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

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American Appraisal China Limited

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" 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 then **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 - General

<u>**Valuers Qualifications**</u> <u>**Authorities**</u>

- ***Certified Land Valuer*** -> Ministry of Land and Resources **(国土资源部)**

First hand <u>land</u> 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 <u>buildings and attached land</u> 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*** *中国评估是师协会*)

Both <u>tangible and intangible</u> assets

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Regulation of Professional Valuers – Import License

Authorities

General Administration of Quality Supervision, Inspection and Quarantine of the People's Republic of China (AQSIQ) / **(**中华人民共和国国家质量监督检验检疫总局**)**

*According to the 2006 Announcement No.135 from the PRC AQSIQ Article 22, "**The Regulations of the People's Republic of China on Import and Export Commodity Inspection**", the following institutions are qualified to conduct valuation related to import and export license :*

1. *CHINA INSPECTION COMPANY LIMITED* **(**中国检验有限公司**)**
2. *CCIC EUROPE B.V.* **(**中国检验认证集团 欧洲有限公司**)**
3. *CCIC JAPAN Co., Limited* **(**中国检验认证集团日本有限公司**))**
4. *CCIC NORTH AMERICA INC.* **(**中国检验认证集团北美有限公司**)**

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Regulation of Professional Valuers – Import License (con't)

<u>Examples of import items which could need pre-shipment inspections</u>

1. Food Processing Machinery Equipment
2. Petrochemical Equipment
3. Textile Equipment
4. Energy, Nuclear Equipment
5. Electronic instrument and its processing equipment
6. Construction equipment
7. Metallurgy, mining equipment
8. Agricultural, printing machinery equipment
9. Metallic and non-metallic processing equipment
10. Forestry, pulp and paper equipment
11. Generating unit, including diesel engine, gasoline engine, generator and its attachments

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Licenses for 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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American Appraisal China affiliated companies

In China, American Appraisal China (AAC) has two affiliated, locally licensed valuation companies which could provide full scope of statutory valuation services for our MNC clients operating in China, they are:

- *Beijing Wansheng Appraisal Firm* (北京万盛资产评估事物所）in Beijing
- *Shenzhen Dezhengxin Asset Valuation Firm* "DZX"(深圳市德正信资产评估有限公司) in *Shenzhen (www.dzxcpv.cn)*

American Appraisal China affiliated companies (con't)

The affiliation with Beijing Wansheng and DZX will allow AAC to considerably expand its China-related businesses. For foreign clients, through DZX's A licence, we are able to immediately provide PRC statutory valuation reports that may be required in relation to their dealings with listed Chinese targets / counter-parties. For Chinese clients (whether Shanghai / Shenzhen listed firms, private companies or SOEs) AAC able to immediately provide valuation / advisory services in relation to their domestic IPO preparation, M&A, JV, financial reporting, outbound investment needs by issuing valuation reports that will be accepted by Chinese regulatory authorities such as SASAC, CSRC, AIC, state / local taxation bureau.

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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%**

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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%

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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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