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Company valuations

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EPF ECOLE D'INGENIEURS

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The origins of valuation

1

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Definition

A valuation is an estimate, based on objective criteria, of the value or the potential value that is being put forward based on subsequent transactions.

- **Such as :**
  - Mergers & Acquisitions,
  - Restructuring,
  - Company mergers,
  - Financing and/or Refinancing,
  - Ability to develop a project,
  - Technical or economic performance.

All these valuation transactions are differentiated by the tools and methods that they employ

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Why use valuations?

To:

- **Improve the competitiveness** of the company (Quality, Innovation, consistency and cohesion of the organisation, etc.),
- Allocate **the real contribution** that different parts of the organisation make to the **value created** by the company fairly (according to objective criteria),
- Be able **to compare oneself with others** (customers, suppliers, partners or competitors),
- Highlight and **develop internal synergies** and/or other potential areas for improvement,
- Put **management indicators in place.**

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In what circumstances?

When:

- An investment is made,
  - On a professional basis: the investor wants to be involved in a company on a long-term basis
  - on a speculative basis: realisation of short or medium-term gains on the acquired company
- A succession takes place,
- The merger or tie-up exchange parity is calculated,
- The company restructures internally,
  - due to the market (lack of competitiveness)
  - due to pressure from shareholders (inadequate profitability)
- New partners appear (customers, suppliers, peers)
- The company is looking for strategic partners
- There is a capital increase or a stock market listing,
- Consolidation and/or vertical deconsolidation transactions take place.

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For what purpose?

To meet various specific requirements:

- **The buyer and/or the seller**: their interests are very different, hence the need for each party to use its own advisors,
- **Employee committee** employees, during mergers, restructuring and redundancy plans,
- Employees, when a **company is being bought out** by its employees (LBO),
- **Partners**, when capital is being withdrawn, especially where an internal dispute arises,
- **Banks and investment funds**, in order to renew their asset portfolios,
- **Future partners**, in order to assess the technical and financial potential of the target company, and to generate external growth,
- **The notary**, who is responsible for drawing up the deeds (living gift, including shares in companies),
- **The heirs**,
- Etc.

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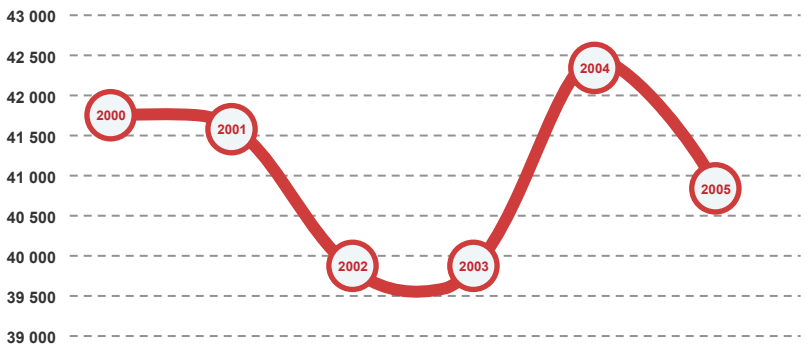
Current situation and outlook

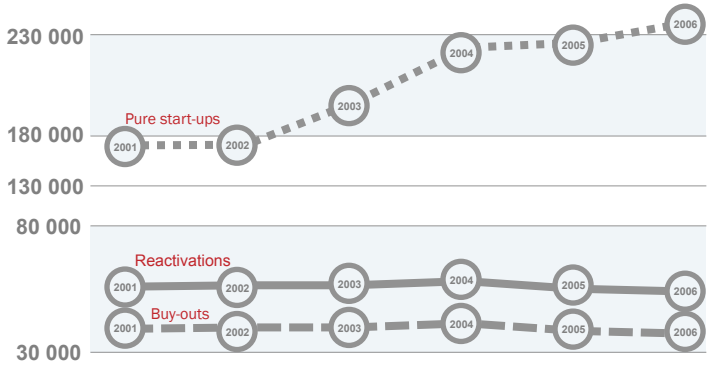
The statistics:

- According to the INSEE, there are over 42,000 company buy-outs in France every year,
- and 60,000 according to the OSEO
- There is no structured information about qualitative or technical valuations...

  ⇨ 90% are small companies (< 10 employees)
  ⇨ 9% are SMBs (10 < 50 employees)
  ⇨ 1 % are medium-sized companies (> 50 employees)

Change in the number of company buy-outs between 2000 and 2005





Source: Company and business directory (SIRENE), INSEE

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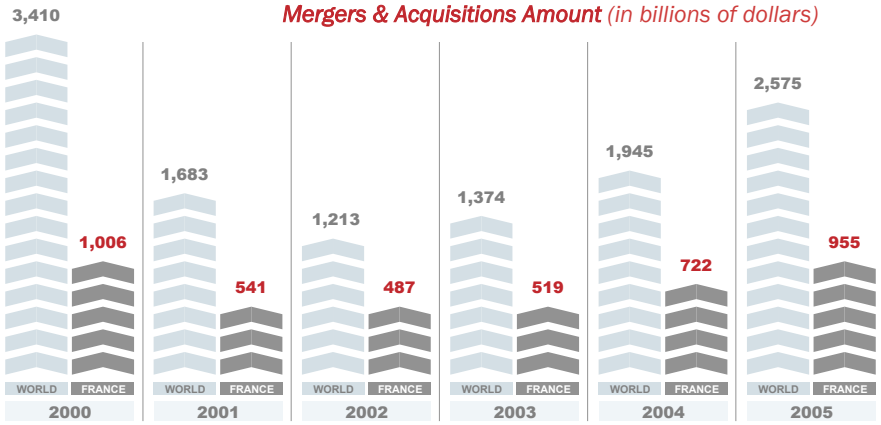
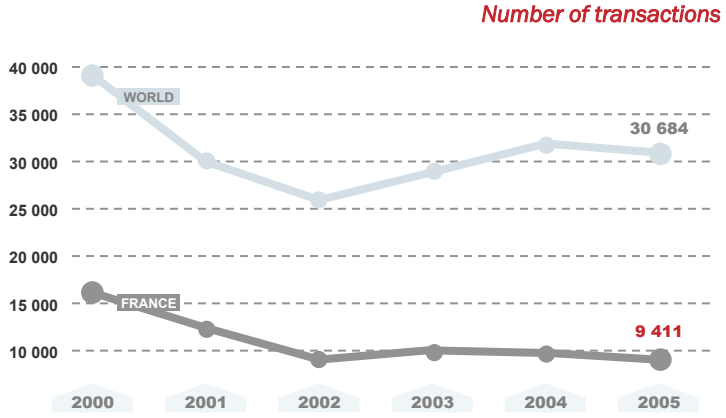
Current situation and outlook

Mergers and acquisitions:

- 2000 saw a historical high in M&A transactions, with the Internet and NITC wave,
- The average number of transactions has stabilised at 30,000 per year in France..

  ⇨ 25 % of M&A projects come to nothing
  ⇨ one acquisition in three fails
  ⇨ 15,000 companies disappear every year in France for lack of a buyer
  ⇨ M&A transactions fell by 56% in 2009 compared with 2008
  ⇨ They amounted to US$600 bn in 2009 compared with US$ 4,000 bn in 2007, as a result of the global liquidity crisis





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The main players...

Banks	As the preferred contact points for company management, they provide a broad array of services, like financial engineering and tax and investment advice.
Venture capital	Through the contribution of equity capital by investors who specialise in unlisted companies, regardless of their stage of development.
Rating agencies	Responsible for rating companies or countries according to certain criteria defined by regulation or by market players.
Mergers & Acquisitions advisors	Mainly independent boutiques who act as intermediaries between sellers and buyers, and also act as the mediator in the transaction.
Chartered accountants	The company's preferred advisors and essential allies for the seller, given their expert knowledge of accounting systems.

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As well as…

Public bodies

When managing public financing projects, especially for research or in the context of supplier referrals.

- When the parties' ability to carry out joint projects is being validated
- As part of the supplier referral process

Companies
Customers or suppliers

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Methodology issues

2

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Internal appraisal

Strengths & Weaknesses

PRODUCTION

- Procurement (*dependence on suppliers)*
- Be mindful of exclusive contracts in the case of a trading company
- Level of computerisation of the production facilities, staff skills
- Inventory (turnover level - quality)

SALES

- The company's position in its own market, its customer portfolio, order book and sales network
- Product positioning (life cycle)

LEGAL AND FINANCIAL

- Capital/Development/Structure
- Main contracts (leases, commercial contracts, etc.), length, breach penalties
- Collective agreements, valid deposits and guarantees

HUMAN RESOURCES

- Age pyramid
- Quality of the teams(turnover)
- Staff qualifications
- Compensation policy
- Current disputes
- Employee relations risks

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External appraisal

Risks & Opportunities

MARKET

- Supply and demand situation
- Market growth and trends

SOCIO-ECONOMIC TRENDS

- Unemployment
- GDP growth
- Interest rates

COMPETITION

- The company's position
- Barriers to entry
- Technological developments
- Substitution products

LEGAL AND/OR REGULATORY ISSUES

- Taxation
- Tender procedures
- Quality and safety standards
- Environmental regulations

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Different types of valuation

- Accounting and financial appraisal
- Due Diligence
- Strategic monitoring
- Extra-financial evaluation

3

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Different types of valuation

Accounting and financial appraisal

3

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A formal and thorough framework

That enables an assessment of a company's financial health to be performed, through examining its net assets and its financial equilibrium, and through analysing its results and its profitability, as well as its cash flow from operations,

- while taking a good look at **"Off-Balance Sheet Commitments"**, etc., and contracts:
  - **For leasing property and assets** *(and their likely impact in the event the leases are terminated, the contractual limitations on business activities imposed by the leases, and rent deregulation, etc.),*
  - **Service supply contracts of > one year** *(quantify the termination terms and conditions),*
  - **Sub-contracting and procurement contracts** *(length of the commitments, the volumes involved, exit clauses, etc.),*
  - **"Intuitu-personae" contracts** *(franchises, marketing, distribution, bank loans and overdrafts granted to an individual),*
  - **Guarantees** granted to customers, creditors and others,
  - **Insurance contracts.**

To protect you from nasty surprises...

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Understanding the past and envisaging the future...

Evaluators will familiarise themselves with :

- The annual financial statements for the last three financial years,
- The forecast financial statements for the next three financial years (Business Plan),
- The budgets, including the comparable investment analyses,
- The statutory auditors' reports,
- Previous valuation reports (if they exist!),
- The experts' reports (property, technical, etc.),
- The latest transactions performed,
- **All contracts** that commit the company over the longer term, their impact on net assets(shareholders' equity) and on the valuation of the company, both in terms of its future results and of whether it can be "freely" restructured.

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Methods...

Asset-based

- The company is worth what it owns!

Profitability and returns

- The company is worth what it generates!

Comparables

- Comparison with similar transactions!

Discounted Cash-Flow

- Discounting future cash flows!

None of these methods is universal! Their use varies depending on the type of company.

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Different types of valuation

Due Diligence

3

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Due Diligence

- Companies that want to attract investments must present a **"Business Plan"**, which is the equivalent of a corporate business card,
- Providing documents is therefore very important in the seduction process; however, once the investor has shown an interest, a second phase, which is more serious, more formal and more demanding, begins: Due Diligence,
- **"Due Diligence"** *(a term borrowed from the securities market)*, essentially means "Audit": the future investor wants to make sure that all the information regarding the company is available and has been independently checked. All the information provided by the company is assembled and reviewed, and the organisation is interviewed by teams of financial experts, lawyers and accountants, in order to analyse it and validate the relevance of the "Business Plan".

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... A situation audit

"Due Diligence" is a fuller and more structured assessment than the one provided by a Business Plan, it includes and dissects the company's strategic components:

- Three-year Business Plan (Medium-Term Strategy),
- Legal & Financial,
- Technical & Production,
- Sales & Marketing,
- General organisation,
- Employee relations.

Successful Due Diligence is key to the likely merger between two future partners.

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Marketing plan

- Business history (execution organisation and profitability per business),
- Political and legal competition conditions(licences),
- Three-year business projections,
- Products and services sold by the company and their uses,
- Comparative analysis of the products and services sold by the company with those sold by its competitors,
- Guarantee and after-sales service terms and conditions,
- Inventory of product or service developments,
- Overview of all the markets where the company is present and breakdown by market (trend and outlook),
- Overview of the market segments where the company is concentrating its resources and of its reasons for doing so,
- Broad picture of the direct competition and description of the main players,
- Strengths and weaknesses analysis of the competition in relation to the company,
- New market evaluation strategy (how is the evaluation decided?),
- Sales promotion plan: description including all the representatives, related sales incentives, sales targets, training to support the sales staff, special offers, and telemarketing and sales agencies,
- Qualitative assessment of the advertising campaigns (cost benchmarks),
- Exhaustive description of the product distribution method,
- Flow chart, from when customer orders are received to billing and delivery,
- Qualitative assessment of the After-Sales Service and the customer service rate (direct line, support, meeting, complaints, upgrades, etc.),
- Customer loyalty mechanisms (rebate rates, etc.),

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Organisation of production and studies

- Description of the manufacturing processes (equipment, software, communications, other),
- Identification of the know-how, expertise and technology transfer used,
- Survey of the main suppliers, equipment, software and services used,
- Production organisation and level of staff qualifications,
- Inventory of study and research capabilities,
- Detail of the patents and inventions registered,
- Infrastructure (electricity, heating and gas supply levels, etc.),
- Transport and communications (satellites, lines, receivers, transmitters),
- Raw materials: sources, cost and quality,
- Relations with suppliers and supporting industries,
- Latest verified health and safety check reports,
- Environmental risk inventory.

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Different types of valuation

Strategic monitoring

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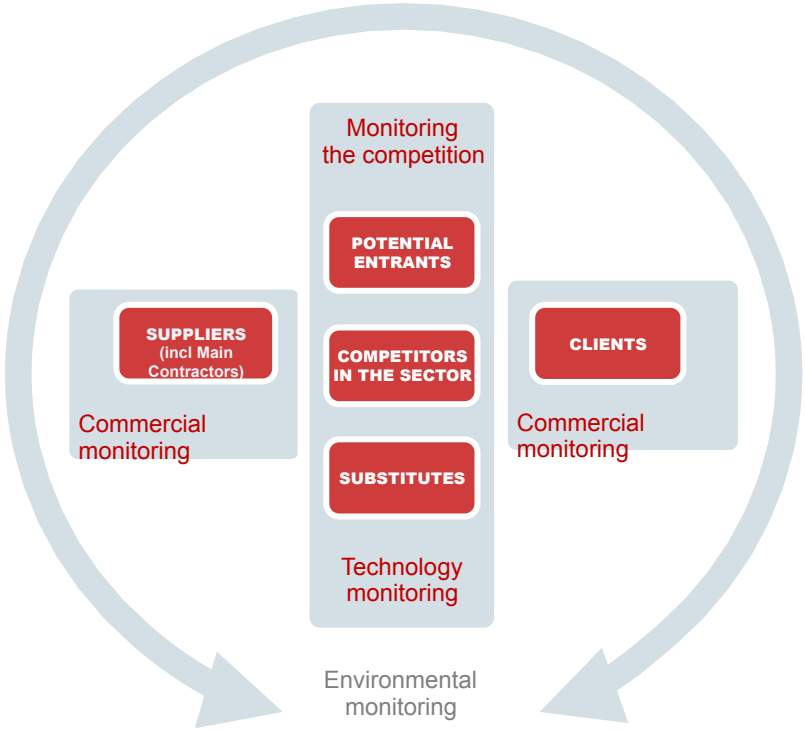
Definition…

A continual, proactive and targeted process for monitoring the company's environment, in order to identify emerging technologies that may be dominant in the future at the earliest stage possible.



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The aims...

Enabling the company to:

- Have the **right regulatory and standards information** available at the right time, in order to make binding decisions,
- Adapt and/or **monitor its proposed environment** in order to secure its assets, by identifying threats and country risk,
- Enjoy an array of potential **partners**, who are in a position to provide support to the company as they executes their projects,
- Assess **the competitive impact of the different technologies** that the company masters or seeks to master,
- Obtain and/or develop a **competitive advantage** that enables the company to bolster its competitiveness, through identifying best operating practices,
- Look for information about **business opportunities** (technological or commercial partnerships, sourcing, innovations, etc.).

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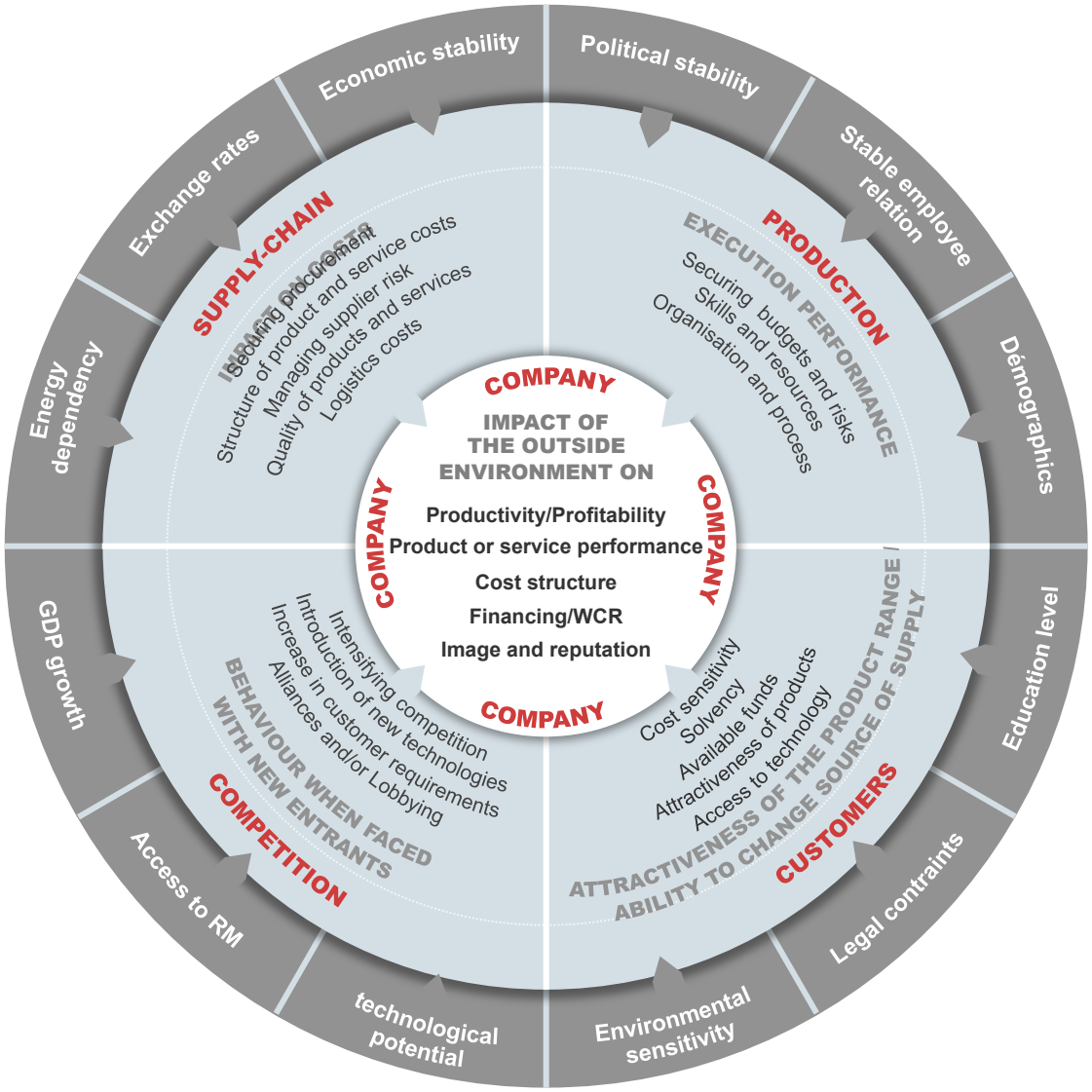
Scope of the investigation



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Gathering information...

Open information:

- Daily newspapers, specialised magazines, periodicals,
- Symposia, conventions, conferences, trade fairs,
- Databases, the Internet,
- Documentation centres, patents,
- Firms that specialise in summarising documents,
- Bodies supplying economic and technical data.

Targeted information:

- Customers, suppliers and sub-contractors,
- Corporate information networks,
- Embassy economic delegations.

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The monitoring process...

Identification:

- Defining the company's context and expectations,
- Defining the information required,
- Gathering *(market data, informal information, etc.)*,
- Analysis & Summary,
- Communication.

Operation:

- Processing *(process reviews, contract revisions, audits, progress schedules),*
- Cross-validations,
- Use *(global corporate strategy, partnership agreements, risk hedges, process review, marketing and industrial positioning).*

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Different types of valuation

Social valuation

3

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Sustainable Development : *Fashion or oxymoron?*

A plethora of concepts

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The need to put issues into perspective

Extra-financial rating

- What for?
  - To provide a structured valuation of social, environmental and ethical practices,
  - To assess the impact of those practices on performance over time,
  - To shed light on potential risks linked to the business activity.
- Who for?
  - The company and its management team,
  - Shareholders and investors,
  - Employees and customers,
  - Civil society *(stakeholders).*
- The aim?
  - To control reputational risk.

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Origins of the concept

- Social rating or "Extra-financial rating" is the financial rating industry's latest offering!
- **The aim is to**: Value tangible and intangible assets *(social, environmental)* in relation with the **Sustainable Development** concepts defined by the United Nations,
- The ten fundamental principles arising from :
  - the Universal Declaration of Human Rights,
  - the International Labour Organisation's Declaration on Fundamental Principles and Rights at Work,
  - the Rio Declaration on Environment and Development,
  - the United Nations Convention against Corruption.
- Major international summits like the G8, the G20, and the Doha Cycle.

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The 10 Global Compact Principles

Human Rights	1	Companies should promote and respect the protection of international human rights legislation in their sphere of influence.
	2	They should make sure that their own companies are not complicit in human rights abuses.
Labour Rights	3	Companies should respect freedom of association and recognise the right to collective bargaining.
	4	They should eliminate all forms of forced and compulsory labour.
	5	They should effectively abolish child labour.
	6	They should eliminate discrimination in employment and occupation.
The environment	7	Companies should adopt a precautionary approach to environmental issues.
	8	They should undertake initiatives aimed at promoting greater environmental responsibility.
	9	They should favour the development and dissemination of environmentally friendly technologies.
Combating corruption	10	Companies should take action against corruption in all its forms, including extortion and bribery.

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Financial rating agencies

Their role

- Assessing the quality of financial instruments

Scope

- Rating companies, countries or a transaction's credit,
- Rating structured products.

Methodology

- Investigations and meetings with rating agencies about their organisational structure, the services offered and ethical issues,
- Processing statistical data supplied by agencies, arrangers and information providers.

Agencies in France

- Major agencies: ***Fitch***, ***Moody's*** and ***S&P*** have offices in France,
- They mainly devote themselves to corporate debt products.

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The main financial rating agencies

Moody's Corporation

FitchRatings

STANDARD &POOR'S

Other players

- AM BEST Compagny
- DBRS Ltd
- Egan-Jones Rating Co
- Japan Credit Agency
- Lace Financial Corp
- Rating & Investment Information Inc
- Realpoint LLC

The agencies' revenues:

- At best, European revenues represent 40% of global revenues *(over half of which are generated in the United States)*

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Extra-financial rating

- Social analysis values a company's commitments, the policies that it implements and its performance in the social, environmental and corporate governance fields,
- based on the interpretation of the information provided by the company or by other stakeholders *(NGOs, trade unions, the media, etc.),*
- according to two approaches:

The avoidance approach

Through the use of screening criteria defined either by the agency or by its clients. The approach applies to controversial business sectors such as tobacco, weapons, alcohol, pornography, and the nuclear industry etc., as well as practices that are deemed to be irresponsible, such as child labour, animal-testing, the use of pesticides, etc.

The performance approach

Based on the definition of positive selection criteria, drawn up by the agency or by its clients. In this case, its aim is to identify sources of medium and long-term financial outperformance in the securities under review.

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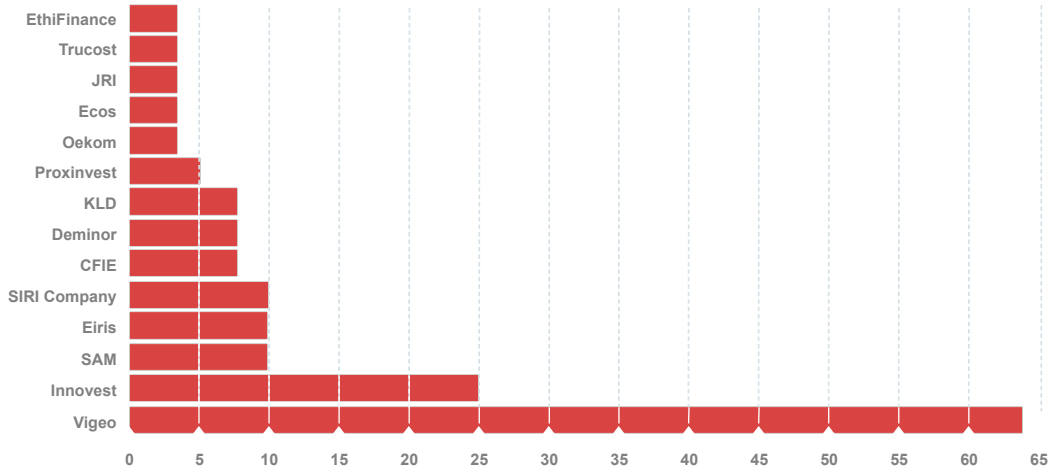
Market participants

Two kinds of structure:

- Associations
  - For-profit associations *(ex: CAER; EIRIS).*
  - Existing associations that have developed a specific social rating expertise *(ex: Fundación Ecología y Desarrollo),*
- Private companies
  - Where the sole business activity is social rating,
  - Specialist consultancies,
  - Companies where the shareholders are specialist consultancies.



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Rating-upon-request

- At the company's initiative, in "Situation Audit" mode,
- In France, CSR pressure applies directly to companies and not to investors *(unimportance of pension funds),*
- Socially Responsible Investing *(SRI)* and social rating have been built around a non-confrontational approach *(exclusion is forbidden),*
- French law does not demand that companies develop a socially responsible approach.

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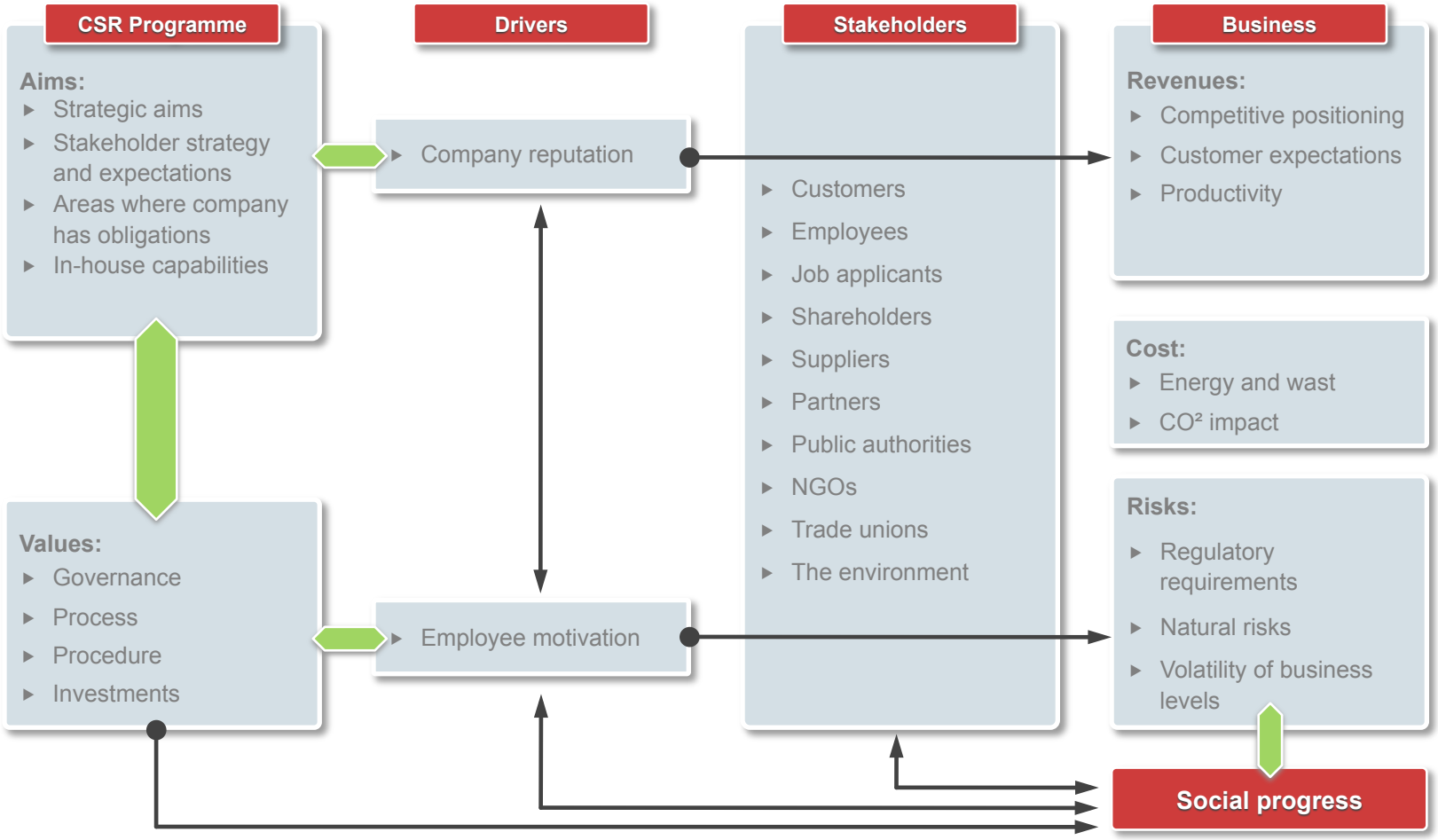
CSR assessment diagram



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Information gathering

- No standardised rules or benchmarks
- The sources are public and transparent!
  - The company is consulted through the use of questionnaires *(questions are directly related to the criteria and indicators used for the assessment),*
  - through setting up meetings with Company Management and the main executives to discuss the company's social and environmental policies,
  - through examining publicly available information *(legal information, annual management reports, Sustainable Development report, etc.),*
  - and the general-interest and specialist press, as well as website(s).
- Even if the results are not!

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Valuation criteria

Areas:

- Human resources policy,
- Customer relations,
- Relations with suppliers and sub-contractors,
- The environment,
- Corporate governance,
- Relations with civil society.

Performance levels:

- Management's commitment and strategic aims,
- Policies and the measures to implement them,
- Results and performance.

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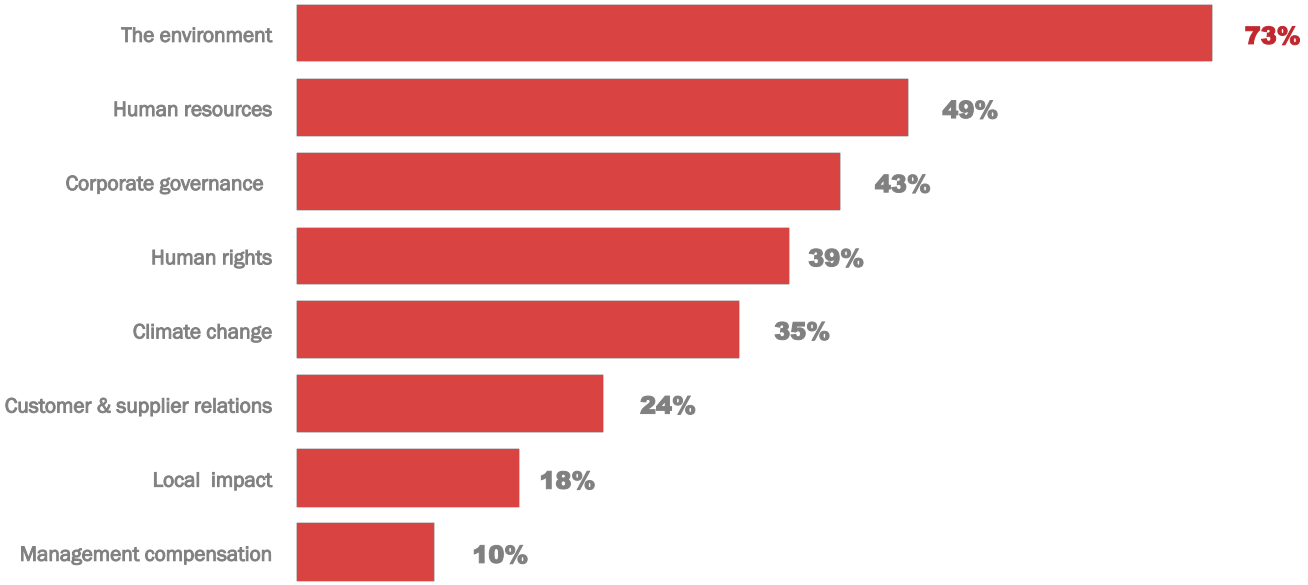
A new source of financing for companies

- 73% of investment funds take SD criteria into account, compared with 46% in 2006.



The "Sustainable Development" approach therefore becomes an attraction point for the company.

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The SRI market in Europe (1)

A few numbers

- €2,665 trillion as at the end of 2007
- 17.5 % of industrial assets
- Up 102% since the end of 2005

Observation

- Increasing SRI demands from investors, which corresponds to a strong desire to manage risk
- A better integration of environmental and social considerations in conventional finance
- Increasing media pressure *(NGOs, the media)* on unethical behaviour
- Increasing collective awareness about issues related to individual well-being

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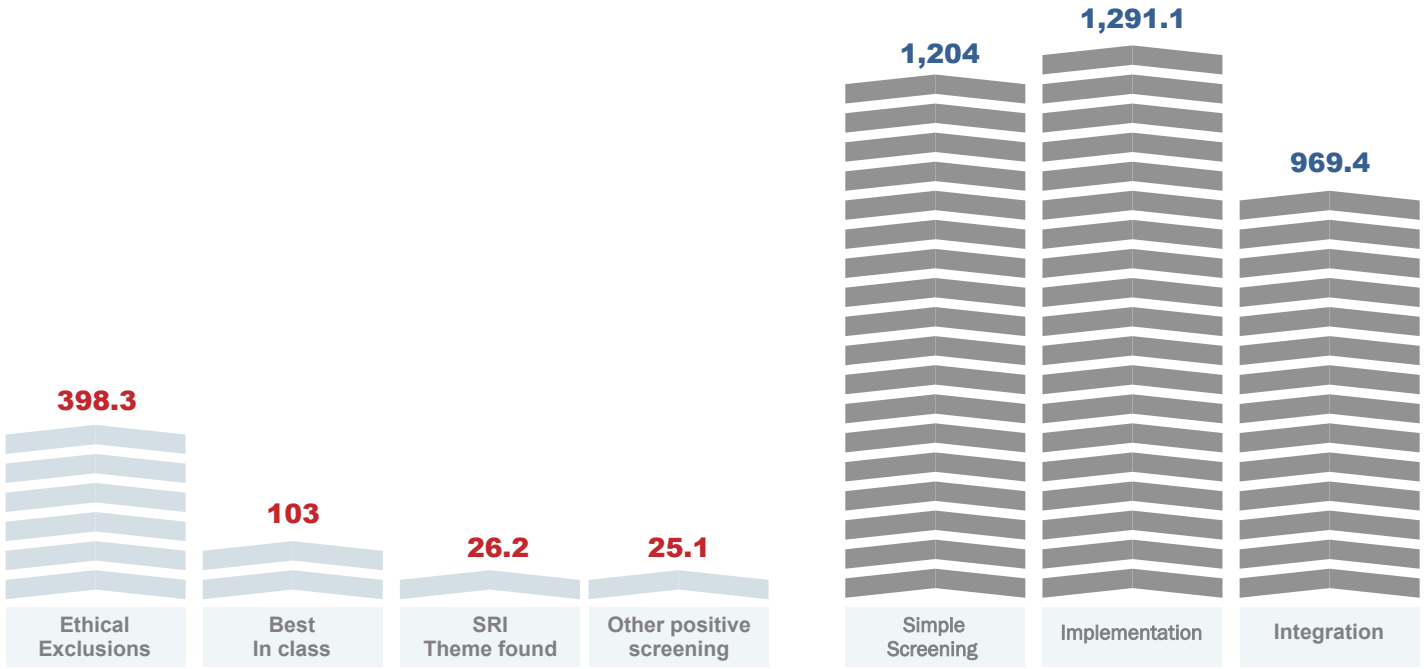
The SRI market in Europe (2)

SRI Strategies applied in Europe (€ Billions)



Core SRI

Ethical criteria and at least two negative criteria

Broad SRI

Exclusion, implementation and integration by sector.

Source: Eurosif European SRI Survey, 2008

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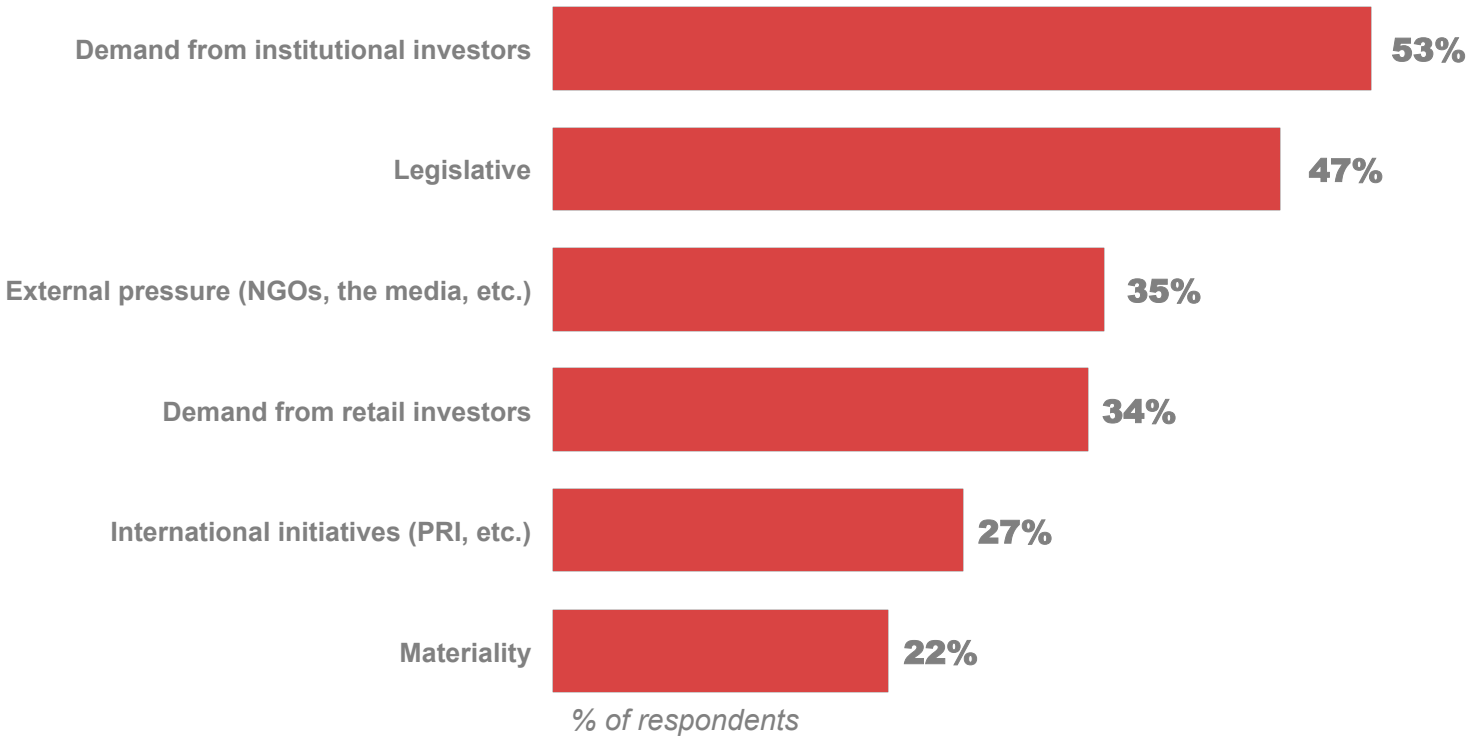
Three-year outlook

Key drivers for SRI demand in the next 3 years



Source: Eurosif European SRI Survey, 2008

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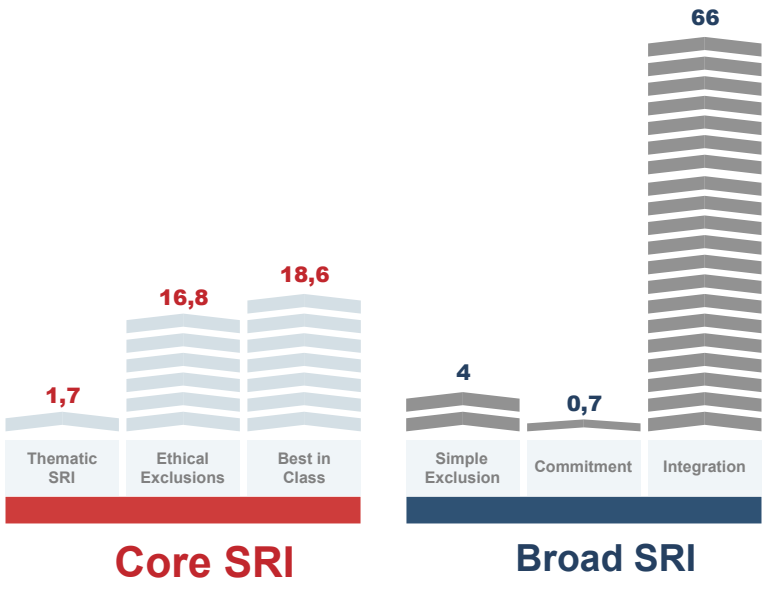
Market values

- 98.6 billions € of financial assets,
- + 615 % since 2005,
- The 2nd best increase in Europe.

SRI Strategies in France (€ Billions)



Distribution of ISR outstanding by type of management

		2006	2007	2008	Variation 2008 vs 2007
Private Management	Individual Investors	3,9	4,6	4,0	115,0 %
	Professional Investors	5,0	5,8	7,1	81,7 %
	Pension Funds	1,1	1,4	2,5	56,0 %
	s/ Total 1	*10,0*	*11,8*	*13,6*	86,8 %
Equity Management	Individual Investors	3,0	4,8	6,7	71,6 %
	Professional Investors	2,7	4,1	8,9	46,1 %
	Pension Funds	1,0	1,2	0,9	133,3 %
	s/ Total 2	*6,7*	*10,1*	*16,5*	61,2 %
	Total	***10,0***	***11,8***	***13,6***	72,0 %

Source: Eurosif European SRI Survey, 2008

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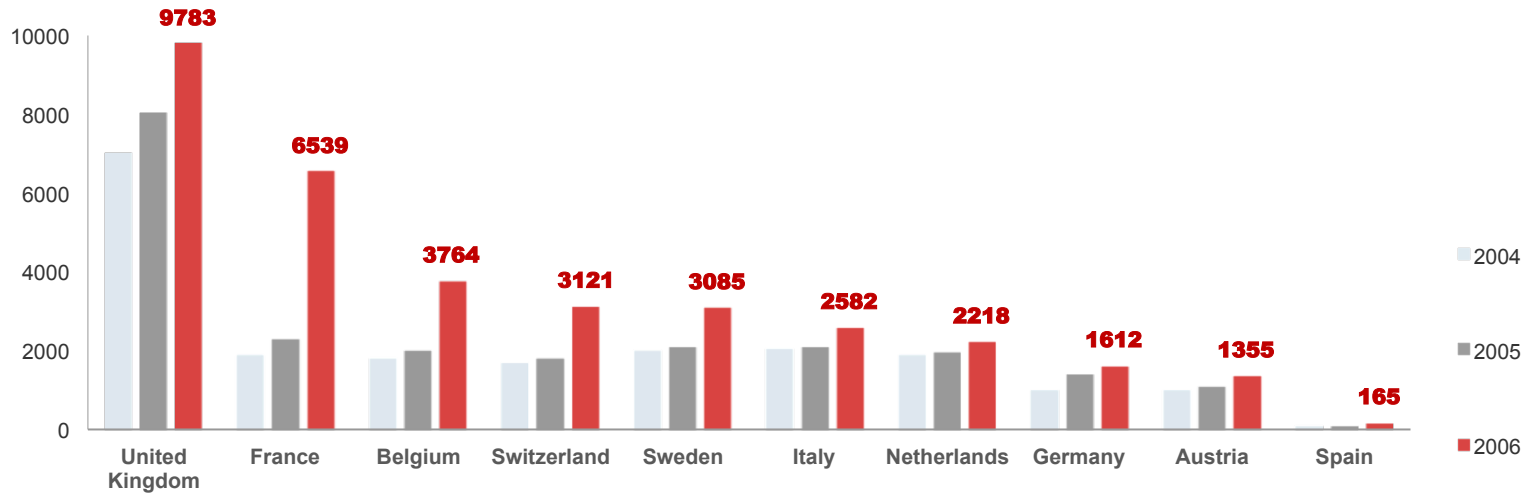
Socially responsible funds

Features

- Incorporate extra-financial criteria into their investment decisions.
- Some of them practice "screening",
- Others make their "ethical and social" voices heard at board meetings,



- A source of funding for "clean" companies,
- "Safe Haven" securities for investors.

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"Ethical" stock market indices

- 1st "Ethical" stock market index launched in the United States in 1990,
- The crisis of confidence suffered by investors since the "Enron" & "WorldCom" affairs has strengthened investors' need to sanitise their investments,
- There are currently more than 14 social valuation indices: ASPI Eurozone, Calvert Social Index, Dow Jones Sustainability Indices, Ethibel Sustainability Indices, FTSE4Good indices, etc., including five in Europe,
- A source of benchmarks,
- A visible indicator of good social and environmental behaviour that companies use in their communications,
- Some companies appear in several indices, with the aim of boosting their visibility!

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The ASPI Eurozone®

- **Advanced Sustainable Performance Indices**: the benchmark European index for companies and investors who want to make a commitment to CSR.

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What is the future for social valuation?

- In the absence of rules or standards, a number of questions arise:
  - Can social rating become a form of governance for SRI?
  - Will extra-financial rating agencies play a role in the development of financial or fiduciary ethics?
  - Are we heading towards involving the financial regulator in validating content?
- Some parties involved are intent on promoting the quality and the transparency of the rating process by improving the dialogue between companies and social rating agencies

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Instructions for use

4

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Summary...

The summary is usually included in a final report where the evaluator will express his or her opinion.

Two levels that will highlight the key issues:

I. Quantitative:

- Critical analysis of the trends for the main numbers and management ratios.

II. Qualitative

- Strengths and weaknesses of each division and of the overall organisation,
- Threats and/or opportunities arising from the economic situation, the business sector and regulatory constraints, or constraints linked to the line of business,
- The company's dependence on its customers or its suppliers.

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The report...

Must include:

- The elements of the context in which the evaluation took place,
- The work and analyses performed,
- The limitations applied to the work, either at the client's request, or due to the limitations of the evaluator's expertise,
- The methodologies and analytical matrices used,
- The justification of the analyses and the evaluator's recommendations.

No particular structure is required. A valuation report is not subject to any legal requirements, except where a court requests such a report from a recognised expert who is certified by said court.

Valuation = A thorough and professional approach..

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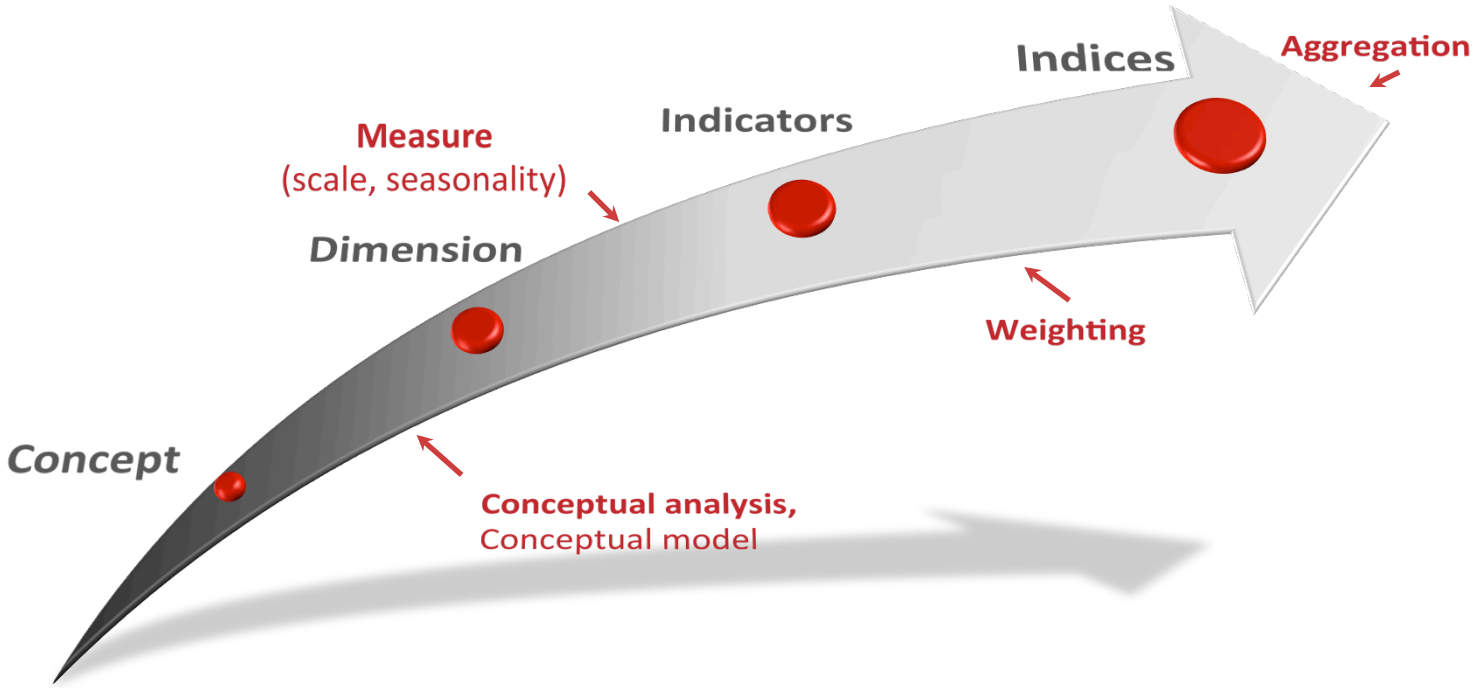
Constructing indicators

Given that we can only improve what we understand, and that we only understand what we measure...

Then let's start by measuring!



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Rating matrix(1)

Areas / Sustainable Development Principles	Environment	Human Resources	Marketing & Commercial	Purchases & Sub-contracting	Civil Society	Corporate Governance	Weighting	Rating
Values & Leadership	5	5		6	3	6	10	50
Organisation of responsibilities	8	7	9	6		8	25	190
Transparency of information	3	4	3	2	5	6	5	19
External Communications & Stakeholders	5	3	4	5	6	4	20	90
Governance & Internal Checks	8	7	9	9	7		15	120
Innovation	5		6	4		2	10	43
Vision and commitments	8	7	8	8	6	5	15	105
Weighting	30	25	10	5	15	15		
Rating	180	138	65	29	81	78		5.93

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Grille de notation (2)

Areas **Sustainable Development Principles**	Environment	Human Resources	Marketing & Commercial	Purchases & Sub-contracting	Civil Society	Corporate Governance
Values & Leadership	Validating the consistency of management's discourse and actions and of the means of communication put in place, in order to ensure the dissemination of the company's values and corporate governance. .					
Organisation of responsibilities	Validating the consistency of organisations and systems for delegating commitment responsibilities					
Transparency of information	Validating general information platforms, their relevance and their reliability. The emphasis will be placed on how interesting the information circulated is and how easy it is to understand generally.					
External Communications & Stakeholders	Validating the external communication resources and frequency as well as the existence of a dialogue between the company's internal divisions and stakeholders.					
Governance & Internal Checks	Validating the operating application of corporate governance principles in processes and procedures as well as the regular performance of application reviews.					
Innovation	Validating efforts to develop innovative products, processes and behaviours within the context of the company's SD commitments..					
Vision and commitments	Validating management's long-term vision of SD concepts and principles, as well as the existence of actions plans in respect of those commitments.					
Weighting						
Rating	Validating both dimensions not also enables both "Areas" and "Principles" to be independently valued at the same time, but also enables the monitoring of individual effort compared with collective effort for each category. This makes the construction of specific indicators easier. .					

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Rating matrix (3)

Areas	Environment	Human Resources	Marketing & Comercial	Purchases & Sub-contracting	Civil Society	Corporate Governance	Weighting	Rating
Sustainable Development principles								
Values & Leadership	Initiatives in favour of the environment, such as REACH certifications, ISO 8000 and 14000 certifications and carbon reports	The company's RH policy will also be included in this area, as well as its ability to involve its employees in SD topics and strategic CSR goals. This area has a significant impact on the ability to attract new talent.	Sales and marketing strategies relating to the CSR initiative are valued under this heading (Increase in revenues, market share, launch of new products, etc..).	Are taken into account as part of the assessment of factors in the Purchasing strategy that lead to the substitution of equipment and materials that consumer energy or generate heavy waste by more recyclable equipment and materials The economic advantages will need to be weighed up against the quality of the initiative.	We will focus on considering the stakeholder reputation and confidence aspect when assessing this cluster. Both issues are intimately linked to the competitive profile of the company and of its products.	The assessment of this cluster will focus on the quality of corporate governance, and especially on issues relating to the company's external communications		
Organisation of responsibility								
Transparency of the information								
External communications and Stakeholders								
Governance & Internal Checks								
Innovation								
Vision and commitments								
Pondération								
Notation								

The general index corresponds to the average of the valuations obtained for each topic

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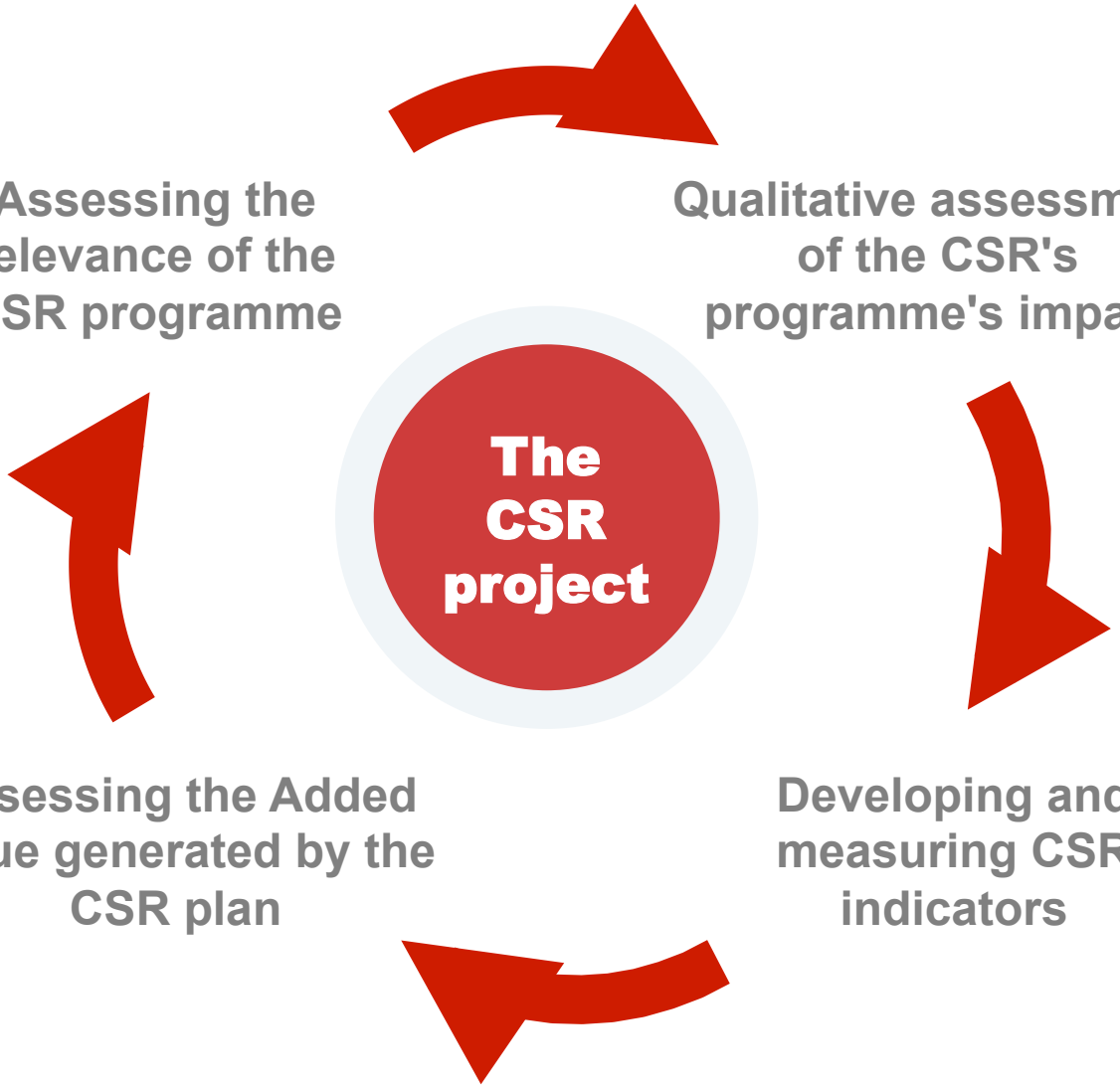
An continuous approach



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How do you use it?

- **As a lever for motivating** and involving the company in order to support its strategic review actions

- **Questions:**
  - How do you act in an uncertain environment, whilst calmly meeting tomorrow's economic and industrial expectations in complex environments?
  - Regulation and/or Deregulation
  - Stability of employee relations
  - Economic profitability
  - Pressure on Raw Materials
  - Energy supply stress

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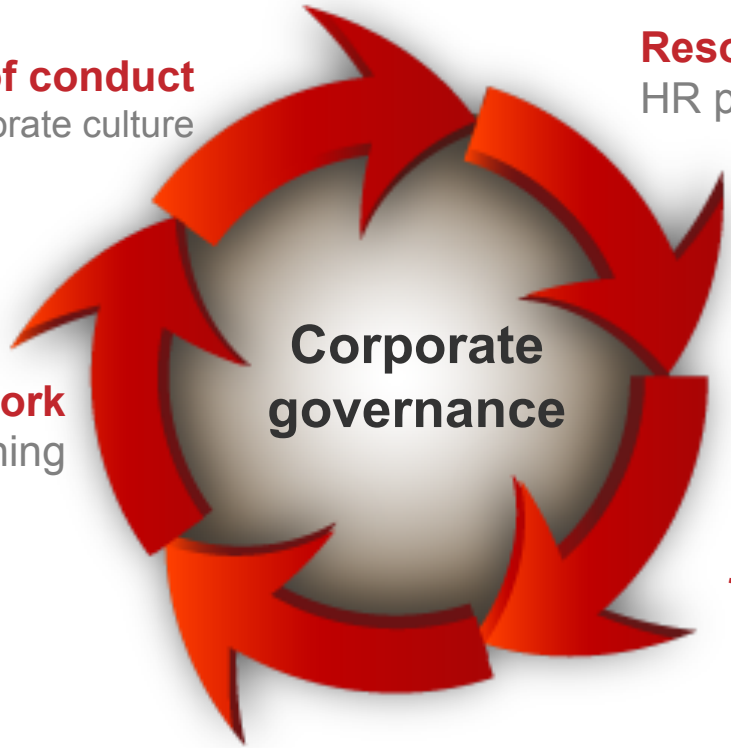
The virtuous circle of motivation



Values/Code of conduct
Corporate culture

Resource diversity policies
HR policy

Flexibility at work
A time for everything

Training as a policy for managing skills and jobs

Preserving and improving working conditions
Employee involvement as a management method

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