LISBON SCHOOL OF ECONOMICS & MANAGEMENT
UNIVERSIDADE DE LISBOA

Master in Finance
Mergers, Acquisitions and Restructurings

Introduction to Business Valuation

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Empirical research evidences weak performance of M&A

- MANAGEMENT APPROACH
  - Managerialism (Reid, 1968; Mueller, 1969)
  - Agency (Jensen & Meckling, 1976)
- RISK APPROACH (Gort & Hogarty, 1980)
- STRATEGIC RELATIONSHIP
  - Horizontal and Vertical M&A show better performance (Chatterjee, 1986; Sing & Montgomery, 1987; Shelton, 1988)
  - Lack of cultural and strategic compatibility imply weaker performance (Kitching, 1967; Perry, 1986; Hunt, Lees & Vivian (1987)
- PRICE
  - Hubris (Roll, 1986)
  - Winner's Curse (Varaya & Ferris, 1987)
- MANAGING THE PROCESS OF M&A
  - (Mirvis, 1985; Jemison & Sitkin, 1986; Haspelagh & Jemison, 1991)
- TIMING OF M&A
  - (Neves, 1993)

VALUE CREATION IS THE BASIC CRITERIA TO EVALUATE THE SUCCESS OF M&A

Why value-creation strategies are essential

- Value creation, long-term growth and profitability occurs when companies develop a continuous stream of products and services that offer unique and compelling benefits to a chosen set of customers.
- This means that to maintain industry leadership, a company must establish a sustainable process of value creation

Why is value so volatile?

- Contingency
- Subjectivity/Perceptions
- Context
- Information availability
- Objectives of the valuation
- Preferences
- Values and beliefs
- Assumptions
- Interests

Different perceptions of value

"Valuation is not an objective exercise, and any preconceptions and biases that an analyst brings to the process will find its way into the value"

Aswath Damodaran

Definitions of value

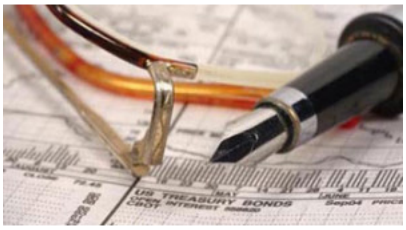
- Market value
- Fair value – accounting vs ISV
- Intrinsic or fundamental value
- Going concern value
- Liquidation
- Control value
- Minority shareholder value (non-control value)
- Illiquid value of shares
- Equity value vs. Enterprise Value

Misconceptions on Valuations

- Myth 1: A valuation is an objective search for "true" value
  - All valuations tend to be biased. The questions are: how much and in which direction
  - The direction of bias depends on who pays the fee
  - The magnitude of bias depends on the amount of the fee
- Myth 2: A good valuation provides a precise estimate of value
  - There are no precise valuation. An interval is likely to be more valid
  - The payoff to valuation is greatest when valuation is least precise.
- Myth 3: The more quantitative a model, the better the valuation
  - One's understanding of a valuation model is inversely proportional to the number of inputs required for the model
  - Simpler valuation models do much better than complex ones

Role of valuator

- What is more relevant? The process or the final result?
- Need for strategic and operational information, besides financial data. Importance of due dilligence
- Value is a function of the information available
- Data and information collection
- Additional relevant information may change the expected value
- Need for continuous update



Understanding the context of valuation

- The basics first:
  - On going value vs Liquidation value
  - Degree of control and distribution of ownership
  - Liquidity of shares
  - Valuation purpose
- Valuation in different life cycles
  - Research, start-up, growth, maturity and decline
  - Ongoing vs liquidation
  - Profitable vs unprofitable
- Valuing requires to know very well:
  - The industry and industry dynamics - the business, the competitors, the environment, etc.
  - The economy and its impact in the business
  - The organization
  - The capability to generate profits and cash-flow

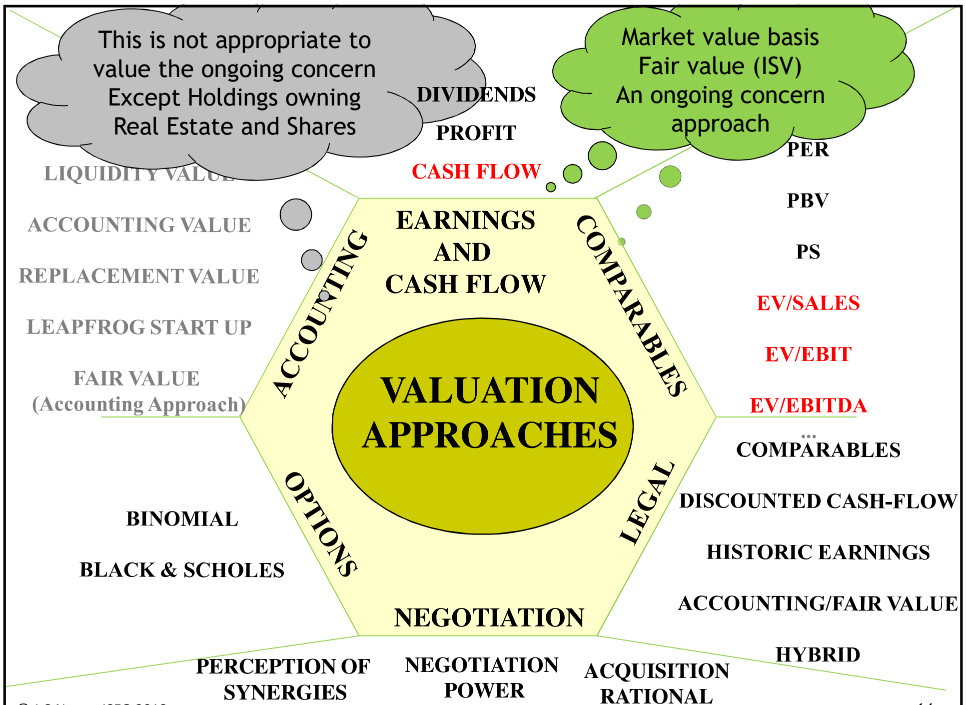
The various uses of valuation

- Fortune, Business Week, etc - performance index
- M&A
- MBO e MBI
- Privatizations
- IPO - Initial Public Offers
- Spin-offs
- Corporate restruturings
- Management Performance evaluation

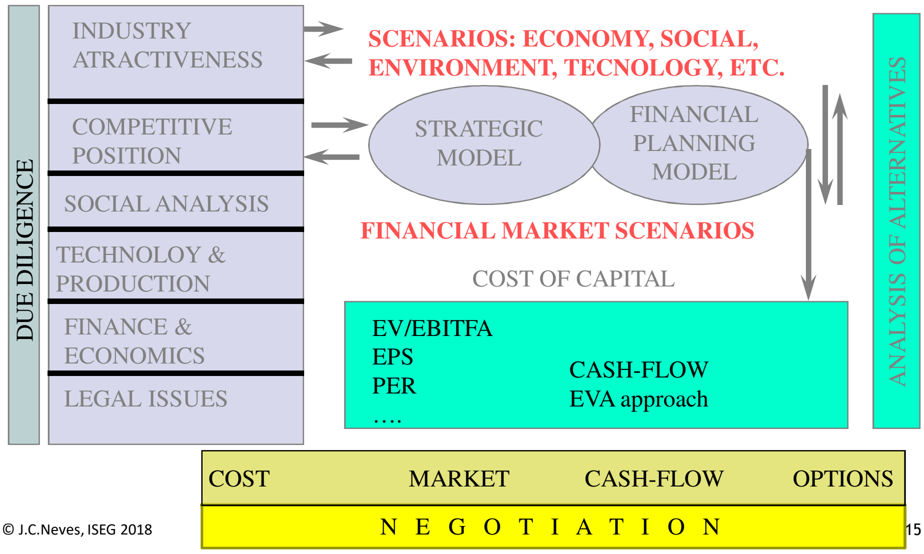
Due diligence

"Search for relevant information concerning the value of all relevant assets and liabilities, business opportunities and risks associated to the past, present e future of the target company"
João Carvalho das Neves

VALUATION METHODS



The valuation process



THE USE OF ACCOUNTING INFORMATION

Accounting do not reflect the company value

Cost of assets is not the market value of assets

Market value of assets is not the market value of a company

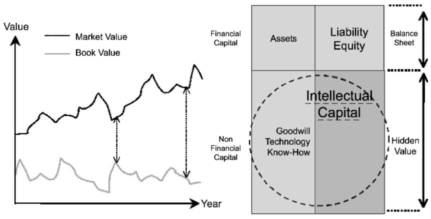
- Accounting doesn’t reflect the business goodwill
  - Human capital
  - Competitive advantages
  - Market position
  - Trademark
  - Growth expectations
  - Etc.
- As well as the power distribution, motivation and number of investors in a transaction

The equity book value

- Assets minus Liabilities = Book Value
- This is not the market value of a company

Adjusted Book Value

- Each item in the balance sheet is adjusted for the market value
- Different Criteia:
  - Replacement value
  - Liquidation value
  - Fair value
- Most relevant adjustments:
  - Hidden reserves
  - Hidden liabilities
- For holding companies that keep exclusively quoted firms in their portfolio adjusted book value is an adequate method for valuation



Source: Market Intelligence Center, Taiwan (2003)

Hidden Reserves and Liabilities

- Hidden reserves?
  - Undervalued assets
  - Overvalued liabilities
- Hidden liabilities?
  - Overvalued assets
  - Undervalued liabilities
- How to adjust?:
  - Using the generally accepted accounting principles
  - Fair market value