Duff & Phelps

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Valuation Insights

In this edition of Valuation Insights we discuss the benefits that can be derived through a robust sell-side due diligence analysis. These can include value maximization through the determination of normalized earnings, increased efficiency in the sale process, and identification of potential tax exposures, among others.

In our Technical Notes section we discuss how effective management and reconciliation of fixed assets can result in improved financial and tax reporting, potential cash savings through the elimination of "ghost assets" and more accurate insurable values.

In our International in Focus article we discuss the latest developments in the Alternative Investment Fund Managers Directive and how alternative investment managers are implementing this regulation in practice.

Finally, our Spotlight article discusses Duff & Phelps' recent acquisition of American Appraisal, a global valuation and fixed asset management advisor.

In every issue you will find industry market multiples which are useful for benchmark valuation purposes. We hope that you will find this and future issues of this newsletter informative and reliable resources.

Read this issue to find out more.

Inside

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Feature Article:
Maximizing Valuations through Sell-Side Due Diligence

In today's highly competitive marketplace, well-established businesses and start-ups, as well as their advisors, are beginning to appreciate the need for a robust sell-side analysis when contemplating a sale or merger. Management, business owners and their advisors have realized that proactive analysis of their financial results is key to minimizing risk in the investment process and, therefore, could substantially increase valuation.

Experience has shown that financial managers understand what the auditors want to see and what their executive teams want to analyze, but rarely do they appreciate the analysis that will be performed by potential investors or buyers of their enterprise. Therefore, the benefits of this analysis, some of which are listed below, are many. The detriments are only the effort involved and the upfront cost, which are outweighed by reducing the time of the diligence process and the potential to increase the valuation of the enterprise.

The benefits of sell-side analysis include but are not limited to:

- **Independent analysis** — The company is provided with an independent analysis that can be used internally or with their advisors. If desired, it can also be shared with potential buyers and their due diligence teams. The deliverables focus on the relevant deal issues, but are also detail-oriented, which provide a full and robust analysis.
- **Normalized vs. reported earnings** — Due diligence focuses on normalized earnings to reflect the true "run-rate" of the business. Businesses, especially those that have been audited, typically report earnings in compliance with U.S. GAAP (or the accounting standards of their relevant jurisdiction). These accounting standards do not necessarily take into account revenues and expenses that will not occur post-transaction (i.e., revenue gains/geographic expansions, or conversely, the sale of a product line, a restructuring, owner's expenses, etc.). In addition, U.S. GAAP financial statements do not take into account changes to the business' results that did not have a full-year impact prior to the transaction (i.e., the business acquired another entity during the trailing twelve month period on which the valuation is based). Further, reported financial statements are not adjusted for "out-of-period" income and expense (i.e., changes in inventory variances, reserve reversals, etc.). Basing deal multiples on normalized earnings often results in increased business valuations.
- **Increased efficiency in the sales process** — Analyses are provided that identify quality of earnings and working capital adjustments that will be of interest to the potential buyers' due diligence teams and prepare the seller's management team for future discussions with potential buyers. In addition, a good team will help create and organize supporting documentation for each adjustment to help facilitate these discussions. A provider can also assist with gathering data to satisfy other requests, significantly reducing the burden on the management team. Sell-side diligence reduces future demands of the potential buyers/investors/financing sources, simplifies negotiations, accelerates the process and increases the likelihood of a successful completion of the transaction under terms that are favorable to the seller.
- **Carve-out transactions** — In the event that only a specific segment, product line or other portion of the business will be included in the transaction, carve-out financial statements that will accurately reflect the prospective results of the stand-alone entity post-transaction need to be prepared. In addition, creating a bridge/reconciliation between the parent company's historical reported financial statements and the carve-out financial statements to allow potential buyers/investors/financing sources to understand how the business will be carved out of the larger entity and the associated implications post-transaction is imperative.
- **Tax analysis and other key analyses** — Often times identifying potential tax exposures and alternative structuring scenarios in order to maximize value for the seller is essential. In addition, analysis can be performed around the company's information technology and human resources/benefits functions in order to identify any potential issues and potential changes in the prospective costs of the services provided by these departments.
- **Purchase agreement and other post-transaction assistance** — Sell-side analysis should also include accounting and tax guidance on certain aspects of the purchase/refinancing agreement including definitions, discussion of the purchase price and related adjustments and the tax implications of the transaction. In addition, analysis around the estimated working capital should be performed so that an appropriate target is established. Further, in carve-out situations, thought must be given to a transition services agreement, if applicable.
- **Customizable approach** — There is never a one-size-fits-all scenario to any business sale. Procedures and deliverables must be tailored to meet the needs and budgets of the company and the industry in which it operates. Deliverables can range from an Excel workbook with several critical analyses, including quality of earnings and related commentary, to a full due diligence report, including key deal observations, quality of earnings, quality of working capital, income statement and balance sheet analysis, discussion of tax matters and information technology and human resources/benefits due diligence, if requested.

A good partner will not only save a company time and money throughout a sales process, but will also provide much needed advice so the company can navigate the transaction mine-field that often blow-up deals, while simultaneously supporting a higher valuation.

For more information, contact:

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This article was originally published in the Deal.

Technical Notes:
Increased Scrutiny: Fixed Asset Controls and Reporting

Fixed assets represent the long-term tangible assets an organization utilizes to produce and deliver its products or services and manage its operations. In many capital-intensive industries such as manufacturing, power generation and healthcare, fixed assets represent the largest item on the balance sheet. Historically, fixed assets were perceived as a low-risk area and received little audit scrutiny, resulting in some major financial frauds being perpetrated through significant misstatements of fixed asset balances in the financial statements of public companies.

Prior to the passage of the Sarbanes-Oxley Act (SOX), auditors viewed fixed assets as having appropriate internal controls and deemed them a low-risk area. Audits of fixed assets were allocated little time and usually assigned to an entry-level staff auditor, who would perform limited audit and reconciliation procedures. However, with the credibility of the financial reporting of publicly owned companies significantly damaged by corporate scandals, investor confidence was severely eroded, and Congress enacted SOX. One of SOX's central components is increased testing of internal controls. Another noteworthy requirement is that publicly owned companies maintain an internal audit function. Combined, these have led to increased scrutiny of fixed assets.

Internal controls over fixed asset acquisitions are straightforward, easy to test and include well-documented items such as issuance and approval of purchase orders, receipt of assets and preparation of receiving reports, authorization and payment of vendor invoices, and more. However, for other types of fixed asset transactions, internal controls are not typically addressed. Resulting missteps include inadequate asset descriptions, little or no use of property identification tags, inconsistent application of the capitalization threshold, improper segregation of construction-in-progress projects into building and equipment accounts, and infrequent or no periodic physical inventory/reconciliation, among others.

Deficient fixed asset records can lead to inaccurate financial reporting, which can lead to a qualified audit opinion and damaged credibility. Personal property taxes, insurable values, and purchase price allocations can also be affected. Personal property tax assessments are typically based on fixed asset accounting records, with rates applied to the assessed value. Unfortunately, organizations sometimes overpay taxes by 10% to 20% because of "ghost assets" — assets that no longer exist but are still on the books. A reduction in overall assessed value can produce immediate cash savings. In addition, fixed asset accounting records are used to determine the replacement cost of personal property for insurance placement purposes. When it comes to insurable values, accuracy is important — especially if a loss has occurred. Finally, validated fixed asset records can also be a benefit in the context of a sell-side due diligence analysis by providing potential investors or buyers with assurances as to the accuracy of the fixed asset balances.

While maintaining accurate fixed asset records can be challenging, especially for large, capital-intensive and decentralized organizations, two solutions are available: diagnostic consulting, and fixed asset inventory and reconciliation.

Typically, organizations maintain some written policies and procedures for purchasing capital assets. However, sometimes the procedures are not updated to reflect changes in the business, regulations and the economy, or they are updated but not practiced effectively. An external consultant can analyze existing policies and procedures, interview staff members responsible for asset life cycles (acquisition to disposition), and recommend modifications.

Even with effective procedures in place, equipment can be moved, transferred and disposed of without proper documentation. A periodic fixed asset inventory, followed by reconciling the inventory to the fixed asset accounting records, can assist with this issue. The reconciliation process will identify matched assets (items found during the inventory and traced to the fixed asset accounting records), unrecorded additions (items found during the inventory but not in the fixed asset accounting records) and unrecorded retirements (items found in the fixed asset accounting records but not during the inventory). There are several approaches to reconciliation: tag number match, hybrid reconciliation and comprehensive line-by-line reconciliation. Results from these approaches vary, with the comprehensive line-by-line reconciliation considered a best-practice approach as it addresses each individual asset until it is verified as a match, retirement or addition.

For many organizations, fixed assets represent the largest item on the balance sheet. Fixed asset inventory and reconciliation analyses provided by an independent, objective third-party consulting firm can help an organization withstand today's increased level of fixed asset scrutiny. In addition, an accurate measure of the fixed assets would provide a refined measure of invested capital which impacts ROIC analyses and related investment procedures.

If you would like to discuss fixed asset inventory and reconciliation services, contact:

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International in Focus: Enhancing Independence: How can Fund Managers comply with AIFMD Valuation Requirements

On 22 July 2014, the Alternative Investment Fund Managers Directive (AIFMD or Directive) transitional period for the Authorisation or Registration by fund managers as AIFMs (Alternative Investment Fund Managers) expired. AIFMs are now subject to the full provisions of AIFMD irrespective of whether they were formally authorised under the provisions of AIFMD. While authorisation signals an AIFM's compliance with most aspects of the Directive, with some of the more subjective areas, however, compliance may be a matter of perspective. The one perspective that matters most is that of the regulator. Complying with the Directive's Art.19 valuation provisions, or more specifically the requirement for independence in the performance of the valuation function, is one such key area.

Addressing investor, auditor and other stakeholder concerns around the issues of subjectivity, transparency and judgment that are inherent in the valuation of illiquid investments is a focal point of the Directive's valuation requirements. The Directive allows for valuations to be performed either internally by the AIFM or externally by a suitably qualified 'external valuer'. Whether performing the valuation internally or engaging an external valuer, the Directive makes it clear that the AIFM must take steps to ensure that the valuation is "functionally independent from portfolio management". Interestingly, the Directive is silent on the inherent conflict it creates by ignoring the fact that an AIFM is ultimately responsible for the fair value assertions provided in the financial statements of an alternative investment fund.

The text of the Directive gives little guidance on the specifics of what constitutes a sufficiently independent valuation function. In practice, we have seen clients choose one of two paths in the months since the new regulation has come into force. Some have chosen an internal valuation process supplemented by a third-party valuation review to add an extra layer of independence. Others, and most notably those who have set up third-party AIFM management companies, with no - or limited - independent valuation capabilities internally, have outsourced the valuation process entirely to an external valuer. In either case, the text of the Directive is fairly ambiguous about how to incorporate the critical knowledge that portfolio management can and should provide in the valuation process. Thus, industry participants have expressed concern about whether their intended valuation process will run afoul of the UK Financial Conduct Authority's (FCA) and other regulators' interpretation of the law.

To address such concerns for UK AIFMs and AIFMs marketing alternative investment funds to UK investors, on 6 March 2015, the FCA published consultation paper CP15/8, which (among other things) addresses the most common questions that have arisen from the AIFM community in the UK. The consultation paper is open for public comment until May 2015. The consultation paper provides clarification that the person that makes the final determination of an individual portfolio asset's value is considered to be undertaking the valuation function. That person is permitted to draw upon advice, data and opinion from other parties such as price providers or valuation advisors, but is not bound by the information provided. Moreover, those involved in portfolio management may provide input into the valuation process so long as the person undertaking the valuation function is not bound to accept the input and that they make reasonable efforts to independently verify, and are competent to question, these recommended values. The consultation paper also makes it clear that the AIFM is ultimately responsible for valuation estimates. In addition, the consultation paper also clarifies that the calculation of the NAV is not considered part of the valuation function, addressing concerns raised by the fund administration community who didn't want to find themselves inadvertently acting as external valuers.

While larger investment managers often deploy dedicated staff resources and engage an independent valuation advisor to enhance the independence of their internal valuation process, they know it is necessary to rely on the judgement and input of their deal teams as part of the valuation determination. They also often establish a valuation committee to review and approve valuation conclusions, to ensure that conflicts of interest are mitigated and undue influence is prevented. In contrast, smaller AIFMs may not have the personnel resources to fully establish an independent internal valuation process in-house.

Complying with the FCA's interpretation of the Directive will not be a one-size-fits-all proposition. Large and small managers alike will probably retain the valuation function in-house, which more fully allows critical valuation information to be obtained from portfolio management who are most knowledgeable about investments. Yet to comply with the Directive, the FCA's paper effectively provides a middle ground where valuation independence can be enhanced through incorporating a qualified, experienced valuation advisor in the valuation process as part of an independent third-party review, without the need to formally outsource the valuation through the appointment of an external valuer.

The FCA's consultation paper goes a long way towards addressing the AIFM community's uncertainties around the implementation and enforcement of many of the aspects of the Directive's valuation expectations, in particular that the AIFM is ultimately responsible for valuation conclusions. While continued dialogue between the FCA and industry is to be expected, the consultation paper makes it clear that the FCA is open to pragmatic solutions to address the question of independence in valuation.

For more information contact:

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Spotlight:
Duff & Phelps Acquires American Appraisal

On February 24, 2015, Duff & Phelps completed its acquisition of American Appraisal, a global full-service valuation and fixed asset management advisor. The transaction included American Appraisal's Real Estate Advisory Group (REAG), a leading real estate advisor with principal operations in Europe.

The acquisition bolsters Duff & Phelps' world-class valuation capabilities, adding professionals in more than 50 offices globally and significantly expanding its geographic footprint in Europe, Asia and South America. Additionally, Duff & Phelps' services will be enhanced through American Appraisal's Fixed Asset Management and Insurance Solutions practice.

Noah Gottdiener, Duff & Phelps' Chief Executive Officer, said, "We are delighted to complete this transaction and to begin realizing the full promise of this acquisition. Through this combination we now have a valuation practice that spans every asset class, offered in dozens of markets around the world. We look forward to ensuring that our clients benefit from our unique positioning within the global valuation market."

American Appraisal has provided leadership in valuation and fixed asset management advisory services since 1896. Its professionals have served thousands of clients with accurate, reliable valuations for financial and tax reporting, fixed asset and risk management, consulting and compliance. American Appraisal's established leadership in valuation and fixed asset management advisory services — which includes serving 85% of the Fortune 500 — aligns seamlessly with Duff & Phelps' valuation expertise.

For more information, please visit **www.american-appraisal.com.**

North American Industry Market Multiples
As of March 31, 2015

Industry	Market Value of Equity to Net Income U.S.	Market Value of Equity to Net Income Canada	MVIC to EBIT U.S.	MVIC to EBIT Canada	MVIC to EBITDA U.S.	MVIC to EBITDA Canada
Energy	12.2	11.8	12.7	11.8	7.1	4.9
Energy Equipment & Services	12.4	12.7	10.3	8.6	6.9	4.8
Integrated Oil & Gas	10.0	—	—	—	7.0	—
Materials	18.8	17.9	15.1	16.0	10.2	7.6
Chemicals	20.2	20.7	16.3	16.0	11.1	10.6
Diversified Chemicals	17.9	—	14.2	—	9.6	—
Specialty Chemicals	25.5	—	18.0	—	12.7	—
Construction Materials	25.8	—	23.9	—	14.7	—
Metals & Mining	13.0	16.5	13.1	16.0	9.6	5.7
Paper & Forest Products	16.4	18.5	14.1	18.8	9.1	9.9
Industrials	20.1	15.2	15.2	14.5	10.8	9.8
Aerospace & Defense	20.1	—	15.8	16.5	11.1	10.9
Industrial Machinery	19.2	19.9	14.2	16.1	10.3	10.0
Commercial Services & Supplies	21.3	11.9	15.4	16.8	10.7	6.3
Road & Rail	22.6	20.9	16.4	15.4	9.5	10.6
Railroads	19.2	—	14.3	—	11.0	—
Consumer Discretionary	21.3	18.3	15.9	14.5	12.0	10.6
Auto Parts & Equipment	18.7	13.7	14.0	11.8	8.2	7.1
Automobile Manufacturers	—	—	—	—	11.9	—
Household Durables	18.4	—	16.6	—	13.1	—
Leisure Equipment & Products	20.0	—	14.0	—	10.7	—
Textiles, Apparel & Luxury Goods	21.2	—	15.9	—	13.4	—
Restaurants	32.0	20.2	22.6	13.2	13.7	—
Broadcasting	17.7	—	14.5	—	11.0	—
Cable & Satellite	18.9	—	14.0	13.3	11.2	7.6
Publishing	19.1	—	14.8	10.3	11.7	5.9
Multiline Retail	22.0	—	14.3	—	12.0	—
Consumer Staples	22.8	22.4	16.2	15.9	12.4	12.1
Beverages	24.0	37.7	19.2	36.5	13.7	17.2
Food Products	22.9	19.4	17.4	15.4	12.8	12.2
Household Products	25.3	—	16.4	—	12.4	—
Health Care	27.0	24.6	20.7	25.5	15.2	16.8
Health Care Equipment	29.0	—	26.2	—	16.7	—
Health Care Services	22.0	—	15.0	—	11.6	—
Biotechnology	30.3	—	32.2	—	32.3	—
Pharmaceuticals	23.4	—	21.4	36.7	16.8	21.3
Information Technology	25.7	17.2	20.9	20.8	15.3	14.7
Internet Software & Services	29.9	15.0	32.6	13.5	19.5	11.5
IT Services	25.8	—	18.4	—	14.8	15.6
Software	33.6	29.6	25.1	40.5	19.4	32.0
Technology Hardware & Equipment	21.8	14.8	17.8	14.7	12.6	12.1
Communications Equipment	24.6	14.8	18.4	13.9	14.4	13.0
Computers & Peripherals	18.1	—	15.1	—	11.4	—
Semiconductors	28.7	—	25.8	—	17.1	—
Telecommunication Services	20.6	16.4	17.4	13.1	8.3	8.4
Integrated Telecommunication Services	13.6	—	15.9	—	6.7	—
Wireless Telecommunication Services	—	—	15.2	—	8.5	—
Utilities	19.3	16.4	15.8	21.6	10.2	12.1
Electric Utilities	18.9	—	16.7	—	10.3	—
Gas Utilities	19.3	—	14.5	—	9.7	—

Industry	Market Value of Equity to Net Income U.S.	Market Value of Equity to Net Income Canada	Market Value of Equity to Book Value U.S.	Market Value of Equity to Book Value Canada
Financials	14.9	11.3	1.1	1.2
Commercial Banks	14.7	11.7	1.1	1.7
Investment Banking and Brokerage	21.7	—	1.5	1.5
Insurance	13.9	10.8	1.2	1.3

An industry must have a minimum of 5 company participants to be calculated. For all reported multiples in the U.S. and Canada, the average number of companies in the calculation sample was 87 (U.S.), and 31 (Canada); the median number of companies in the calculation sample was 47 (U.S.), and 13 (Canada). Sample set includes publicly-traded companies (private companies are not included). Source: Data derived from Standard & Poor's Capital IQ databases. Reported multiples are median ratios (excluding negatives). MVIC = Market Value of Invested Capital = Market Value of Equity plus Book Value of Debt. EBIT = Earnings Before Interest and Taxes for latest 12 months. EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization for latest 12 months.

European Industry Market Multiples
As of March 31, 2015

Industry	Market Value of Equity to Net Income	MVIC to EBIT	MVIC to EBITDA
Energy	12.8	11.2	7.3
Energy Equipment & Services	8.6	10.2	7.0
Integrated Oil & Gas	19.2	10.5	6.0
Materials	18.1	15.8	9.3
Chemicals	21.9	16.6	10.4
Diversified Chemicals	18.6	14.8	9.2
Specialty Chemicals	23.3	17.1	11.4
Construction Materials	19.0	16.7	9.7
Metals & Mining	13.7	12.1	8.5
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Industrial Machinery	18.3	14.4	10.8
Commercial Services & Supplies	19.3	14.7	9.4
Road & Rail	14.3	13.8	7.5
Railroads	—	—	—
Consumer Discretionary	17.1	14.9	10.5
Auto Parts & Equipment	15.6	12.8	8.5
Automobile Manufacturers	11.7	17.3	10.8
Household Durables	13.2	12.3	10.2
Leisure Equipment & Products	18.9	13.7	10.6
Textiles, Apparel & Luxury Goods	16.5	14.6	11.7
Restaurants	19.8	16.8	11.3
Broadcasting	19.7	14.9	12.4
Cable & Satellite	41.1	26.7	14.0
Publishing	14.0	15.4	10.3
Multiline Retail	16.0	14.4	11.8

Industry	Market Value of Equity to Net Income	MVIC to EBIT	MVIC to EBITDA
Consumer Staples	17.2	15.2	10.1
Beverages	21.4	16.8	11.3
Food Products	14.9	14.2	9.5
Household Products	—	14.6	9.1
Health Care	24.7	21.6	15.9
Health Care Equipment	24.7	21.7	16.5
Health Care Services	19.8	14.6	9.2
Biotechnology	27.7	42.9	23.7
Pharmaceuticals	26.6	24.0	17.5
Information Technology	18.2	16.2	11.5
Internet Software & Services	24.5	19.2	14.0
IT Services	17.0	12.6	9.5
Software	22.6	19.3	12.5
Technology Hardware & Equipment	15.6	15.4	11.4
Communications Equipment	13.8	16.1	11.8
Computers & Peripherals	12.9	13.0	9.9
Semiconductors	27.7	29.4	14.1
Telecommunication Services	17.5	14.9	8.3
Integrated Telecommunication Services	15.8	13.7	7.7
Wireless Telecommunication Services	19.0	19.8	9.1
Utilities	15.8	16.8	10.3
Electric Utilities	13.1	14.8	9.5
Gas Utilities	13.5	15.7	10.1

Industry	Market Value of Equity to Net Income	Market Value of Equity to Book Value
Financials	13.2	1.0
Commercial Banks	12.1	0.7
Investment Banking and Brokerage	17.7	1.5
Insurance	12.3	1.3

An industry must have a minimum of five company participants to be calculated. For all reported multiples in Europe, the average number of companies in the calculation sample was 93 and the median number of companies in the calculation sample was 42 Sample set includes publicly-traded companies (private companies are not included). Source: Data derived from Standard & Poor's Capital IQ databases. Reported multiples are median ratios (excluding negatives). MVIC = Market Value of Invested Capital = Market Value of Equity plus Book Value of Debt. EBIT = Earnings Before Interest and Taxes for latest 12 months. EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization for latest 12 months.

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