the sell out workshop in October last year more WACC workshops were held in Sydney on 31st March, Brisbane on the 1st April and in Adelaide on the 18th April 2011.



It was great to see current and previous clients, academics, researchers as well as new faces attend the three workshops. It was also great to have a full house at each venue.

Replicating the format of the Melbourne WACC workshop designed for an intimate exchange of ideas with experienced and relevant speakers plus a panel of industry experts the workshops were clear concise and entertaining.

Dr Steve Bishop and Prof Bob Officer's presentation style combined a wealth of experience and knowledge with real life commercial application. Coupled with industry experts and chaired by Dr Kevin Davies of the ACFS the delegates to feel relaxed, informed and became actively involved in the workshop.

It was wonderful to see Mark Day from Value Adviser Associates amongst the speakers in Adelaide providing local and relevant content to the South Australian workshop.

Value Adviser Associates will be running WACC workshops on an annual basis. If you are interested in when the next series will be please contact Kerrie Doherty on k.doherty@vaassociates.com.au.

Value Adviser Associates is a specialist valuation firm providing services in assisting firms create and deliver shareholder value through strategic planning linked explicitly to financial forecasts and valuations, capital expenditure evaluation, M&A due diligence and compensation design.

In addition, Value Adviser Associates provides valuation services for compliance purposes, e.g. Independent Expert Reports, purchase price allocations, tax consolidations, AIFRS reporting. Further information is available on our website www.vaassociates.com.au or call 1800 912 226.

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