


Dissecting Value: Differences in Valuation Practices in Cross-border M&As

July 1, 2011

American Appraisal China Limited






“ A valuer is someone who can see places in people's houses that usually require a search warrant to access”

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State of Chinese Valuation Regulation and Valuation Practices

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Legal Framework of Professional Valuation

- In the past, independent valuers were only clearly mandated in acquisitions/transfers of state-owned assets
- **2006 M&A Regulations:** The assets of domestic enterprises being acquired must be valued according to “internationally accepted principles”:
 - share swap: overseas share must have “**proven value**”
 - equity or asset transfer at below “**fair value**” prohibited.
 - formal submission to relevant authorities of valuation report required
- Appraisal Law under consideration by Finance and Economic Committee of the National People’s Congress

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Valuation Practices in China – Regulator Prospective

General “Rules of Thumb” in

“Safeguarding State-owned Assets !!”

- For the foreign party in a JV, intangible assets and technology contributions generally is kept to no more than **20%** of the total investment value
- All assets contributed by the Chinese side in a JV will usually have a minimum value of **15%** of cost, regardless of condition or utility
- Valuations more than **15%** below the book value of the assets would usually receive careful scrutiny
- The negotiated transaction price does not go below **10%** of the appraised value

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Regulation of Professional Valuers

Valuers Qualifications Authorities

- **Certified Land Valuer** -> Ministry of Land and Resources (国土资源部)
First hand land transaction in which approval from Ministry of Land and Resources is required
- **Certified Real Estate Valuer**-> Ministry of Housing and Urban-Rural Development (住房及城乡建设部)
Property transaction on both buildings and attached land in which approval from Ministry of Housing and Urban-Rural Development is required
- **Certified Public Valuer** -> Ministry of Finance (财政部)
(via **China Appraisal Society** 中国评估师协会)
Both tangible and intangible assets

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Regulation of Professional Valuers

“A-licensed” valuation firms

- Some firms have additional recognition from the China Securities Regulatory Commission (the “A-license”) to value assets of listed companies in transactions for public disclosures.
 - Valuation of assets for ***domestically listed firms***
 - *Number is limited, not open to foreign valuers*

M&A Practitioners beware:


Qualification of valuers have to match the nature of transactions and comply with the governing authorities

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Differences in Valuation Considerations

Equity Deal

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Case Study- Power Sector

- An acquisition by the a Hong Kong utility company of a Chinese SOE power company in Northeastern China
- The book value of the target was over RMB 10 billion (US\$ 1.2 billion). Valuation was based on the discounted cash flow (DCF)
- The Chinese valuer assigned a higher value to the Chinese partner's assets
- On behalf the Hong Kong utility company AAC performed a DCF valuation of the plants, and discuss with the Chinese valuer over the ASA prescribed methodology

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Case Study- Power Sector :

Differences in Discount Rate Components

- **Risk Free Rate:**
 - The Chinese valuer used a local currency one year deposit rate (2-3%). international valuers like us tend to use the standard US \$ T-bond rates (5-6%).
- **Use of Company Beta:**
 - Chinese valuer followed the local practice of including only Chinese listed comparables
- **Weighted Average Cost of Capital (WACC):**
 - Chinese valuer used a hypothetical and high debt/equity ratio in the WACC, leading to an artificially low cost of invested capital. AAC used the actual debt/equity number

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Case Study- Power Sector : Differences in Discount Rate Components

■ **Company Specific Risk:**

- It is not the local valuation practice to consider company specific factors:
 - Limited coal suppliers
 - Reliance of government support on low transmission fee
- Factors to considered in deriving CSF:
 - Ownership structure
 - Company history
 - Previous historic financial performance
 - Level of customer, supplier and product diversification
 - Quality of Management

■ **Small Size Premium & LOMD:**

- Chinese valuer didn't assign a premium for the relative small

size of the target and lack of marketability of the target

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Case Study- Power Sector : Pre-discussion Comparison

Cost of equity	Chinese Valuer	American Appraisal
Risk-free rate	2.30%	5.69%
Average Levered beta	0.85	0.60
Equity risk premium	6.39%	6.00%
Small size premium	0.00%	5.33%
Company-specific Risk	0.00%	2.30%
Cost of equity	7.73%	16.92%
Cost of debt	5.76%	5.76%
Tax	33.0%	33.0%
After tax cost of debt	3.86%	3.86%
Market Debt Ratio	60%	27%
Market Equity Ratio	40%	73%
WACC (Rounded)	5.4%	13.4%



Case Study- Power Sector : Differences in Discount Rate Components

- **Risk free rate and Company Beta:**

As the target's returns are all in local currency, and will not be repatriated, the consensus was to use the local currency risk-free rate. Both sides use separate sets of comparables on Beta calculation

- **Company Specific Risk, Small Size Premium and LOMD:**

Chinese valuer consent to take into account CSR, SSP and LOMD

- **WACC:**

AAC convinced the Chinese valuer to use a higher equity component in the WACC determination. This increased the discount rate due to the higher return requirement on equity

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Case Study- Power Sector : Post-discussion Comparison

Cost of equity	Chinese Valuer	American Appraisal
Risk-free rate	2.30%	2.30%
Average Levered beta	0.85	0.60
Equity risk premium	6.39%	6.00%
Small size premium	5.33%	5.33%
Company-specific Risk	1.45%	2.30%
Cost of equity	14.51%	13.53%
Cost of debt	5.76%	5.76%
Tax	33.0%	33.0%
After tax cost of debt	3.86%	3.86%
Market Debt Ratio	20%	27%
Market Equity Ratio	80%	73%
WACC (Rounded)	12.38%	13.59%

Previously 0%





Differences in Valuation Considerations

Asset Deal

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Differences in Valuation Considerations


- Difference in **depreciation** expenses due to different application of useful life
- **Residual value** could be overstated
- Inadequate **market data**
- Issue of **Economic Obsolescence**
- State allocated land creates need for **exchange/premium** with acquisition of use rights

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Non-valuation Observations in Company Due Diligence

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Points to note in Cross-border M&As

- Is there a deal?
 - Strategic fit or go-driven? The “country manager mentality “
 - Pearl in straw? Still mostly straw, intrinsic value not there
- Before contact potential targets...
 - Posing as a potential customer
 - Visit, ascertain physical existence
- When working out LOIs / MOUs could include:
 - “**No Shop**” clause, avoid price manipulation
 - “**Clawbacks**”, price flexibility

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Points to note in Cross-border M&As

- When actually carrying out due diligence
 - Shadow companies
 - Tax GAAP
 - Related party transactions
 - Off balance-sheet items
 - Compliance with local regulations

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Conclusion

- In conclusion:
 - It is only different, no wrong or right.
 - Be open-minded to learn and to understand
 - ***Value is different from Price !***

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Thank you!

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