January 2008
Volume 19

InterChange®

Connecting the Transaction Community

Ernst & Young
Quality In Everything We Do

Transaction Valuation

What attributes do the best acquisitions and divestitures share? In superior transactions, measurable outcomes fulfill the strategic goals and advance the business imperatives of the organization.

Putting valuation at the center of the transaction process is critical to achieving success.

NEEDED: PERSPECTIVE. Valuation is a discipline that helps define, measure, predict, and shape the sources of value in an asset. At best, valuation analysis is objective and broad enough to incorporate all significant factors influencing value but offering the perspective to determine which factors are most important.

Bringing the analytical perspectives and methodologies of valuation to the entire corporate development process enhances strategic decision-making and implementation. To be most effective, these approaches must be consistently applied throughout the process and adjusted as new information becomes available.

Too often, lack of consistency in valuation creates a gulf between the idea behind a transaction and its execution. The business development team may pursue a deal based on one notion of value while the financial people take another view. Meanwhile, the tax team designs a new structure and assigns value to different legal entities. The three functions aren't in sync.

When views of value are at odds in this way, the result can mean challenges from the SEC and IRS. Moreover, if a consistent view of value hasn't been carried through execution, pricing, closing, and integration, chances are that desired results won't be achieved.

MULTIFACETED. Dealmakers who see valuation only in terms of deal pricing fail to fully utilize its power. Valuation has relevance across the entire transaction lifecycle, on the sell side as well as on the buy side (page 2). Strategic finance aligns analysis of value drivers, financial synergies, and transaction measurement, thereby improving strategic decision-making (page 4).

Accurate models are at the heart of transaction valuation. As companies sell off non-core businesses in greater numbers, sophisticated carve-out models are needed to identify the real value of the divestiture to both sellers and buyers (page 3). When shared services are involved, parsing the costs and risks of operations and technology is critical to model-building (page 3).

Value drivers and component factors, of course, can vary wildly. Transactions in the biotech and pharmaceutical sectors invite specialized valuation approaches (page 5). In Russia, valuation is still a developing art, fraught with challenges for the foreign investor (page 6). While valuation insights bring sharp focus to a deal, the applications are as far-flung as the globe itself.

Don Charles ■ Atlanta
Transaction Advisory Services

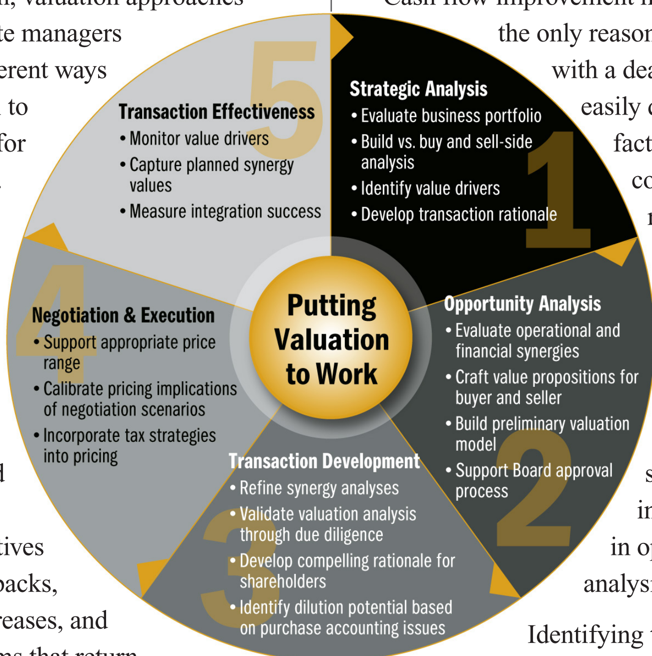
InterChange® is a bimonthly newsletter published by the Transaction Advisory Services practice of Ernst & Young LLP.
Elizabeth Ehrlich, Editor | **Michelle Horner**, Managing Editor | ey.interchange@ey.com

Harnessing the Power of Valuation

Valuation is usually thought of in terms of pricing, as a process taking place before a buyer makes a bid or a seller puts an asset on the block.

However, the seller's asking price is usually different from the value of the target to the buyer. The true power of valuation is in its ability to bridge that gap. Indeed, valuation methodologies and perspectives can help illuminate the entire transaction lifecycle and make dealmakers more effective every step of the way.

STRATEGY. In the first, or strategic, phase of an acquisition, valuation approaches help corporate managers consider different ways to use capital to create value for shareholders. It's a matter of good governance to critically evaluate "build" versus "buy" options – and to compare those alternatives to stock buybacks, dividend increases, and other programs that return value directly to owners.



Discounted cash flow analysis is the main tool to assess the various strategic options. A comprehensive analysis examines costs, projected returns, risks, and market factors. Ramp-up timetables and the competitive landscape may temper projected returns for internal investment while synergy and cost-cutting assumptions on possible acquisitions must be challenged in light of associated risks.

Companies too often react to opportunities rather than deciding that a transaction is the best way to use the organization's resources. The answer to "What's a fair price for this deal?" often fails to gauge the deal's real value contribution to the business.

OPPORTUNITY ANALYSIS. The optimal price to pay lies between the target's stand-alone value – the present value of projected cash flow of the target assuming no synergies or improved efficiencies – and the target's investment value after realistic synergies and improved efficiencies are factored in. Evaluating which synergies to pay for is critical to shaping the optimal bid.

Cash flow improvement may not be the only reason to proceed with a deal. While not easily quantified, factors such as competition, reputation, people, or new market entry can be legitimate deal drivers and should be incorporated in opportunity analysis.

Identifying the value drivers – whether they are operational, financial, strategic, or even "intangible" – saves time and cost by efficiently eliminating inappropriate targets from the pipeline.

EXECUTION. Considering the value impact and not solely the earnings/EPS impact changes the way buyers evaluate the economic benefits of a transaction. Focusing on financial value drivers, for instance, may reveal financial synergies or potential cost savings that can help to shape the most advantageous deal structure.

During due diligence, when bidders work to understand quality of past earnings and find potential deal-breakers, they should also be refining their understanding of the target's stand-alone value and value contribution to the buyer.

At the same time, broad financial, tax, and commercial due diligence – including competitive and operational questions along with intangibles such as brand and customer relationships – yields information that enriches the valuation model. A valuation perspective improves due diligence and helps bidders make the most of increasingly constrained due diligence windows.

A sophisticated valuation model is an unsurpassed tool in negotiations, as it embodies the buyer's point of view on what the deal is worth and why. Within the bidder's organization, a model that clearly outlines the rationale of the proposed deal from a value perspective helps gain the support of directors and other stakeholders.

TRANSACTION EFFECTIVENESS. A transaction formulated on the basis of value drivers and value analysis, from strategy to closing, offers distinct advantages. The complex model created in the process provides standards and guidance, improving the odds of positive post-close effects. The key drivers identified in strategy and refined in due diligence become benchmarks against which the integration team can track postdeal progress.

Modeling, combined with a good due diligence process, transfers knowledge across the organization, helps promote organizational change, and provides criteria for realistic measurement of outcomes. For companies with more deals in their future, learning from experience is truly a source of value.

Stephan Thollot ■ New York
Transaction Advisory Services

How Carve-Out Models Bring 'Science' to the Sell Side

More and more companies are coming to a sensible conclusion: Non-core businesses should be sold. Executing this strategy can be tricky, however, when it comes to valuation.

Determining the value of a business or asset is always a multifaceted exercise. It's particularly complex when the object will be "carved out" from a larger, ongoing business that may contribute to its success, draw from its resources, or otherwise have an impact on value and selling price. One way sellers address valuation in such cases is by adapting financial models to the specifics of the sale.

WHAT-IFS. Carve-out models can be designed as highly flexible, decision support instruments, accomplishing numerous goals beyond helping companies understand the value of the business being sold. These models also create a fleshed-out picture of what the purchase can offer potential buyers – and demonstrate the sale's effect on the seller too.

Well-designed models allow sellers to construct what-if scenarios using a wide range of variables and risk factors – and then use the scenarios to calculate any number of results, from discounted cash flow to debt-equity ratios. They feature management dashboards, clear formulas, and uniform structures with built-in error-checking. The ability to update assumptions and calculations during a transaction is a basic requirement.

When should sellers employ such models? First, during the strategic planning phase, a model that identifies the real value of a business allows the company to see whether a proposed carve-out makes sense. The model also can reveal whether additional investment in the business will improve its sale prospects. For instance, a company could calculate the impact on EBITDA of a $100 million, three-year investment in production technology.

Once the decision to sell has been reached, the model's input-output mechanism may help identify likely purchasers. The model also helps sellers focus on changes that should be made to attract the best buyers. And by weighing the impact of corporate shared services and economies of scale, a good model creates an accurate picture of stand-alone value and operating costs (see sidebar).

A sell-side model can help enable marketing decision support. Changes that might be made to the business may be fed into the model, enabling sellers to create a powerful story about possible outcomes. Using such elements as pricing changes, just-in-time inventory innovations, headcount reductions, facility consolidation, or outsourcing of back-office functions, modelers can build a smart, customized portrait of the outcomes a buyer may expect – along with any needs for transitional services.

OVERHANG. There's another use for these models: identifying so-called overhang costs left behind once the transaction is finalized. Usually involving such back-office or administrative functions as human resources, legal, and information technology (IT), overhang costs can be sizable and are often underestimated.

Modeling can show the seller the cost impact of a sale on its IT infrastructure; for example, once the number of divisions supported drops from five to four, the model will point to the staff reductions or other changes needed, helping the seller plan more efficiently for life postdeal.

Financial models provide a systematic, flexible method for establishing the entire value proposition of a carve-out and navigating it well, while avoiding unpleasant surprises along the way.

By adding a more scientific approach to the sell-side process, financial modeling brings real value.

George Carey ■ New York
Transaction Advisory Services

Scott B. Rivello ■ Chicago
Transaction Advisory Services

Components of Stand-Alones

A company wants to sell a division. The business is thriving, and margins are good. But the division, relying on the parent company's purchasing leverage, has had the benefit of discounted telephone service, raw materials, and freight. What's more, the parent has been selling certain materials to the division on a cost-plus basis. The division uses software licensed to the parent, and a newly built corporate data center has freed the division from running its own.

As a carve-out, no longer the beneficiary of corporate bounty, what happens to margins? And what's the right price?

These questions are increasingly relevant. Over the past decade, many companies expanded their corporate shared services. Centralized finance, technology, HR, and other functions offered economies of scale to these organizations as they grew. But now, as divestitures multiply, the dependence of carve-outs on shared services adds to the complexity of those transactions, from sell-side valuation to postdeal operating models.

Typically, deal prices are based on a multiple of EBIDTA, so buyers and sellers primarily focus on stand-alone recurring costs – the costs of managing the business – when performing valuations. However, the value of a carve-out involving shared services is also affected by one-time costs of ramping up the target under a new owner. In addition, valuation must take into account the costs of any transition service agreements that may be needed.

Understanding the stand-alone value is far from simple. Scale-driven financial processes include accounts payable, payroll, and time and expense, each with its own cost considerations. Costs allocated by the seller to the division for scale-driven processes such as accounts payable and payroll may not apply to the division operating as a stand-alone company. Understanding costs for other areas such as shared distribution, manufacturing, and IT services or supplier arrangements also takes knowledge of these specific elements in their industry or market context.

Jonathan Lawrence ■ New York
Transaction Advisory Services

The Discipline of Strategic Finance

The quality of a company's strategic decisions determines its M&A history and subsequent financial performance. While many acquisitions create value for the targets in the form of increased share price, this is less often the case for the buyer. That creates a variety of risks and challenges in managing transaction effectiveness.

To improve value resulting from transactions, companies must take a disciplined approach to evaluating acquisition strategy, pricing their bids, and allocating capital in transaction integration. Above all, strategic and financial management decisions must be aligned.

The "strategic finance" approach begins early in the transaction lifecycle as managers develop a strategic rationale for acquisition based on a set of realistic financial synergies. Once strategies are in place, the next step is to develop financial and value targets along with key transaction measures to monitor performance. This helps ensure continued focus and accountability for value enhancement.

Ultimately, performance is tied to management incentives and compensation, making transaction strategies and the metrics that define them a basis for effective execution.

QUANTIFYING SYNERGIES. A major transaction risk lies in overpaying the control premium, defined as the amount an acquirer is willing to pay over the target's current market value. Many deals fail to create value because acquirers are overly optimistic about potential synergies, leading to inflated deal pricing.

To assess risk, evaluate deal feasibility, and monitor performance, an acquirer must translate a transaction's strategic rationale into specific goals for financial synergy and cash flow. Financial synergies typically include value enhancements in the form of sales growth rates, expense reduction and increased net operating profit margins, increased capital efficiencies, lowered costs of capital, and reduced financial risk. These are the tangible areas of transaction performance that lead to strategic advantage in the long run.

A strategic finance assessment evaluates the potential effects of strategic and operational decisions which may be required to achieve targeted synergies. It analyzes the present value of incremental cash flows before investment, in relation to the present value of potential improvements, taking into account the fixed and working capital investments necessary to achieve them along with related capital costs. By integrating strategic and financial decisions as part of transaction management, companies gain a clearer view of what it will take to achieve these synergies before strategic commitments are made.

DECISION ANALYSIS. Understanding the financial implications of multiple strategic choices can present a variety of challenges throughout the transaction lifecycle, requiring robust decision analysis methods. Staples of decision analysis include operations research, portfolio analysis, and business risk quantification with an emphasis on understanding corporate value drivers.

Value drivers are those strategic, operational, and investment areas of a business that must be managed most intensively to enhance value. Building a complete picture of value drivers also requires evaluating the role of non-financial measures relating to R&D, human capital, customer satisfaction, quality, and other initiatives important to value creation.

FEEDBACK LOOPS. Improving value from transactions requires well-informed feedback on financial performance. Value drivers must be kept in focus throughout transaction integration. This can be facilitated by the use of value scorecards which summarize and link strategic, operational, and investment performance areas with financial results.

Implementation plans supporting transaction measurement are critical. These should address reporting and timing requirements for monitoring value, communications, change management, and decision-making methods supporting ongoing value management. This acknowledges that nonfinancial, cultural, and behavioral issues – along with effective feedback loops and a commitment to continuous learning – improve operational and financial outcomes.

Finally, perhaps the most important step is linking transaction performance with compensation, rewards, and recognition, to ensure strategic accountability for targeted financial results.

Patrick Schaefer ■ McLean
Transaction Advisory Services

Valuation Challenges in Pharma Deals

Biopharma deals are on the rise as patents expire, capital needs grow, and the industry becomes increasingly global. Valuing today's opportunities requires rigorous modeling and analysis that challenge corporate resources, teams, and protocols.

In the biopharma sector, evaluating acquisition and licensing candidates requires weighing diverse sources of information – whether scientific, regulatory, commercial, or financial – to understand their effect on shareholder value. The information can be both quantitative and qualitative. The ultimate decision frequently relies on experience, gut feel, and, possibly, political give and take.

An ongoing Ernst & Young study of biopharma valuation practices shows a growing need for companies to supplement judgment and intuition with structured analysis to properly integrate quantitative and qualitative factors. Systematic valuation can help organize data, articulate uncertainties, and identify gaps in information.

UNDERSTANDING VALUE. Given today's increasing transaction activity, buyers and sellers have more at stake than ever. With more deals being done at early phases of development, valuing the businesses and products is difficult and highly subjective. Discounted cash flow, the standard valuation methodology, has serious shortcomings in this context. Setting consistent financial metrics for Board approval is particularly demanding.

The problem is multiplied overseas. In such promising emerging markets as India and China, understanding the value of brands, technology, production facilities, and other assets is complicated by tax, regulatory, cultural, and other differences. Marshalling functional and operational capabilities for a global deal requires business development leaders to excel as technicians, managers, and diplomats.

INTEGRATING ANALYSIS. While many tough decisions boil down to numbers, such as allocating R&D investment, pricing an acquisition, accounting for intangible assets, and assessing stock price effects, the numerical results are just one aspect of valuation. Critical to using the numbers is a deep understanding of valuation methodologies, underlying assumptions, and how to quantify qualitative issues in the analysis. Integrated valuation analysis has become essential to a biopharma industry facing increased focus on efficient capital allocation and pending accounting rules that emphasize fair value, at the same time that transaction activity is rising in both M&A and early stage in-licensing.

Leading Companies Work Toward:

- ✓ Building enterprisewide commitment to use rigorous valuation analysis to support transaction decision-making
- ✓ Developing world-class valuation skills in-house
- ✓ Helping the Board and senior management become educated consumers of valuation analysis
- ✓ Reconciling transaction valuation with financial reporting and tax needs
- ✓ Creating supportive culture, structures, and processes

Preliminary results of the Ernst & Young study identify several elements critical to building transaction valuation capabilities. These include:

Learning from the Past: Comparing current results with the original analyses used to gain approval provides a better understanding of the strengths and weaknesses of valuation models.

Getting Connected: Connecting isolated pockets of expertise creates opportunities to develop more capable people, reduce risk, and build a common language to support value creation across the company. One significant benefit: regulatory exposure can be reduced by aligning valuations for financial reporting, tax compliance, and M&A.

Balancing Standards and Flexibility: Standard approaches, including financial models, discount rates, and growth assumptions, reduce duplicated effort, facilitate training, and make senior management reviews more efficient. However, standards need to be adapted for different business units and regions. For example, mandating a single corporatewide discount rate may not be appropriate in a biopharma doing deals in ethical pharmaceuticals and consumer health care.

Virtual Teaming: Each transaction valuation requires quality contributions from throughout the firm, including finance, accounting, R&D, sales and marketing, tax, and manufacturing. Information and feedback must flow freely among these groups throughout the process. Achieving necessary levels of communication in real time can be difficult in a complex global organization, particularly when the key players have multiple responsibilities and valuation is not their "day job." But companies with well-defined roles and procedures, as well as a collaborative culture, typically produce more useful valuations.

By strengthening valuation capabilities throughout the organization, individual executives can better synthesize diverse information and improve decision-making for transaction investments.

Jeffrey Greene ■ New York
Transaction Advisory Services

Russia's Valuation Challenge

Russia is a nation of extremes. It is urban and agrarian, developed and undeveloped, with remnants of a controlled economy existing alongside a market-based economy. Political and social concerns often dominate transactions as U.S.-based businesses buy in and Russian-based businesses move toward becoming global players. Both inbound and outbound transactions are affected by the lack of standardized valuation procedures in what is still very much an emerging market.

This unique business environment extends to other countries of the CIS and affects everything from appraisal standards to the usefulness of appraised values differs from the standards in more developed nations. When a Russian or CIS company wants to "go global," the transition is often difficult. It recently took a team of outside experts and hundreds of thousands of dollars to convert a Ukraine steel plant from the local cost-based accounting system to a fair value accounting system.

In many cases, the primary challenge is proper interpretation of the limited market data that is available. Appraisal did not exist in the controlled economy. During the turbulent transition to today's market-based economy, there was little or no market information, and transaction prices were determined almost at random.

Even now, Russia, with 15 years of free market operations, has seen a limited number of transactions on significant properties. With little comparability, market indicators have hardly existed. Moreover, in the onerous tax regime of past years, financial information was often less than transparent.

APPRAISAL ANOMALIES. Without the centralized data sources or analysis that exists in more developed nations, appraisers in Russia must spend more time on data collection, use a much wider set of resources for benchmark data, and apply both logic and creative solutions to data analysis. The task is compounded by the sheer magnitude of many Russian business enterprises. One of Russia's largest banks, for example, owns real estate assets in more than 6,000 locations in 700 cities across 11 time zones from the Pacific Ocean to the borders of Europe and Scandinavia.

Gathering information item by item in digital form makes the process more manageable, together with statistical analysis and sufficient testing, to ensure the reliability of results. Once valuation models are established, the biggest challenge is keeping up with the speed and diversity of market changes for subsequent appraisals. Since various asset types change value at different rates and for different reasons, the variety of items involved is often a more significant challenge than the volume.

To compensate for the lack of solid financial data, valuation teams must spend considerable time with management, evaluating the capital expenditure plan, analyzing the competition, and making projections.

In addition, nonfinancial factors – political uncertainty, tax compliance history, business structure, product mix, organizational and management processes, financial management and reporting, and even the existence of a business plan – can make or break a company's value.

Social factors must also be evaluated in context. Russia has long had a culture of full employment, and Russian employers are still reluctant to significantly reduce headcount. But the apparent disadvantage inherent in the average eight to ten man-hours it takes to produce one ton of steel in Russian mills, against less than two hours in Western mills, may be offset by the fact that Russian workers earn in a week what Western workers earn in several hours.

FROM DISCOUNT TO PREMIUM. In the early years of the market-based economy, valuation discounts of as much as 70% to 80% recognized the uncertainty of doing business in Russia. Political instability created an environment of limited investment and short-term thinking. After 15 years of progress, Russia now has a complete set of civil legislation on which business can operate, although there is still considerable uncertainty because the rule of law is not always enforced.

For the most part, the political environment has settled, and the rules of the game have become much clearer. As a result, although the situation varies considerably among industries and according to whether the specific target is operating in the local or the global economy, the discount has generally shrunk to a far more sedate 5% to 15%. With risk substantially reduced, longer-term investment of up to seven years is more attractive. In some sectors, we may even see a "Russia premium."

Meanwhile, the key risks continue to be Russia's dependence on high prices for oil, gas, and minerals and the impact on business of its "managed democracy" political system. Both are reflected in the Russia discount that is still available to investors in this market.

Despite the challenges, securing a foothold in the Russia market presents vast opportunity. But appraisers must be flexible and creative in determining appropriate methods for analyzing market information, company operating characteristics, and the combination of financial and nonfinancial factors – the local economy, culture, and politics – that go into the valuation model.

Robert Stall ▪ Atlanta
Transaction Advisory Services

Gerald Gaige ▪ Moscow
Transaction Advisory Services

JANUARY 2008

22 **Transaction Advisory Service Breakfast Series**
Four Seasons Hotel Houston, Houston, TX
Contact: Cameron Atkinson +1 214-969-8648

23 **Transaction Advisory Service Breakfast Series**
Park City Club, Dallas, TX
Contact: Cameron Atkinson +1 214-969-8648

23 **The North American Advisory Panel – Corporate Development Function and Role**
Four Seasons Hotel Philadelphia, Philadelphia, PA
Contact: Michelle Horner +1 212-773-4129

24 **Corporate Development Officer Roundtable**
Can Can Restaurant, Richmond, VA
Contact: Zina Janabi +1 703-747-0741

31 **Corporate Counsel Roundtable**
Chantilly Restaurant, Redwood City, CA
Contact: Annmarie Escamilla +1 415-894-8331

FEBRUARY 2008

2 **Harvard Business School's 14th Annual Venture Capital and Private Equity Conference**
Harvard Business School, Cambridge, MA
Contact: Kathy Farrell +1 203-674-3208

4 **Corporate Development Officer Roundtable**
Marriott Hotel, McLean, VA
Contact: Zina Janabi +1 703-747-0741

7 **Media & Entertainment Roundtable**
The Beverly Hills Hotel, Beverly Hills, CA
Contact: Pam Walker +1 213-977-3046

7 **Chief Executive Officer Roundtable**
The Pacific Club, Orange County, CA
Contact: Annmarie Escamilla +1 415-894-8331

8 **New York University 2008 Stern Private Equity Symposium**
NYU Kimmel Center (60 Washington Square South), New York, NY
Contact: Kathy Farrell +1 203-674-3208

14 **Divesting for Value: Carve-Out Financial Statements and Operational Separation**
www.ey.com/webcast
Contact: Michelle Horner +1 212-773-4129

15 **Columbia University Business School's 13th Annual Private Equity and Venture Capital Conference**
Low Library, Columbia University Morningside Campus, Broadway and 116th Street, New York, NY
Contact: Kathy Farrell +1 203-674-3208

26 **Cross-border Transactions: Emerging Markets, Corporate Development Officer Roundtable Series**
Biff's, Toronto, ON Canada
Contact: Terry Kelly +1 416-943-3395

27 **Ernst & Young's 3rd Annual Partners and Managing Directors Private Capital Event**
Rosewater Room, Rosewater Supper Club, Toronto, ON Canada
Contact: Elyia Morgan +1 416-943-2264

MARCH 2008

3 **Transaction Leaders Reception**
Magnolia Hotel Houston, Houston, TX
Contact: Cameron Atkinson +1 214-969-8648

13 **Corporate Development Officer Roundtable**
Four Seasons Hotel, Palo Alto, CA
Contact: Annmarie Escamilla +1 415-894-8331

APRIL 2008

24–25 **The Conference Board's Business Development Conference: An Enterprise View**
Westin New York at Times Square, New York, NY
Contact: Kathy Farrell +1 203-674-3208

Mark Your Calendar

Ernst & Young will once again sponsor

The Conference Board's Business Development Conference

April 24–25, 2008 at The Westin New York, Times Square

This year's conference will address the growing centrality of business development to the entire corporate endeavor. The agenda will include such topics as:

- **Transaction Strategy and Market Leadership**
- **Divesting for Value**
- **Working with the Business Units**
- **Integration in the Real World**
- **The Shifting Transaction Landscape**
- **Infrastructure**
- **Tomorrow's Great Deals – The Private Equity View**

The Business Development Conference is intended for business development officers, corporate transaction leaders, and other key contributors to their organizations' corporate development function, including senior tax, strategy, HR, operations, finance, and legal executives.

To be eligible for the Ernst & Young discounted rate, please call customer service at (212) 339-0345 and mention the "Business Development Conference" and discount code, E&Y 904008. The discounted rate will be $1,995 through February 6; after February 6, the member rate will be $2,295.

ERNST & YOUNG LLP

www.ey.com/us/interchange

SCORE No. CE0475

In line with Ernst & Young's commitment to minimize its impact on the environment, this document has been printed on recycled paper.