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2012 OIV Business Valuation International Conference

Old and New Issues in Business Valuation

Mauro Bini
Dept. of Accounting Bocconi University
Chairman of Management Board OIV

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Old Issues

Discretionality vs. Judgment

Standard	Valuation standards
Best Practices	Guidelines
Facts and circumstances	Professional Judgement (= inescapable subjectivity area)

Generally speaking the global valuation could be considered at this stage as being:

Standard	Valuation standards	discretionality
Best practices	Guidelines	(= avoidable
Facts and circumstances	Professional Judgement (= inescapable subjectivity area)	subjectivity area)

Regulators demand for meaningful, sustantive change **as soon as possible [time's up for calm reflection]**

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Discretionality cannot be validated

To do this in a global world, with different jurisdictions we need:

at Standard level:

International Valuation standards	Domestic Valuation standard

Domestic valuation standard with the same conceptual framework of IVS

at Guidelines level

IVSC TIPS	AICPA/TAF Guidelines	Other Organizations' Guidelines/Practice aid

A strong coordination among guidelines in terms of contents and details

at Professional level

Non- credentialing organizations	Credentialing organizations

Reductions in differences in BV credentials, more attention to objectivity of valuer and analytical competencies

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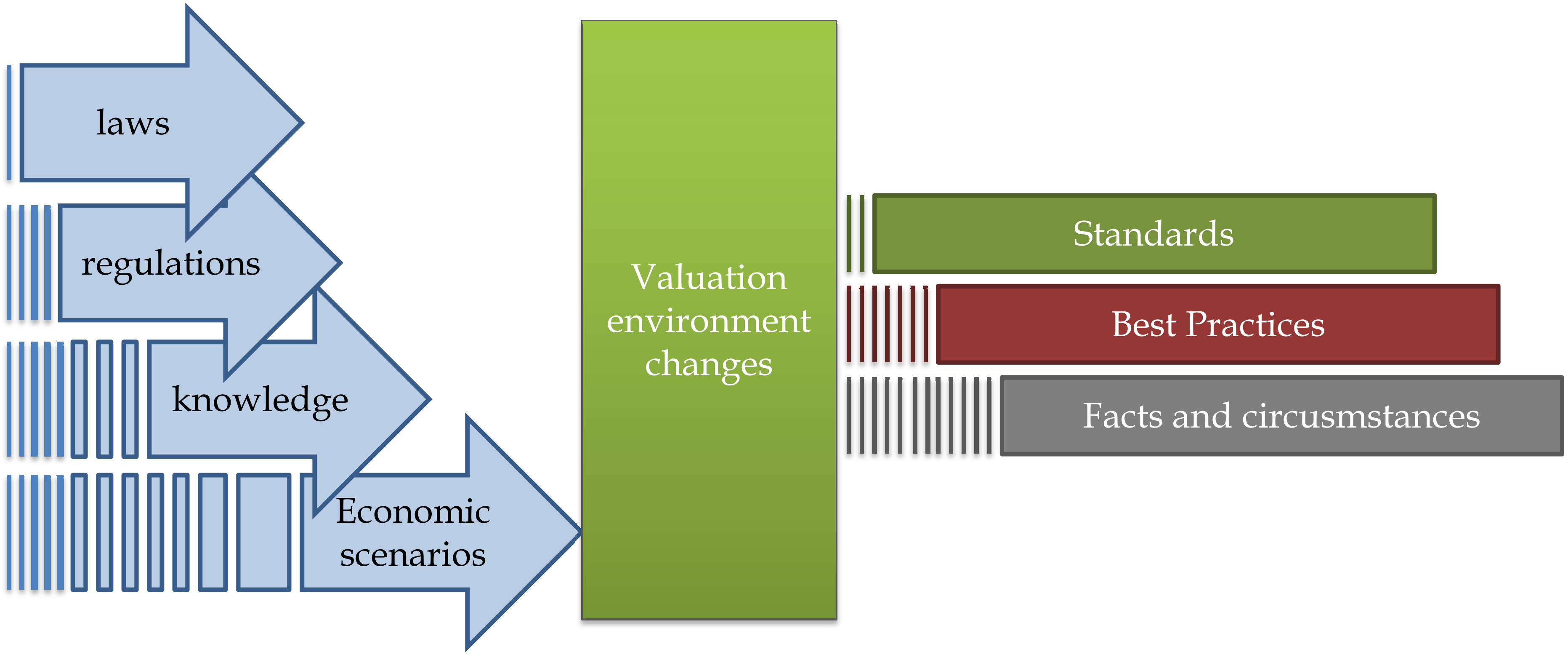
The valuation discipline is a dynamic process at different speeds



Confusion in regulations?

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Is Solvency II consistent with the market participant accounting view?

Fair value measurement IFRS 13 (ASU 2011-04):

- […] from the perspective of a market participant that owes the liability;
- [..] consider the amount that a market participant would receive to enter into an identical liability.

Solvency II (insurance industry):

Tecnical provision for unhedgeable liability =

+ PV best estimate
+ PV risk loading (risk margin)

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Discretionality in a dynamic world tends to extend naturally, to contrast this trend we need…..

Always Updated Guidelines

Malpractices | Grey area | Best practices

Without updating old guidelines and developing new guidelines the grey area spreads out

Enforcement Mechanism And Continuing education

No qualification | Opacity | Valuation credentials

Without enforcement mechanisms and continuing education curriculum the opacity of the valuation process increases

Loss of confidence in valuation?

IASB letter to ESMA, August, 4, 2011

……some companies holding Greek government bonds classified as AFS have stated that they are relying on internal valuation methodologies, rather than on market prices, to measure the fair value of the assets as on 30 June 2011.

How had different banks recognised losses on Greek debt as on 30 june 2011 ?		
	French Bank SA	German Bank SA
AFS write-down	21%	51%
L&R write-down	N/A	21%
Maturities	< 2020	All maturities

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Global CRUF priority list (Valuation Issues)

- CRUF (Corporate Reporting Users'Forum) letter to IASB, December, 6 -2011

Topic	High	Medium	Comment
Discount rate	√		Insurance/Financial instruments and pension
Intangible assets		√	Creation and amortization of intangible assets resulting from acquisition
Liabilities		√	

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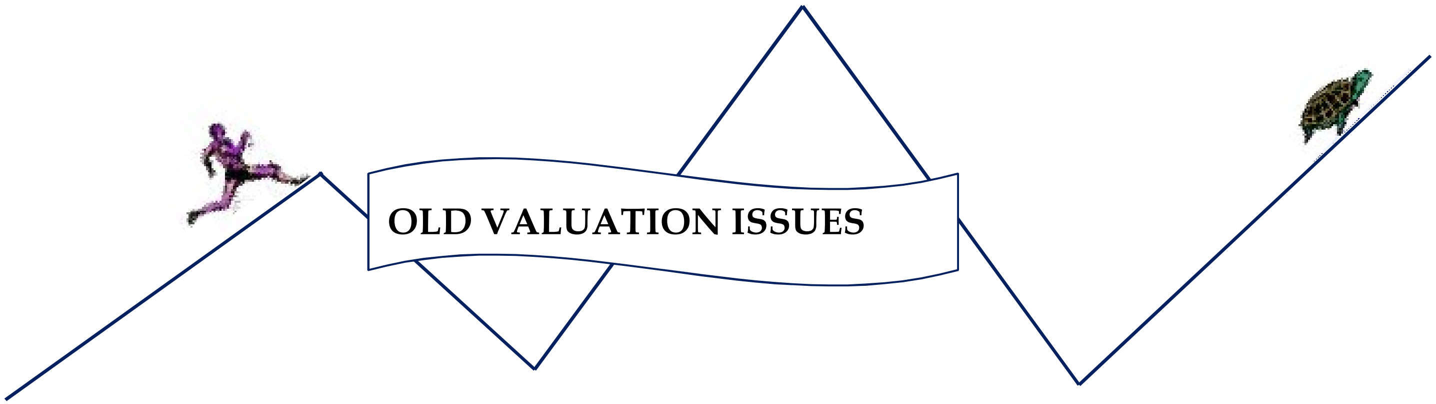
We have to avoid the “Achilles and the Tortoise" paradox

As profession, in the recent past, we have had to solve a long list of valuation issues (allowing the tortoise a head start) , before starting to solve the newest



Zenone of Elea (489 BC – 431 BC): In the paradox of_Achilles and the Tortoise, Achilles is in a footrace with the tortoise. Achilles allows the tortoise a head start of 100 metres, for example. If we suppose that each racer starts running at some constant speed (one very fast and one very slow), then after some finite time, Achilles will have run 100 metres, bringing him to the tortoise's starting point. During this time, the tortoise has run a much shorter distance, say, 10 metres. It will then take Achilles some further time to run that distance, by which time the tortoise will have advanced farther; and then more time still to reach this third point, while the tortoise moves ahead. Thus, whenever Achilles reaches somewhere the tortoise has been, he still has farther to go. Therefore, because there are an infinite number of points Achilles must reach where the tortoise has already been, he can never overtake the tortoise.

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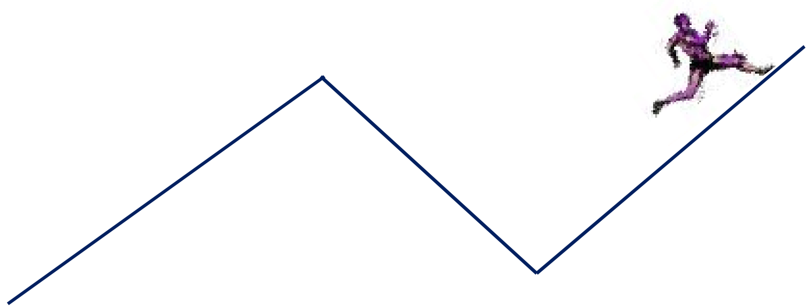
What has been done



Extraordinary Effort in Issuing Guidelines

AICPA	STATUS
"Assets Acquired to Be Used in Research and Development Activities", Guide **(IPR&D Guide)**	Near Final Draft
"Testing Goodwill for Impairment", Guide	Near Final Draft
"Valuation of Privately Held Company Equity Securities Issued as Compensation", Guide **(Cheap Stock Guide)**	Near Final Draft
"Business Combinations", Guide	Early Stage

TAF (The Appraisal Foundation)	STATUS
WG1, "Identification of Contributory Assets and Calculation of Economic Rents"	Issued
WG2, "The Valuation of Customer-Related Assets"	Discussion Draft
WG3, ""Assessment and Measurement of Control Premiums in Valuations for Financial Reporting"	In progress
WG4, "Valuing Contingent Consideration"	Early Stage

IVSC	STATUS
TIP 1, "Discounted Cash Flow"	Issued
TIP 2, "The Cost Approach for Tangible Assets"	Issued
TIP 3, "The Valuation of Intangible Assets"	Issued
DP, "Valuation of Uncertainty"	Exposure Draft

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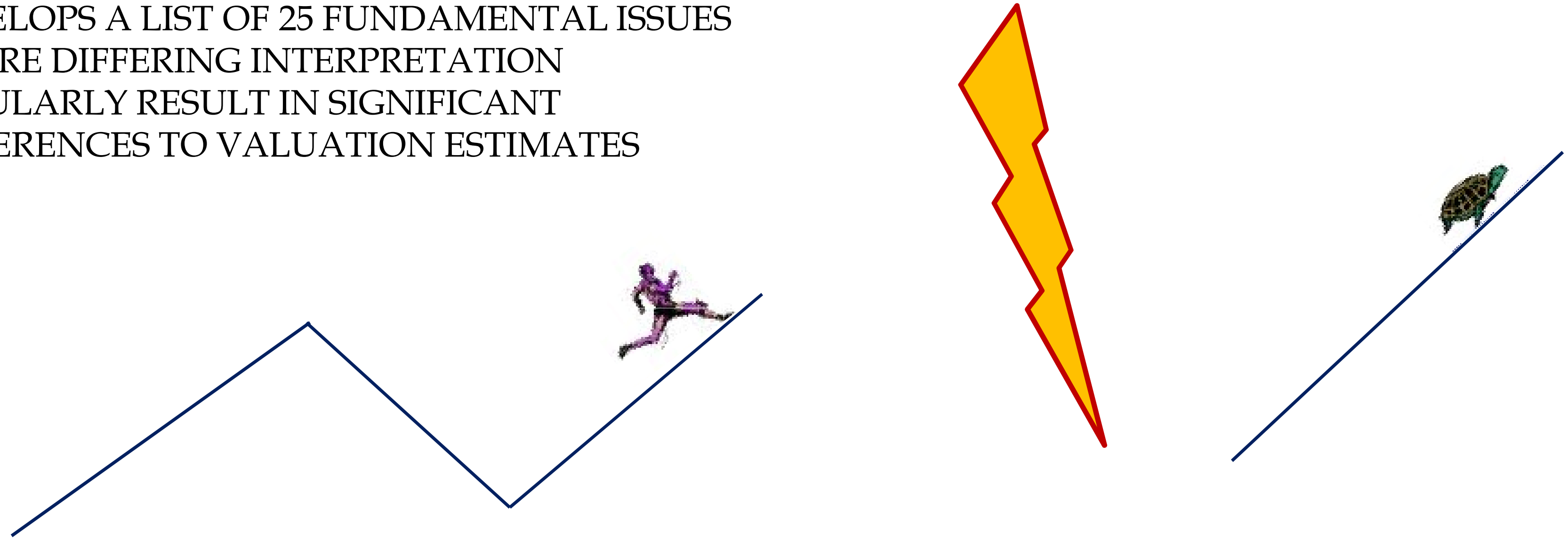
After all the work done, where are we?

2006

AITF-Appraisal Issues Task Force
DEVELOPS A LIST OF 25 FUNDAMENTAL ISSUES WHERE DIFFERING INTERPRETATION REGULARLY RESULT IN SIGNIFICANT DIFFERENCES TO VALUATION ESTIMATES

2008
Financial crisis

2012



Extraordinary Efforts in Issuing Guidelines

Substantial progress

… but , discretionality is still too high

Too many different solutions to technical issues

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The Italian experience of OIV

- Founded in November 2011
- IVSC Sponsor member in January 2012
- Issued ED Impairment Test Guidelines in Financial Crisis Context in march 2012 (final text in june 2012)
- In Progress: ED Conceptual framework of PIV (Italian Valuation Standards) in november 2012
- In Progress: PIV in 2014

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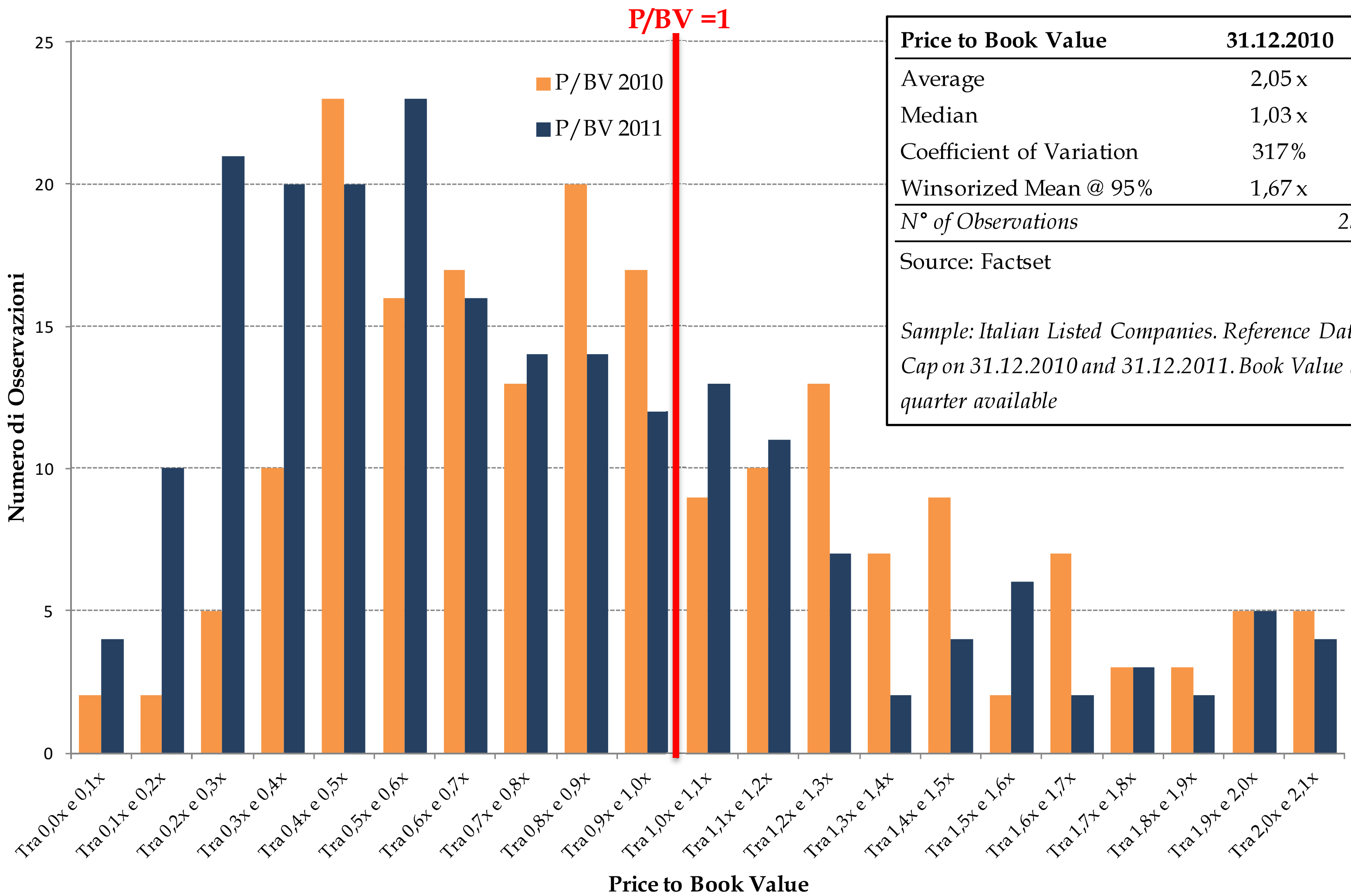
Price to book value distributions [2010 and 2011] (Italian listed companies)



Price to Book Value	31.12.2010	31.12.2011
Average	2,05 x	1,30 x
Median	1,03 x	0,79 x
Coefficient of Variation	317%	150%
Winsorized Mean @ 95%	1,67 x	1,20 x
N° of Observations	*255*	

Source: Factset

Sample: Italian Listed Companies. Reference Date: Market Cap on 31.12.2010 and 31.12.2011. Book Value at the latest quarter available

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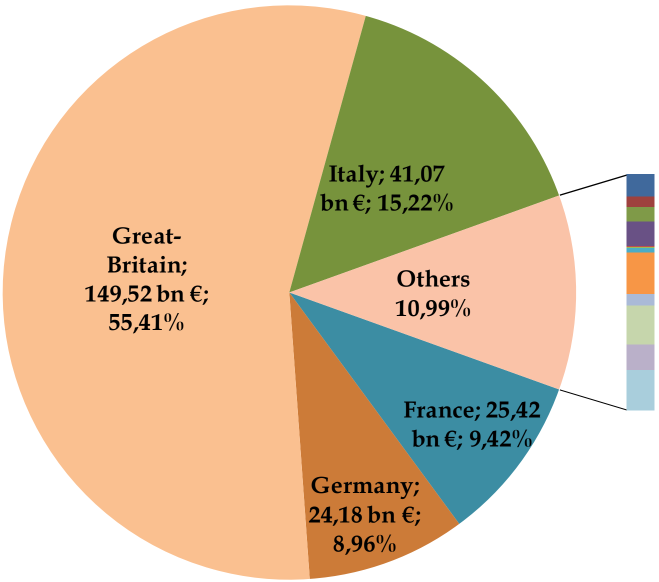
Impairment Test in Italy before and after OIV Guidance

Evidence suggests that applicative guidance might have contributed to an increase in transparency in financial statements. OIV published Impairment Test Guidance before AR 2011 closing date. It has been considered the best practice by the main Italian listed companies.

2005-2011 Cumulated Impairment by volume



	Cumulated $Impairment_{2010}$/ Gross $Goodwill_{2010}$
Great-Britain	33,5%
Spain	13,8%
Finland	13,4%
Denmark	12,8%
Norway	11,9%
Austria	10,3%
Germany	8,5%
Luxembourg	4,8%
Sweden	4,7%
France	4,7%
Netherlands	4,2%
Switzerland	3,3%
Italy	**2,9%**
Ireland	2,2%
Belgium	1,3%
Greece	0,5%
Portugal	0,4%

	Cumulated $Impairment_{2011}$/ Gross $Goodwill_{2011}$
Great-Britain	33,7%
Italy	**24,7%**
Spain	24,4%
Austria	24,1%
Finland	20,1%
Norway	12,6%
Denmark	12,6%
Germany	10,0%
Sweden	8,0%
Netherlands	6,4%
France	6,2%
Luxembourg	4,7%
Switzerland	4,3%
Greece	3,7%
Ireland	2,4%
Belgium	2,2%
Portugal	1,5%

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New Issues

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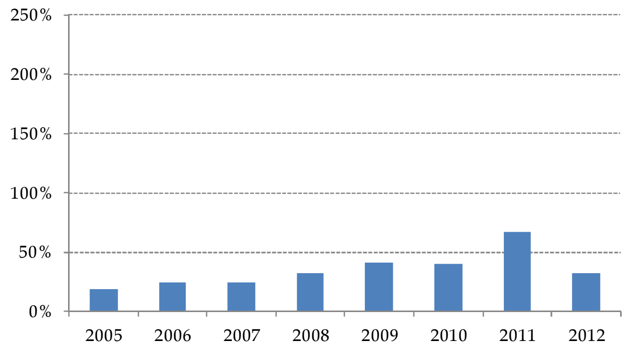
Market Approach: fewer comparables

Median Coefficient of Variation of P/E Multiples

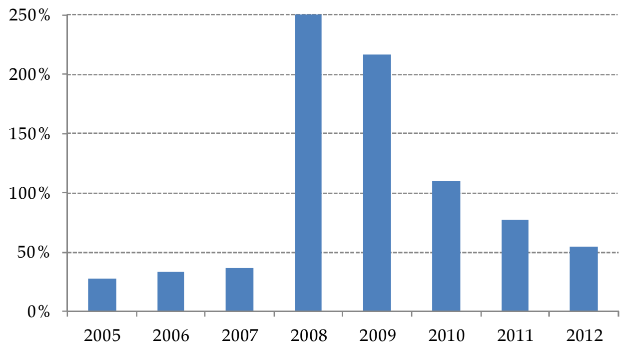
Slightly Increasing | *Reverting Downwards* | *Still Troublesome*

Europe

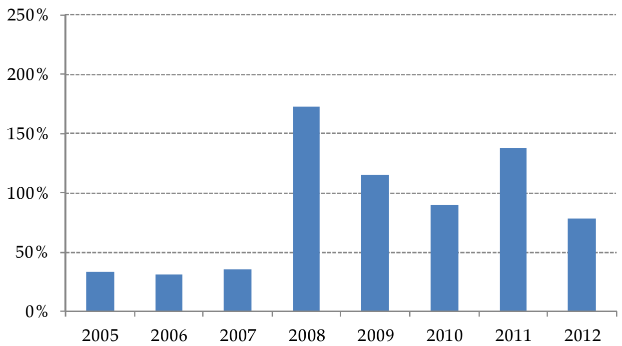
Utilities - STOXX 600



Banks - STOXX 600

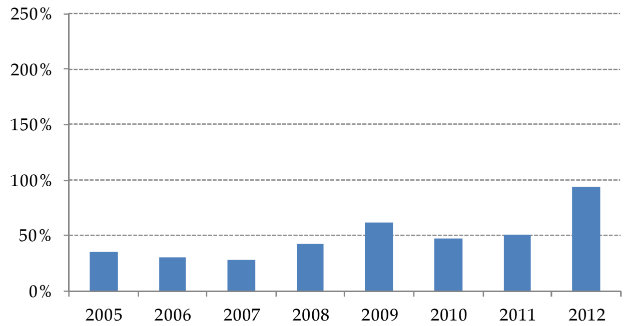


Industrial Goods & Services - STOXX 600

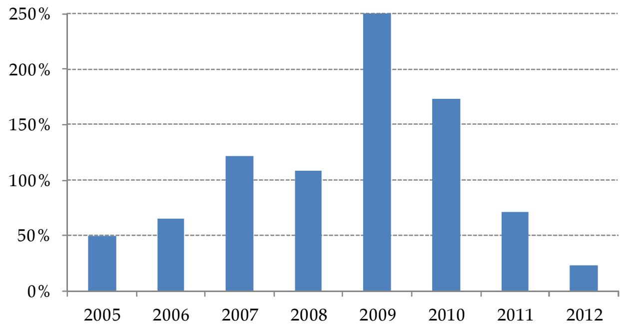


USA

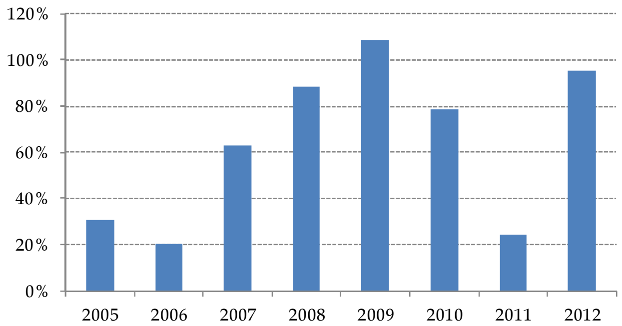
Oil & Gas - S&P 500



Personal & Household Goods - S&P 500



Retail - S&P 500



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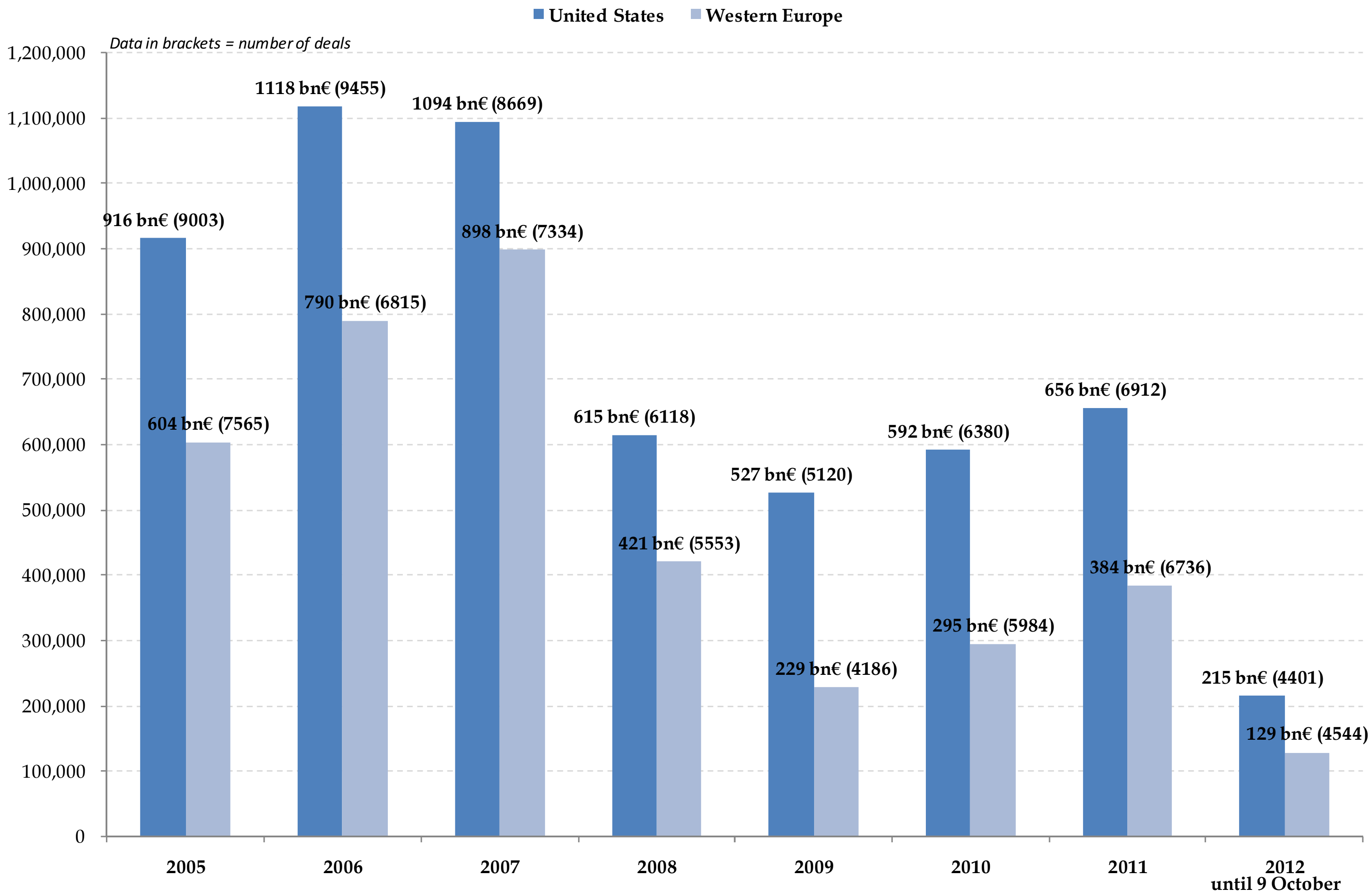
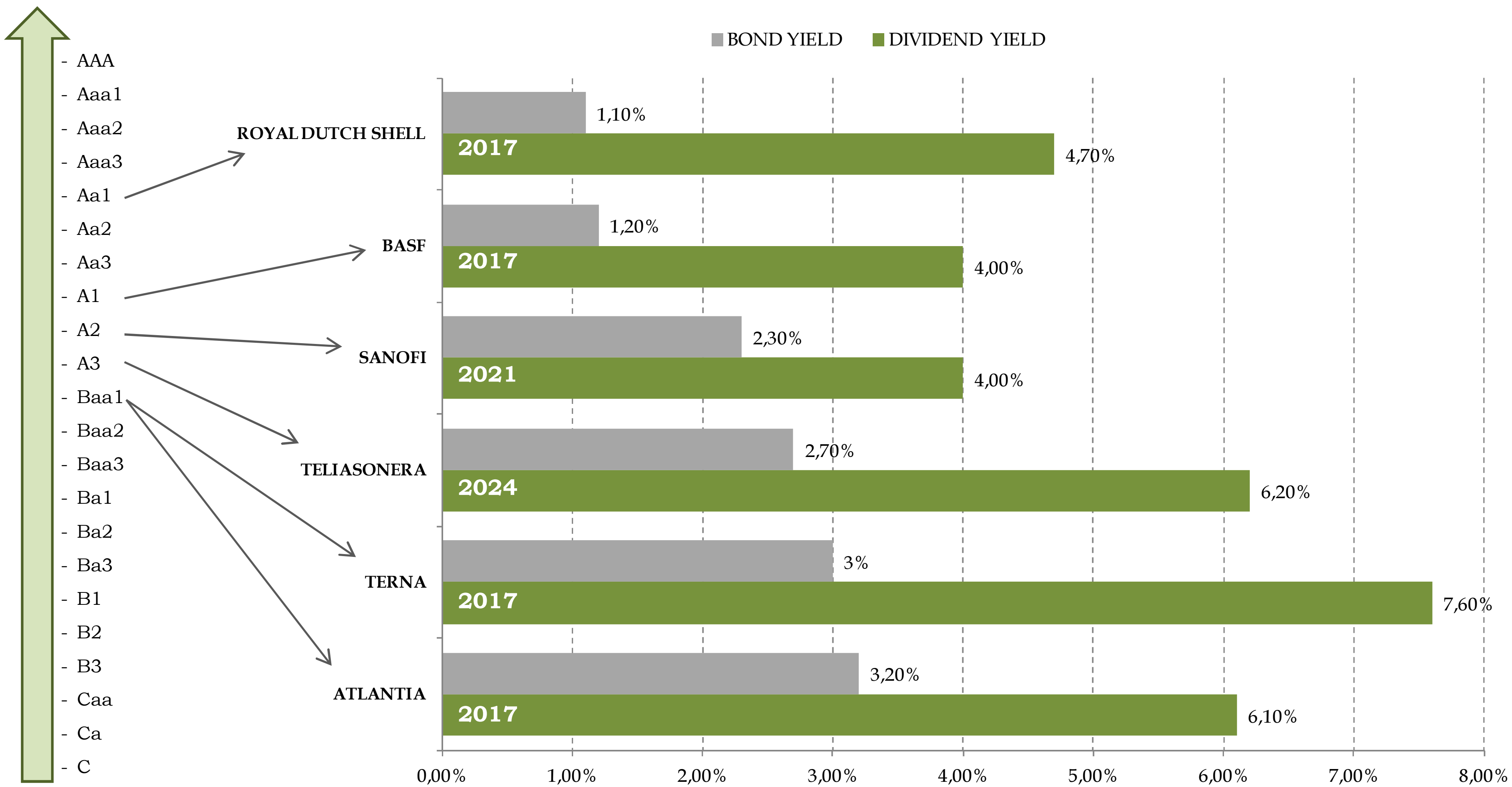
Market Approach: fewer transactions



Market Approach: dividend yield vs bond yield



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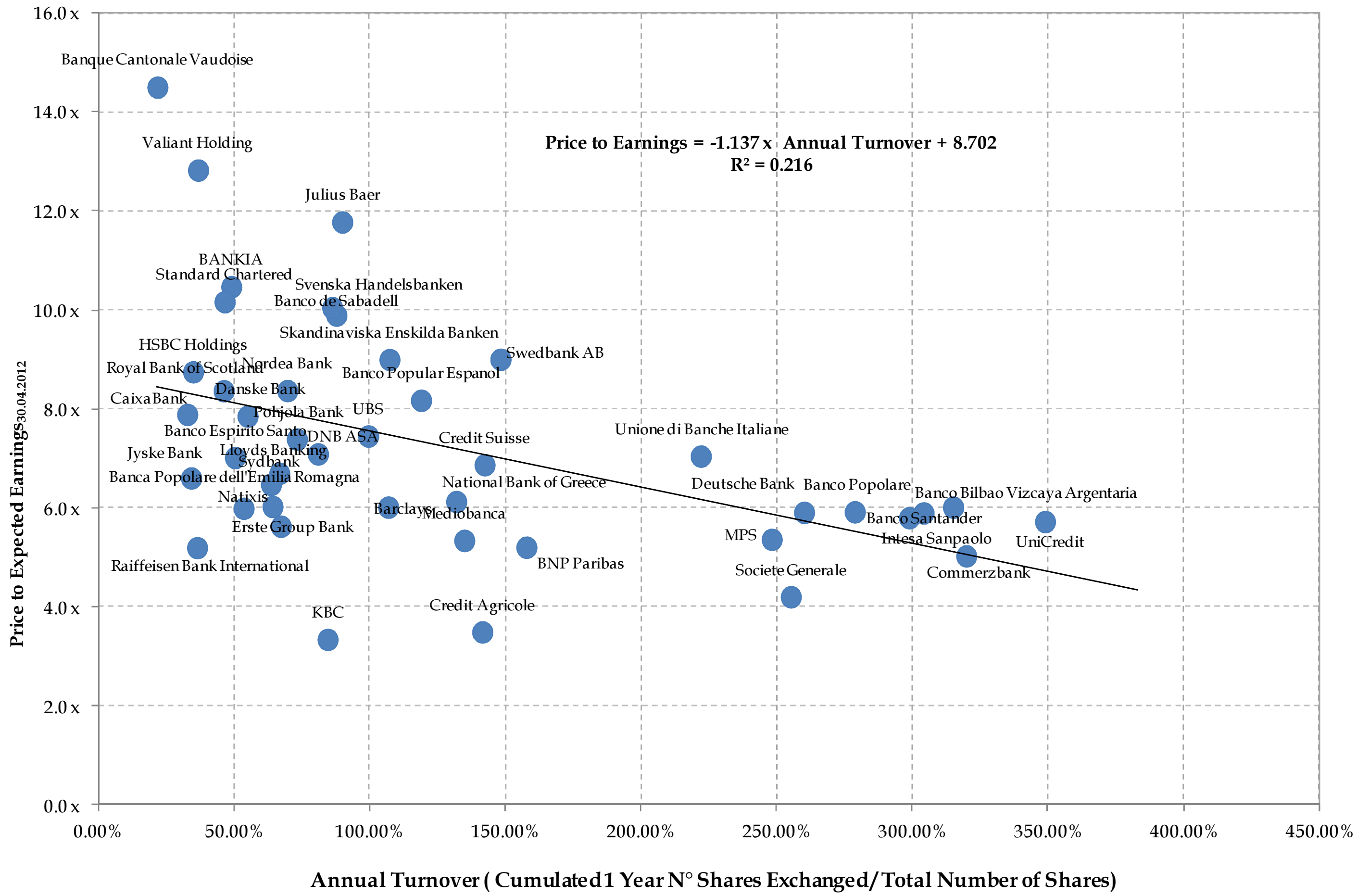
Market Approach: shares turnover vs P/E



<u>European Banks</u>
Relationship between Price to Expected Earnings and Annual Turnover became negative and with a sign opposite to the theory:
more liquidity implies fewer multiples

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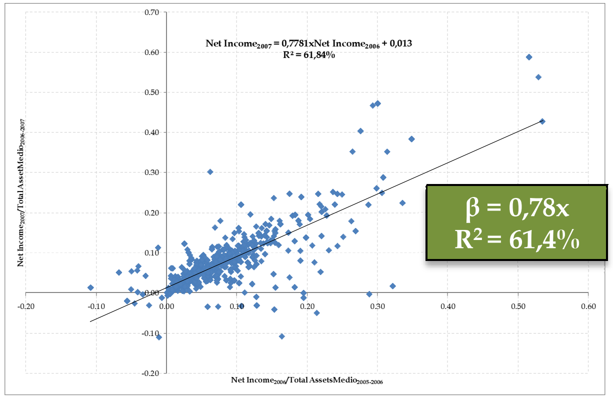
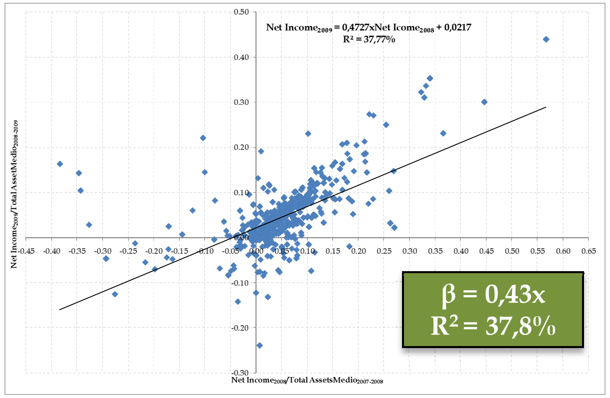
Income Approach: Earnings persistence, disappeared during the crisis, is coming back…

Stoxx 600 - 2007



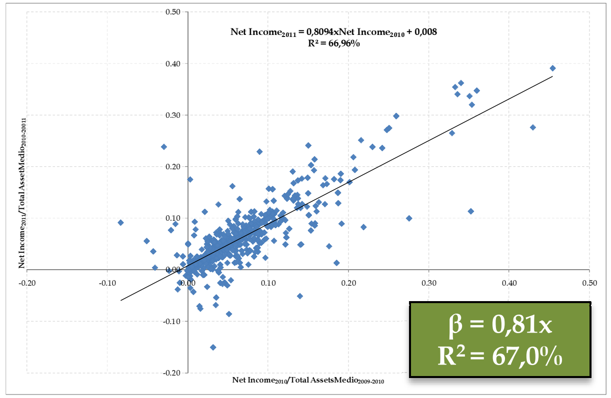
Observations = 548

Stoxx 600 - 2009



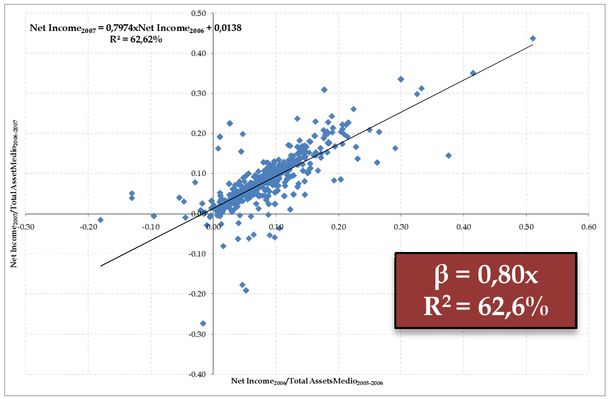
Observations = 548

Stoxx 600 - 2011



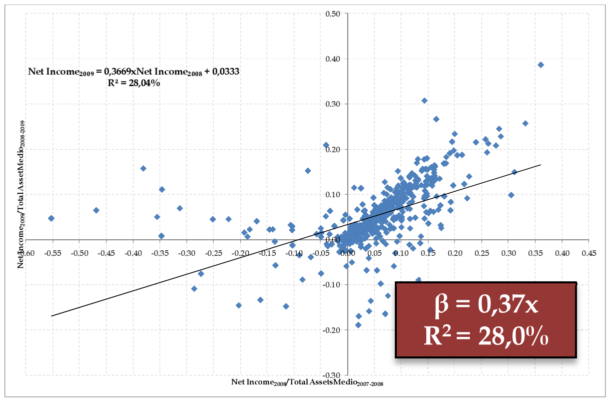
Observations = 548

S&P 500 - 2007



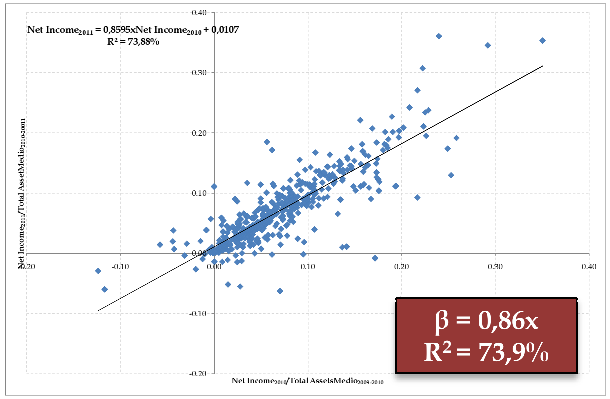
Observations = 475

S&P 500 - 2009



Observations = 475

S&P 500 - 2011



Observations = 475

$$\text{Regression Model}: E_t = \alpha_t + \beta_t \times E_{t-1} + \varepsilon_t$$

E = earnings at t and at t-1. In order to reduce the heteroschedasticity, net income is scaled by the average of Total Assets.

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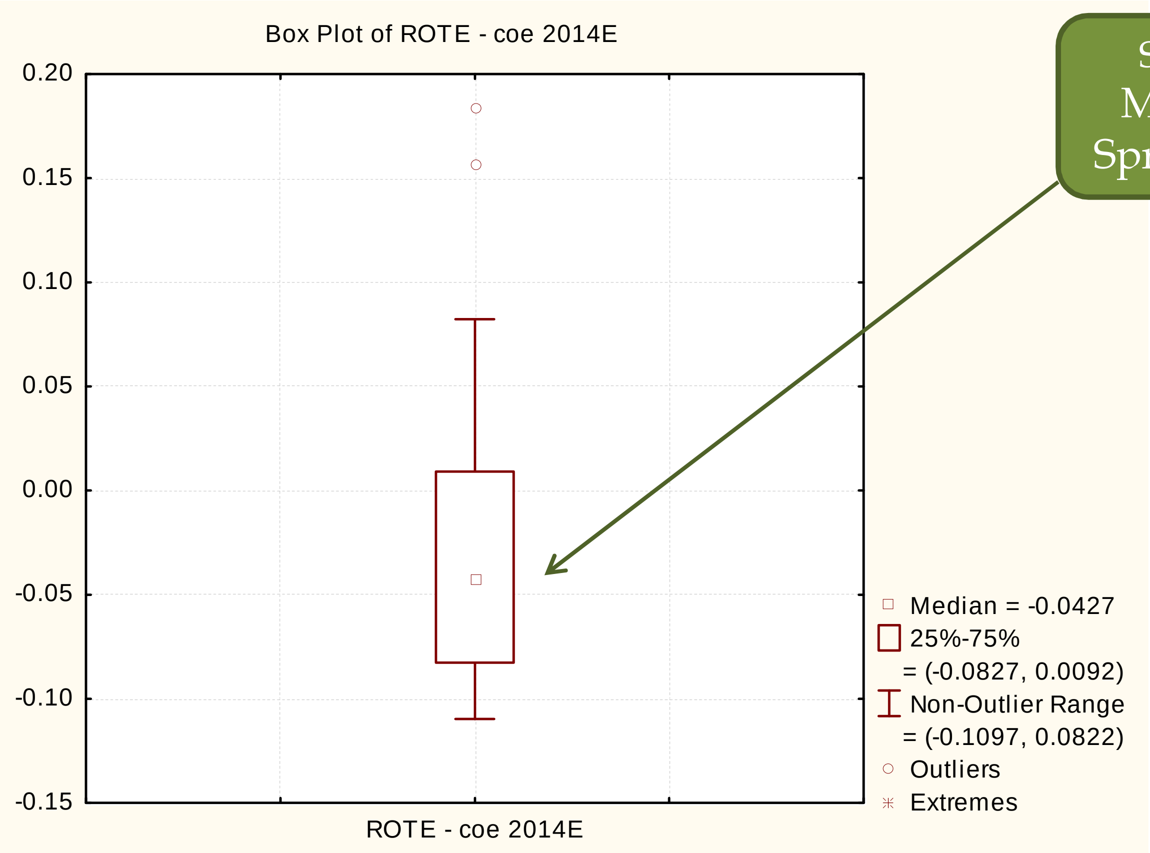
… but we still have a problem in terminal value estimate

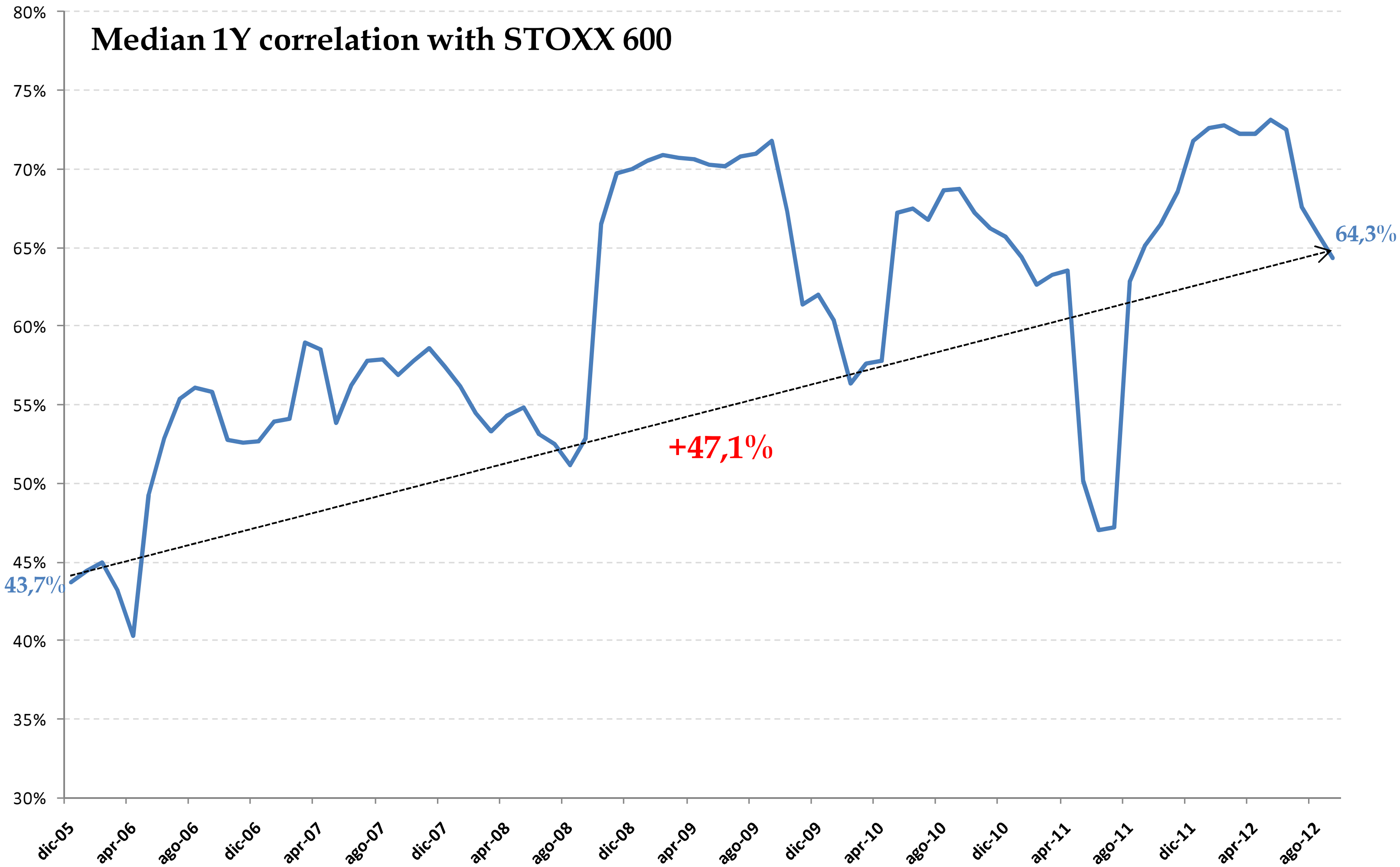
For some sectors, equity analysts project in the long term return on tangible equity figures that are fewer than cost of capital, impliyng value destruction; should we use this figure in estimating terminal value?



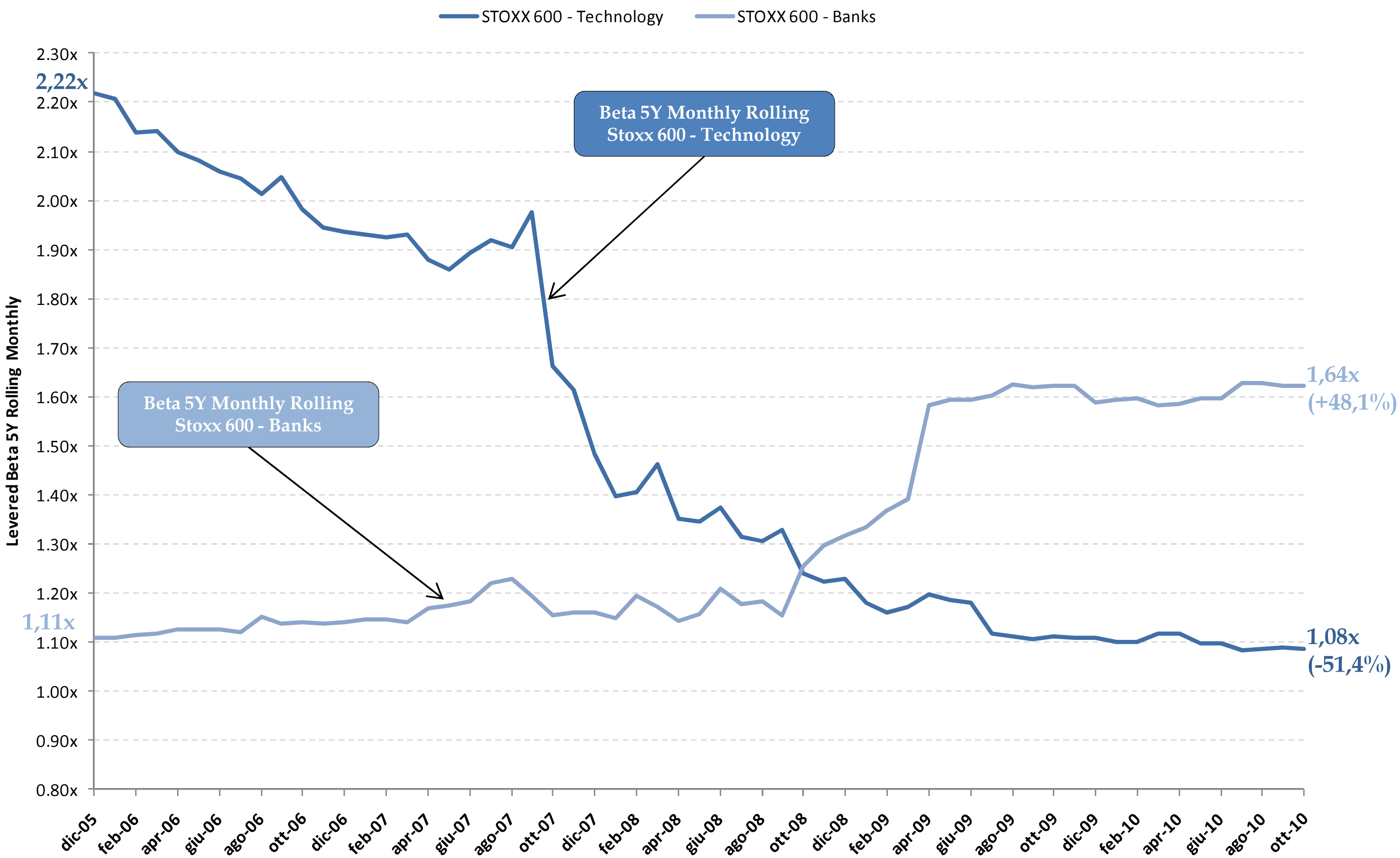
STOXX 600 Banks Sample (41 Banks)
Median Return on Tangible Equity Spread 2014 (ROTE Spread)= **- 4,27%**

Should we project a negative ROTE Spread in perpetuity?

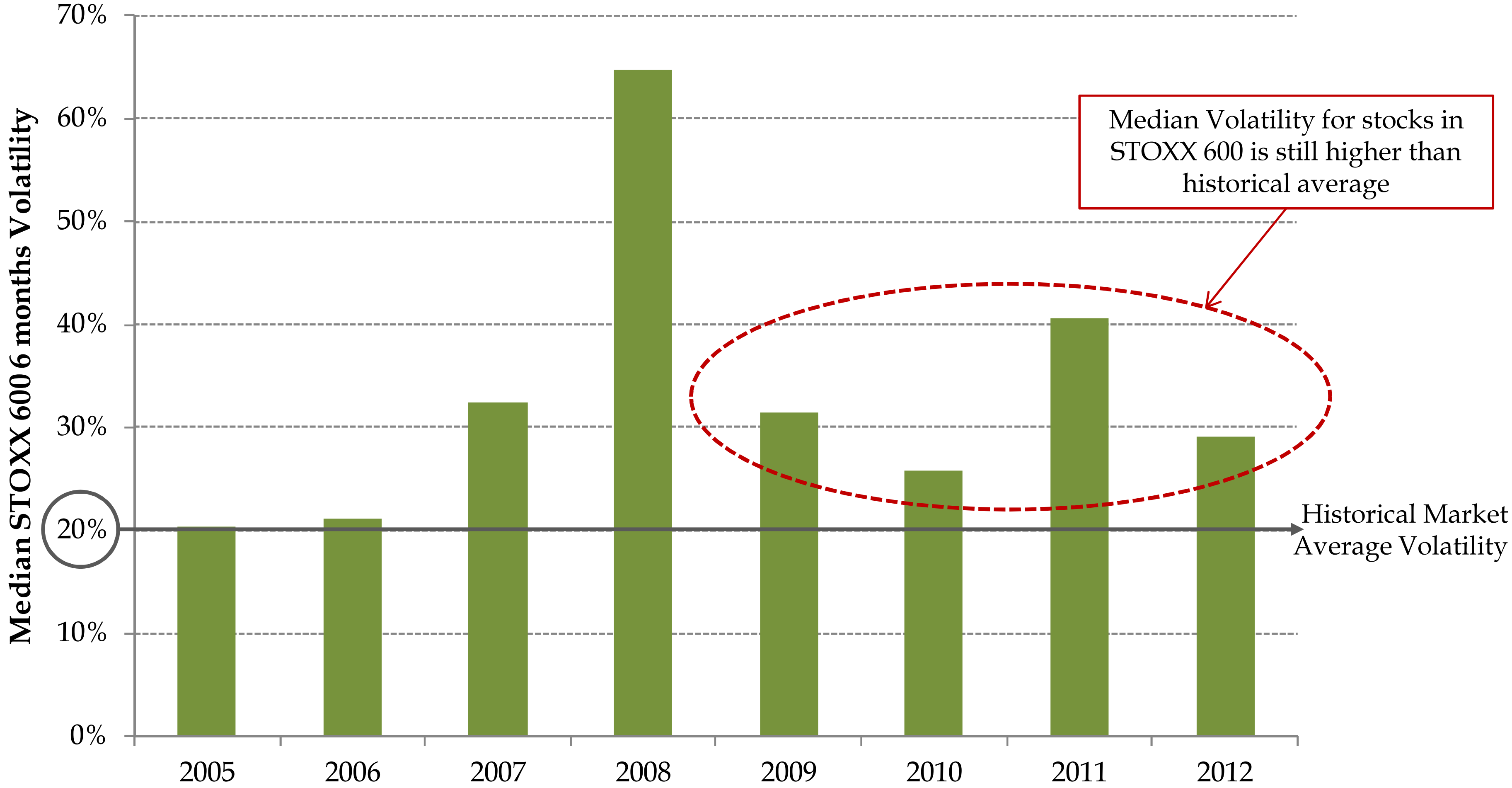
Income Approach: less diversification



Income Approach: less beta stability



Income Approach: more volatility



Income Approach (Liability): Bond Yield vs CDS

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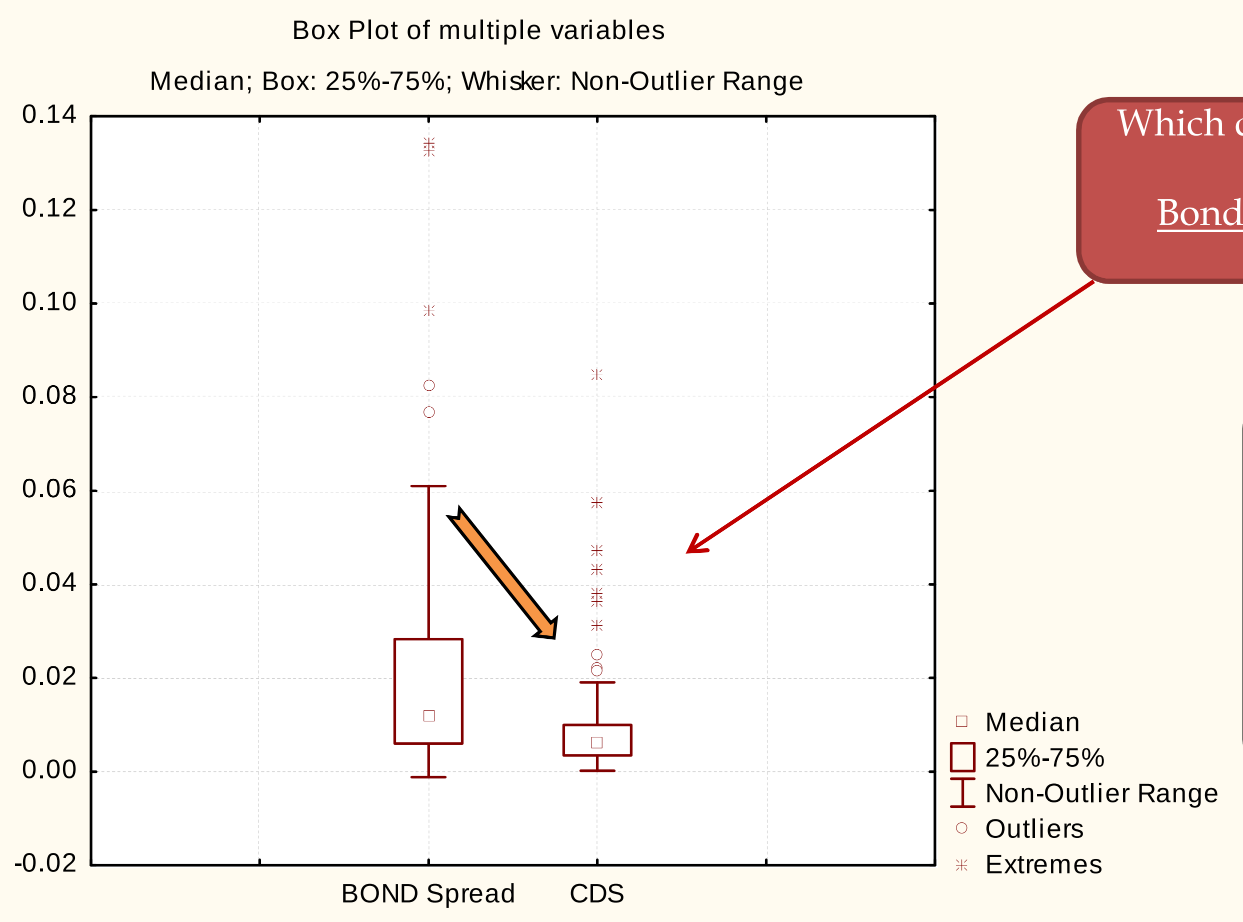

Which discount rate to use for fair value computation?
<u>Bond spreads are more widespread compared to CDS.</u>

The differences are due to:

1. illiquidity;
2. different risk free considered by CDS market participants;
3. existance of bond covenants;
4. different definition of restructuring event.

The example considers Bond and CDS spreads for the same sample of european companies. Sample's bond maturity date is fixed at 2016. The analysis is performed at the end of 2011. CDSs are 5Y maturity date as well.

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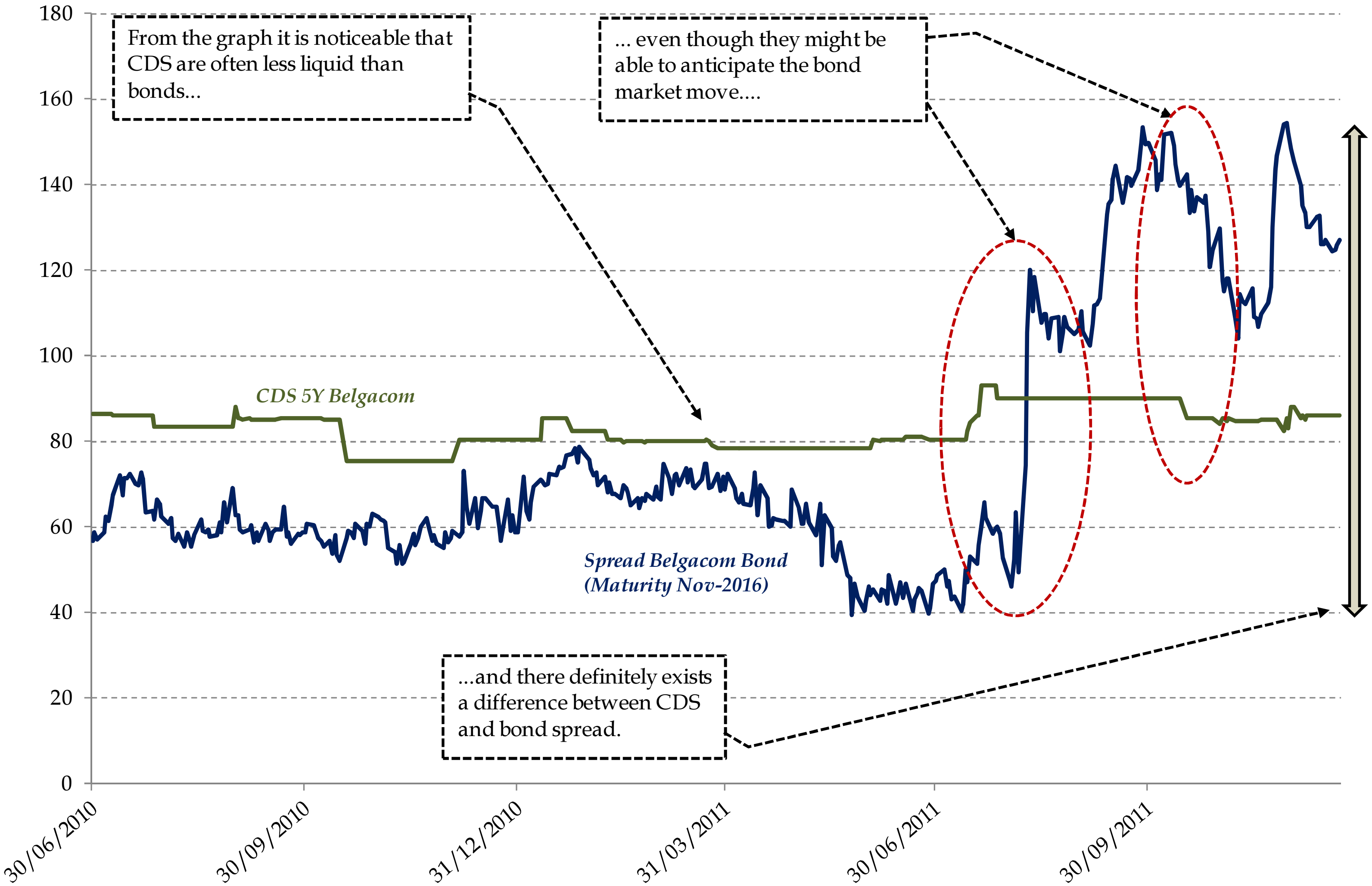
Income Approach (Liability): Bond Yield vs CDS



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Income Approach (liability): non performance risk

An example of fair value option usage in debt accounting: JP Morgan 9m 2011 Report Excerpt

NOTE 17 – Fair Value Option

The Corporation elected to account for certain financial instruments under the fair value option. For additional information on the primary financial instruments for which the fair value option elections have been made, see Note 23 – Fair Value Option to the Consolidated Financial Statements of the Corporation's 2010 Annual Report on Form 10–K.

The table below provides information about the fair value carrying amount and the contractual principal outstanding of assets and liabilities accounted for under the fair value option at September 30, 2011 and December 31, 2010.

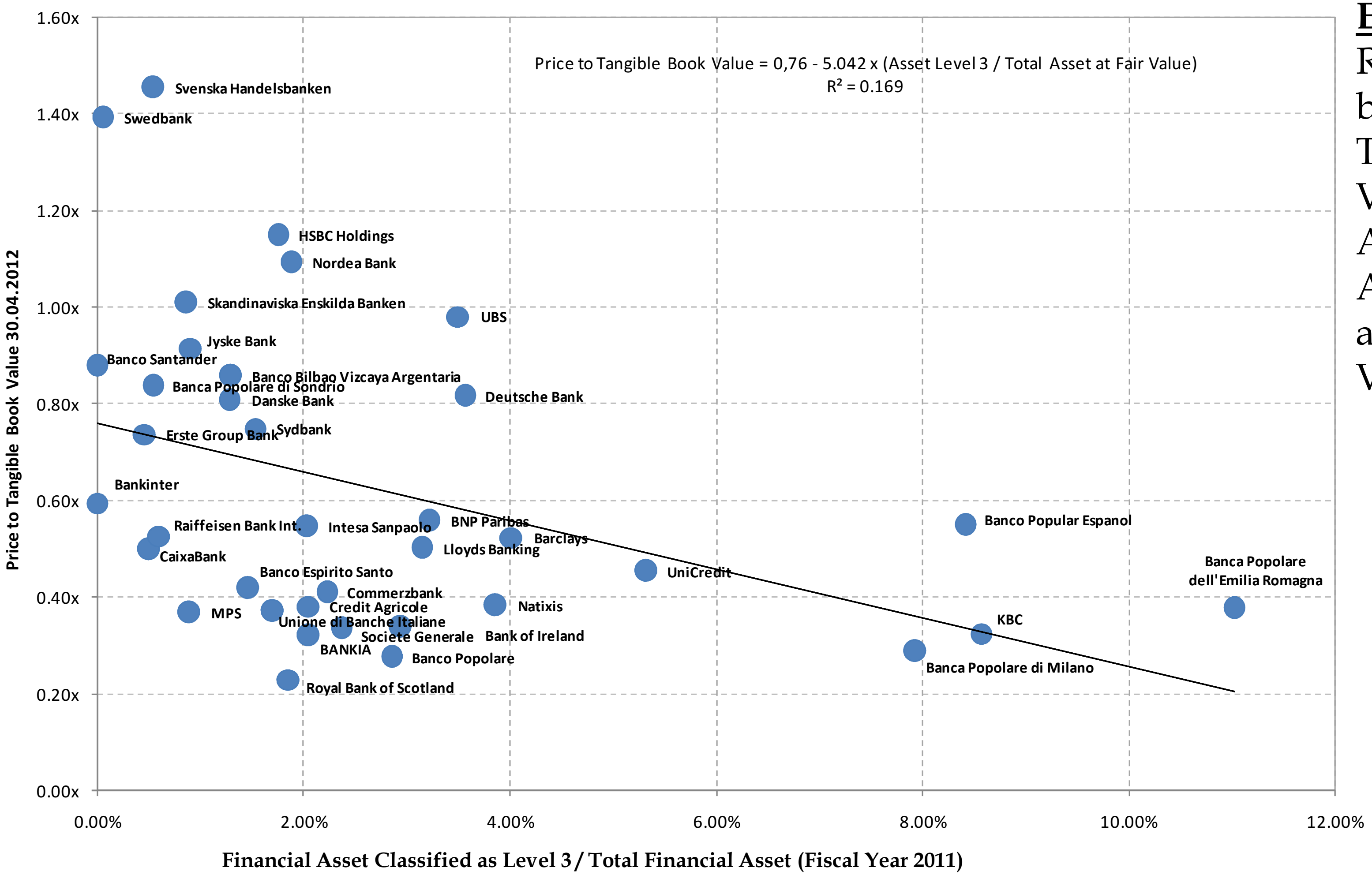
Fair Value Option Elections

	September 30, 2011			December 31, 2010		
(Dollars in millions)	Fair Value Carrying Amount	Contractual Principal Outstanding	Fair Value Carrying Amount Less Unpaid Principal	Fair Value Carrying Amount	Contractual Principal Outstanding	Fair Value Carrying Amount Less Unpaid Principal
Loans reported as trading account assets	$ 1,337	$ 2,693	$ (1,356)	$ 964	$ 1,917	$ (953)
Corporate loans	11,224	15,938	(4,714)	3,269	3,638	(369)
Loans held–for–sale	11,183	13,070	(1,887)	25,942	28,370	(2,428)
Securities financing agreements	129,385	128,852	533	116,023	115,053	970
Other assets	361	n/a	n/a	310	n/a	n/a
Long–term deposits	3,268	3,071	197	2,732	2,692	40
Asset–backed secured financings	667	1,294	(627)	706	1,356	(650)
Unfunded loan commitments	1,343	n/a	n/a	866	n/a	n/a
Commercial paper and other short–term borrowings	5,527	5,548	(21)	6,472	6,472	—
Long–term debt [1]	48,235	62,054	(13,819)	50,984	54,656	(3,672)

(1) The majority of the difference between the fair value carrying amount and contractual principal outstanding at September 30, 2011 relates to the impact of widening of the Corporation's credit spreads, as well as the fair value of the embedded derivative, where applicable.

n/a = not applicable

Asset Approach: fair value Level 3



European Banks
Relationship between Price to Tangible Book Value and Amount of Assets Classified as Level 3 in Fair Value Hierarchy