

Valuation Matters

a regular newsletter from Value Adviser Associates

Capital markets update

by Michael Churchill

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

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With European debt markets the topic on most lips, a 2011 wrap couldn't start without contemplating what major debt write-offs mean for this part of the world...

The US economy is down but not out. China has slowed.

Major European debt write-offs (Italy needs to carve up to €1 trillion off its debt to have a sustainable level of debt) will cause shock waves through the European banks that have lent to Italy and Greece.

This year saw a number of smaller Spanish PPPs defaulting on concession payments. Not only do we see sovereign debt costs at all time highs (Greece is 25% and showing no signs of reverting any time soon) but the view of many investors that PPPs represent safe havens has been shattered.

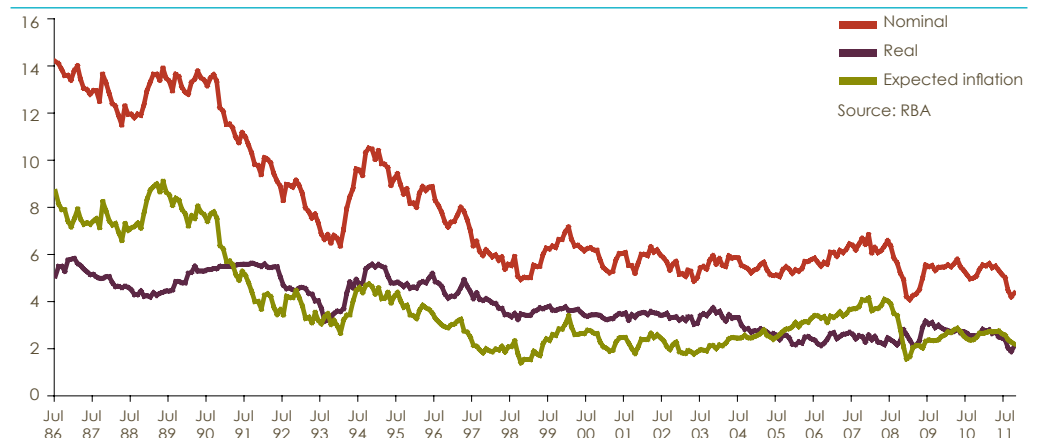
The knock-on effect for Australia is likely to manifest as lower exports and a significantly lower dollar. The AUD is seen by the rest of the world as a leverage play on Chinese growth. A drop in European and US demand will slow the Chinese economy and consequently, Australian production. It has been suggested that we could see the AUD at 0.70 once again.

However, whilst this is good news for unhedged exporters, the AUD is expected to rebound strongly when the turmoil has passed and most pundits believe we will see the AUD : USD in a range of 1.30 to 1.70 in the mid to longer term.

Interestingly, our government bonds are trading at a low level (around 4%) – less than the implied long-term inflation outlook of around 3% and a real interest rate of around 2.5%. This phenomenon is described as a convenience yield, reflecting the demand for low-risk assets and a flight to quality. Investors are effectively over-pricing our bonds in order to reduce the risk of loss of capital.



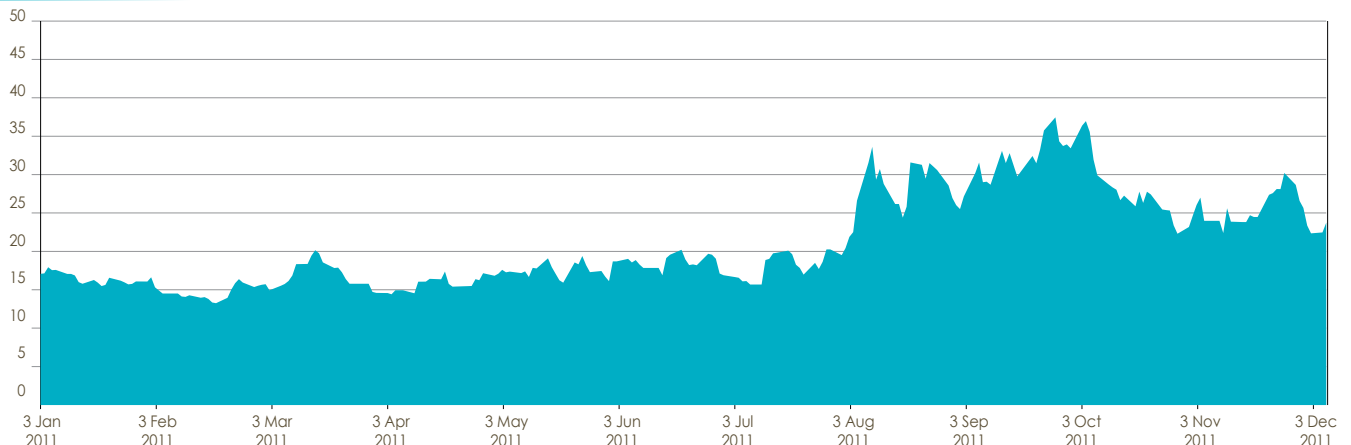
Indexed & Nominal Treasury Bonds (%)



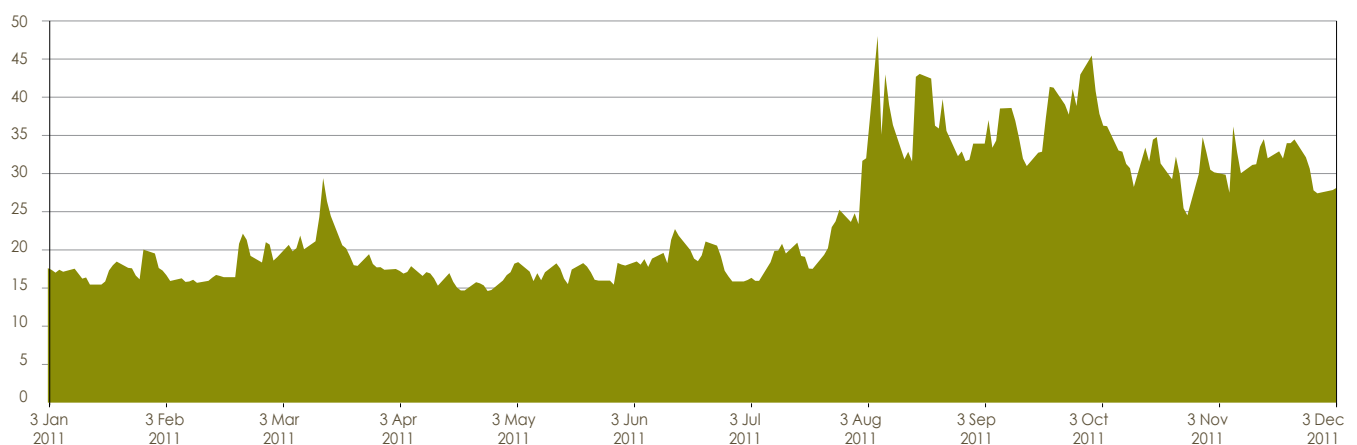
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Equities Volatility, Australia 2011 (%)



Equities Volatility, US 2011 (%)



By comparison, the equities markets remain turbulent with the VIX (a useful measure of short-term return expectations due to high correlation with the equity market risk premium) sitting in a trading range of 30-40%. What does this mean? The VIX is one of the few actively-traded instruments which prices the volatility of the S&P500 (and there is an equivalent Australian instrument known as VXI). The volatility measure is calculated by reference to options over the S&P500. The near-perfect correlation with the equity market risk premium means we can use the VIX as a proxy for short-term market returns.

Currently, the outlook for equity market returns is in excess of 18% (a riskless return of 4% and a 12-month expectation of equity risk premium of around 14%).

Sounds unlikely? Not so.

We've seen short-dated instruments issued in the current market which closely match this construct. On balance, the cost of capital in most sectors has risen slightly during the year – largely due to the short-term volatility and the failure of credit spreads to revert to long-term averages.

However, the more significant issue for valuations is the possibility of cashflow/earnings weaknesses as a consequence of the two-speed economy, weaker demand in our major trading partners and critical skill shortages in the resources sector impacting operating costs.

The carbon tax and MRRT will also have a bearing on the profitability of many of the larger emitters and resources companies. However, the net position for the economy is nil as the carbon tax and MRRT spoils are redistributed around the economy (in the form of government spending, compensation and incentives in the renewable energy sector).

Don't expect any coal fired generators to be shutting down anytime soon though – we just don't have the capacity in the installed generators or a pipeline of projects to fill the void left by knocking out a large proportion of supply (e.g. Loy Yang A – one of the generators that we value – provides 2gW of power to Victoria and South Australia and there is no near-term substitute). ▽▲



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Carbon Tax Readiness



Your solution to risk and uncertainty

If you operate, or have a fund investment in, a company with large CO₂ emissions, the introduction of the Carbon Tax next July could materially impact the value of the company.

The "500 biggest polluters" will pay \$23 per tonne CO₂e in F2013; rising by 2.5% per year until an ETS is introduced in F2016 ... maybe!

Looking at the 200 biggest Scope 1 emitters¹ the estimated cost of the carbon tax is over \$8B per year; with a potential impact on market value over \$64B².

And it is not just the very large emitters (top 50) that could be materially impacted... the average market value (negative) impact of the second 50 emitters is estimated to be greater than \$100m each... based simply on costs.

Remember that while Scope 1 costs can be reasonably estimated, the impact on the revenue line is harder to gauge.

What's your situation?

For many the value impact will be immaterial; for some it will be marginal; and for some it will be material.

The initial questions appear straightforward:

- Do you know the likely carbon tax cost to the business (and how reliable is that estimate)?
- How will the value of the company be impacted by the carbon tax?

But those initial questions come with a brace of follow-on questions which are more complex and time-consuming:

- What tolerance do you have for a "do nothing" response?
- What carbon price causes a rethink of this answer?

- What strategic options are available if the expected carbon tax impact is greater than the tolerable level?
- Has the business case been developed for each strategic option?
- How has the possibility that the carbon price is short-lived been addressed?
- Has the company built capability to effectively manage its carbon risk?


This is uncharted territory for most of us... with associated uncertainties and risks. As a business valuation specialist, Value Adviser Associates is able to assess the value impact of the carbon tax on your business.

We also have a range of services to help companies respond strategically – from management education to devising strategic options to value analysis and business casing those options.

Value Adviser Associates has developed a quick and simple diagnostic which provides a preliminary assessment of two key issues:

- What is the impact of the carbon tax on our business value?
- And, how ready are we to strategically respond?

The diagnostic informs management where it needs to focus to manage through the uncertainty and risk.

Contact Michael Churchill or Alan Edwards on 03 9626 4300 to discuss a diagnostic for your business or investment; or to discuss our full Carbon Tax Readiness services suite. 

¹ NGER 2010

² Not adjusting for Federal Government compensations e.g. emissions intensive/trade exposed



Fundamentals of beta

Value Adviser Associates' clients may be interested in how we arrive at our equity beta assessments.

What approach do we use and why do we use this approach? Do we pass off adjustments as 'professional judgement' by plucking a figure off the computer screen or do we take the time to consider or 'ponder' how we arrive at the beta calculations?

Projects that the team work on often require analysis of the criteria used by other valuers to arrive at beta. In order for us to understand the process they use, we compare their criteria to the approach used by Value Adviser Associates. There have been some interesting results that have emerged.

There are a number of choices that need to be considered in assessing an appropriate equity beta from a peer group including total returns vs. price returns, monthly vs. weekly, two years vs. five years time horizon. The information following offers a little insight into why these are important and the differences which can emerge.

Case study

We recently advised a client on the value of a funds management subsidiary and discovered that the default Bloomberg/Reuters equity beta was showing a median of around 0.7.

This immediately struck us as being unlikely given the fundamentals of the funds management industry – we expected to see a number around 1.5.

On closer examination the difference lay principally in the fact that both Bloomberg and Reuters default to a two-year price-only basis of beta estimation.

This massive difference caused us to look more closely at the data providers' beta estimation approach and the outcomes are summarised below.

Total returns/ price returns

Total returns consider both price appreciation and dividends.

Price returns only consider the price appreciation.

Total return relates to variation of the relative risks of market.

The difference between the beta when using total returns and price returns may not be too great, however, total returns reflects all the gains a stock has earned over a period of time and is our preferred approach for beta estimation.

The following table highlights the difference in beta resulting from the use of price vs. total return estimates. The selected companies are all (broadly speaking) from the fund/wealth management community.

Table 1: difference between the median beta derived from price and total return measures

Name	5 Year Monthly		Diff ⁿ
	Price Return	Total Return	
Platinum Asset Management	0.7093	0.7385	(0.0291)
IOOF Holdings Ltd	1.2433	1.2369	0.0065
Perpetual Ltd	1.2145	1.2671	(0.0526)
BT Investment Management Ltd	1.4755	1.4465	0.0290
Hunter Hall International Ltd	1.7662	1.7415	0.0247
Treasury Group Ltd	1.8528	1.8395	0.0132
Australian Ethical Investment Ltd	1.1379	1.1789	(0.0410)
K2 Asset Management Holdings	2.3733	2.2976	0.0757
Magellan Financial Group Ltd	1.6708	1.6889	(0.0182)
Fiducian Portfolio Services	0.8925	0.9010	(0.0085)
HFA Holdings Ltd	3.5201	3.3492	0.1709
MEAN	1.6233	1.6078	
MEDIAN	1.4755	1.4465	

Monthly / weekly

Monthly data will be less noisy in terms of information related to trading than weekly data; making it a better criteria to arrive at long term beta (refer table 2).

Two years / five years

The statistical significance is an important factor when arriving at beta.

Value Adviser Associates recommends five years worth of data points to arrive at beta, as opposed to two years which will not contain enough trading data and a period over five years may not reflect the current market conditions (refer table 2).

An argument that is sometimes presented is that the GFC has been a one-off event and should not be included in the data set. However, there are regular market events which cause major changes in market capitalisation and the use of a two year term excludes the inevitability that there will be more such events in the future.

Dimson beta

Dimson betas are used to assess the impact of serial correlation in indices (which is caused by infrequent trading) on 5 year weekly and 5 year monthly betas. This shows that serial correlation has a significant impact on weekly betas, but no impact on monthly betas. Thus monthly betas are more accurate and are preferred (refer table 2).

Note: Our Dimson betas are computed by omitting missing data points, rather than using Bloomberg's standard approach to missing data.

Value Adviser Associates prefers five year monthly (i.e. 60 data points) total returns; however, the impact on beta through price returns instead of total returns is not significant. When compared two year weekly with five year monthly price returns, the weekly data is significantly impacted by thin trading. Hence, a reasonable alternative would be to calculate beta using five year monthly price returns.

Table 2: Beta Bridge

	Default Reuters data	Dimson beta calcs show monthly obs are more accurate	Beta increases over time shows 5 year window is better	Theory shows yearly return is more appropriate	VAA Preferred Approach	Dimson Beta
Periodicity	Weekly	Weekly	Weekly	Monthly	Monthly	Weekly
Time Window	2 year	5 year	5 year	5 year	5 year	5 year
Return Type	Price Return	Price Return	Price Return	Price Return	Total Return	Price Return
Overall Avg Eq Beta	0.8491	0.9713	1.4336	1.6078	1.5198	
Overall Median Eq Beta	0.7593	1.0162	1.3594	1.4465	1.4465	

Conclusion

Be wary of the default Bloomberg and Reuters beta estimates. They are not "wrong" per se but suffer some fundamental flaws which can be quickly and readily remedied. Both data providers use two-year price-only return measures as the default.

Our preferred approach is to use five-year total returns and adjust for thin trading if the companies are particularly thinly traded. The difference in outcome can be significant and result in some pretty wild valuation outcomes!

Call Thushani Fernando or Gareth Thompson if you would like help in changing the default settings in Bloomberg to get a better answer. 📞



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Incentive plan design solutions at your fingertips



Aligning incentive compensation to shareholder wealth creation and the two strikes policy

by Justin O'Brien

Over the past 10 years, both executive base salaries and total executive compensation (including short and long-term incentives) in Australia have grown at a compound rate of 10% p.a.

In contrast, the ASX200 (price and dividends) has grown at only 3% p.a. - well below the equity cost of capital.

The recently introduced 'two strikes' policy (whereby shareholders can now vote to spill a Board if the remuneration report receives a "no" vote from more than 25% of shareholders two years in a row) is forcing many Australian companies to re-examine how aligned their incentive plans are to shareholder value creation.

Value Adviser Associates has developed an offering to help support clients better align their compensation schemes. Right alignment requires understanding wealth creation targets, a long-term value creating strategic plan, detailed knowledge of shareholder embedded expectations, and how key value drivers should be cascaded through the organisation.

As well as a clear understanding of benchmark practices for how compensation is split, what the short and long-term measures should be, and other considerations including form (performance rights, shares), vesting, tax, and ease of implementation for fair value accounting.

We have developed a short-form diagnostic that can quickly assess likely areas of concern for shareholders, and potential sources of misalignment.

Contact Justin O'Brien to discuss how Value Adviser Associates can help. 



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Value Adviser Associates update

Events wrap for 2011



2011 has been another great year for Value Adviser Associates. We have increased our service offering to clients, introduced some great marketing initiatives, welcomed new clients whilst still offering current clients the same (if not better) levels of service.

Value Adviser Associates successfully launched a CPD program this year. Clients have relished the opportunity to have a team member from Value Adviser Associates conduct a professional development session. In an ever increasing time-poor working environment a 45 minute session allows clients to bridge the gap they may have in the commercial application of their knowledge, meet an industry expert, have reference material to keep and to top it off, this session is conducted at the clients premises.

Round Table Lunches (RTLs) were a big hit this year – 14 events, five states, many plates of delicious food devoured accompanied by a premium wine selection and, of course, great topics of conversation were had on relevant matters – the use of alpha, the impact of carbon tax, incentive compensation, to name a few. For those that attended one of our RTLs this year, thank you for attending. For those that couldn't make it, don't worry we will be running them again in 2012.

This year has seen the ongoing demand for governance work, valuation services and M&A assignments. To add to this Value Adviser Associates has worked on an increasing number of independent expert reports, dispute work relating to managed investment schemes and welcomed some significant fund managers to our ever growing stable of quality clients. Welcome aboard Palisade Investment Partners, Australian Super and Access Capital Advisors, to name a few.

Meet a new team member

A CPA and an AMCA; Thushani Fernando started working at Value Adviser Associates in July this year.



As an experienced analyst with over 9 years of experience covering both domestic and international markets Thushani is a great addition to the team, providing ongoing support to the senior team.

Her previous roles includes Advisor at KPMG, and an Associate Vice President at AMBA Research where she has provided extensive analyst work which includes capital market research, building models, valuation support. The clients she worked for includes hedge funds, investment banks, an institutional asset management company, a pension fund, among many others.

Contact Thushani in our Melbourne office on 03 9626 4300 or at t.fernando@vaassociates.com.au

Congratulations

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congratulates

Havilah Resources Ltd

on moving to a 90% holding of

GEOTHERMAL RESOURCES LTD

Value Adviser Associates is proud to have provided Geothermal shareholders with an Independent Expert Report in relation to Havilah's offer.

September 2011

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 ValueAdviserAssociates
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provided the Independent Expert Report to the Independent Directors of

TATURA MILK INDUSTRIES PTY LTD

in relation to the Scheme of Arrangement offer from

Bega Cheese Limited

November 2011

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All the team at Value Adviser Associates wishes you a Merry Christmas and a happy and prosperous New Year.

Our offices will be closed from close of business, Friday 23 December 2011 and will reopen on Monday 9 January 2012.

Any urgent messages will be returned by a member the team during the office closure. 

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