February 2012

The Global Corporate Advisor

The Corporate Finance newsletter of Crowe Horwath International

Welcome to the February edition of the Global Corporate Advisor (GCA) newsletter

Today's fast-changing, globalized economy presents us with a maze of challenges and opportunities. For example, the Fukushima nuclear disaster in Japan in March 2011 led many organizations in the power generation industry to reassess the potential of renewable energy companies as potential M&A targets.

In this month's issue, Olivier Grivillers from Crowe Horwath France discusses the 'sum of the parts' approach to valuing renewable energy companies, and examines two major transactions in France and Spain.

While growth remains slow in developed economies, many organizations are turning to emerging markets such as India for M&A opportunities. Vijay Thacker from Crowe Horwath India provides us with commentary on the importance of 'culturally appropriate' due diligence to ensure transactions in emerging markets run to plan.

Around the world, our members are busy advising clients on cross-border transactions. Most recently, Crowe Horwath in the United States and Poland advised a division of the NYSE-listed Worthington Industries on the purchase of the assets of STAKO, a Poland-based producer of automotive liquefied propane gas tanks. Our team members in the United States and Poland assisted Worthington Industries by providing accounting and tax due diligence services.

Crowe Horwath in India and the United States also helped Worthington Industries with accounting and tax due diligence services related to its formation of the Nitin Cylinders Limited joint venture.

In next month's issue we'll turn our attention to the mining and resources sector. Until then, don't forget you can contact me or the team to discuss any of the ideas in this issue, or for any needs relating to M&A transaction support, valuations, and M&A advisory.

Marc Shaffer
Chairman, Global Corporate Advisors
marc.shaffer@crowehorwath.com

Contact Us

For further information, contact:

Marc Shaffer
Chairman,
Global Corporate Advisors
marc.shaffer@crowehorwath.com

For your local contact, visit our website at www.crowehorwath.net

Inside This Issue:

Mergers and Acquisitions in the Renewable Energy Industry: Valuation and Transaction Features

By Olivier Grivillers, Partner, France

The renewable energy sector has seen a large number of merger and acquisition (M&A) transactions in the past few years. Major national electricity providers in France and Spain, EDF and Iberdrola, led the way by announcing buybacks of minority stakes in their renewable energy subsidiaries, EDF Energies Nouvelles and Iberdrola Renovables respectively.[1]

These transactions were conducted in the wake of the Fukushima nuclear crisis in March 2011, which led the power generation industry to reassess the importance and potential of renewable energy.

Financial analysts are now raising questions about how they could analyze and evaluate renewable energy companies. To gain an accurate picture of a company's value, analysts must account for each project's development phase through a 'sum of the parts' approach.

Crowe Horwath Paris analyzed the two major transactions (EDF and Iberdrola) based on the commonly applied multiple of enterprise value divided by earnings before interest, tax, depreciation and amortization (EV/EBITDA). This ratio reflects transaction multiples of 9.9 times 2012 EV/EBITDA and 8.4 times 2013 EV/EBITDA for EDF Energies Nouvelles SA, and 9.4 times 2012 EV/EBITDA and 8.5 times 2013 EV/EBITDA for Iberdrola Renovables.

In contrast, if we look at EBITDA multiples of two comparable companies, Italy-based Enel Green Power SpA and and Spain-based EDP Renovaveis SA, they both stand at 7.3x EV/EBITDA 2012, and 6.2x and 6.1x EV/EBITDA 2013, respectively.

There were two reasons for the differences between the transaction multiples (approximately 8x and 9x) and the multiples of comparable listed companies (approximately 6x and 7x). The first was that the EDF/EDF Energies Nouvelles and Iberdrola/Iberdrola Renovables deals involved control premiums of about 10%. The second was that stock markets fell by about 30% during the second half of 2011, which had an impact on company valuations.

At first glance, these EBITDA multiples would be suitable, after a possible discount, to evaluate small companies operating in the field of renewable energy. The ratio of enterprise value and megawatts of installed capacity (EV/MW) is another common metric used to value companies in the renewable energy sector.

Figure 1: *Top five recent global renewable energy M&A deals (July 2010-April 2011)*

Date announced	Target company	Target country	Bidder company	Bidder country	Deal value €m
March 2011	Iberdrola Renovables SA	Spain	Iberdrola SA	Spain	2,567
April 2011	EDF Energies Nouvelles SA	France	Electricite de France SA	France	1,515
April 2011	Sunpower Corporation	USA	Total SA	France	1,012
March 2011	DONG Energy A/S – Anholt Offshore Wind Farm	Denmark	PKA A/S – Pension Danmark A/S	Denmark	805
August 2010	John Deere Renewables. LLC	USA	Exelon Generation Company, LLC	USA	710

Source: Merger Market

Figure 2: *Stages of a renewable energies project lifecycle*

Evaluating a project's development

The multiples approach can be used to value a company as a whole, but does not consider the particular stage of development of each of its projects. In order to more accurately evaluate a renewable energies company it is necessary to identify what phase of development each project has reached. Figure 2 illustrates the stages of a renewable energies project lifecycle.

Figure 3 shows the lifecycle in greater detail, which can help to identify project phases.

The *feasibility study* stage is a preparatory phase in which the company analyzes the economic and environmental aspects of the project and assesses the opportunities behind the planned investment. The project is in its early stages and it is unlikely to be completed.

1 Source: Infinancials November 2011

Figure 3: *Stages of a renewable energies project lifecycle*

Study Phase	Development Phase		Construction Phase	Operational Phase
Feasibility Study	**Design Phase**	**Approval Phase**	**Construction**	**Power Generation**
• Economic and profitability analysis • Environmental constraints analysis • Local deputies' opinions • Contacts with third parties	• Technical study • Land agreements • Permits filed	• Public survey • Operational permits obtained • Administrative construction permits obtained • Connection to network • Certificate entitling the electricity purchase obligation • Signing of the construction contract	• Construction contract signed	

The *development* phase is divided into two sub-phases: design and approval. The *design* phase involves developing the technical aspects of the project, submitting the necessary permits and signing land agreements. In the *approval* phase, the company completes and collects all the required authorizations and financing. By the end of this phase, the project is reasonably likely to be completed.

In the *construction* phase, capital expenditures grow significantly and the project has a high probability of success.

Transaction analysis makes it possible to obtain EV/MW capacity multiples for the various phases of the projects. Due to differences between wind and solar assets, these multiples must be analyzed separately. As regulations and tariffs are different between countries, this approach can also be done by country.

The following table below shows EV/MW multiples based on an analysis of around 100 transactions in 2011 in France.[2]

In €m/MW of Capacity	Wind	Solar
Installed projects (operational phase)	1.5x	3.8x
Projects under construction	1.3x	3.4x
Projects in development – approval phase	0.2x	0.3x
Projects in development – design phase	0.04x	0.11x
Study phase	0.0x	0.0x

The 'sum of the parts' approach

Our analysis showed that projects under construction or with installed capacity will significantly affect the global enterprise value, while projects in development represent only a small share in the overall business value.

We also observed that projects in the feasibility study phase do not contribute any significant value to capacity.

So, it is possible to value the company by a 'sum of the parts' approach that includes the company's various projects and considers the option value of those in development.

Even if the EV/EBITDA multiples approach to valuation is conceivable when a company is at the same development stage as its competitors, the sum of the parts approach gives the opportunity to refine a company's valuation based on the progress of its various projects, the different countries in which it operates and the sources of energy it develops.

2 Source: Epsilon research

For more information:

Olivier Grivillers is a Corporate Finance Partner at Horwath Audit France. He can be reached at ogrivillers@horwath.fr.

Planning and Executing Due Diligence in Emerging Markets

By Vijay Thacker, Director, India

With sluggish growth hampering M&A prospects in developed economies, many organizations are seeking opportunities to invest in emerging markets, such as India. Such investments are supported by due diligence work; however, it is important to be cognisant of some specific issues that could arise, and should be covered, as part of such diligence work.

In this article, we examine three considerations that are relevant to planning and executing transaction-related due diligence in emerging markets.

Business 'off the books'

It is not uncommon to be confronted with situations of business and profits 'off the books.' These transactions are not officially settled through the banking system or recorded in the books of account. The transactions could be:

- revenue generating – sales made and revenue realized in cash that is not recorded in the books. Such revenue can represent the full value of the sale or part of the real sales proceeds, through differential pricing. This could also be represented as a discount or allowance once the sale is complete. For example, credit notes for non-genuine 'claims' relating to quality, damages or short supplies
- false expenditures – these include business expenses that need to be incurred in cash. Some businesses try to account for these expenses with the help of manufactured supporting documents. Alternatively, some businesses may record false expenses to take improper payments from the company.
- fixed assets or the right to use valuable assets that are intended for personal use or benefit – and which have been acquired with company money and are maintained with company money – but are not on the company's books.

Sale due diligence

It is important to understand how much off-the-books business exists and to what extent the seller will seek to be compensated for it.

The seller will want his or her 'cash profits' to be considered as part of the valuation. Therefore, if EBITDA is recorded at $10 million and there is $3 million off the books, and if the typical valuation multiple is seven times EBITDA, the seller will seek to value the business at $91 million, while the books will reflect this at $70 million.

While the deal valuation may be in the hands of the M&A team and not the due diligence team, the due diligence team must understand how this differential will be presented during deal-making discussions and seek to highlight the gap in the records to the seller; this will help address to the extent possible the documentation required to be in the virtual or paper-based data room.

Buyer due diligence

As long as the buyer-side due diligence stresses on the reported EBITDA and any adjustments to EBITDA proposed by the seller, no specific attention to profit adjustment is required because of unrecorded profits.

Again, if the seller has recorded expenses that reduce the taxable income, these are technically of limited concern to the buyer (since the EBITDA base for valuation is reduced), unless they fall into the category of objectionable payments that could cause legal complications. If these expenses, payments or transactions constitute actual or suspected money-laundering, fraudulent or corrupt activity then the due diligence reviewer must fulfil the applicable reporting obligations irrespective of the impact (or lack of impact) on valuations.

Buyer-side due diligence must conclude that no hidden contracts will one day surface and result in unexpected claims for compensation for services. Similarly, the diligence must seek to identify unrecoverable balances; for example, it is possible that outstanding receivables from customers, whether by way of retention monies or otherwise, are not collectable as these receivables have already been realized in unaccounted cash. As most markets are not typically supportive of balance confirmation processes on trade and other receivables, it is important that due diligence experts review the realizable value of these balances with a watchful eye.

The buyer-side due diligence must keep an eye open for assets that are not being transferred, other than such assets that have already been identified by the seller or in the deal negotiation as assets not being transferred. These assets can often be lease rights, IP, brands and intangibles rather than actual fixed assets on the seller's balance sheet.

If the deal valuation accepts an adjustment on account of previously unrecorded profits, the due diligence reviewer may be requested to assess the reasonableness of such additions, with reference to largely indirect evidences or bases. Such reviews can often provide interesting insights into the company's business and business processes.

‘Greasing the wheels’

Inducements, speed money, facilitation payments and cash incentives are an unfortunate reality of business in some emerging markets. The variation in amount and frequency of these types of transactions may of course differ greatly from region to region, and from business to business.

Some business owners may have been pushed by others to pay small or large amounts of money, ranging from payments to hasten a process, to sums for ‘bending the rules.’ These situations are often dependent on local business practices.

How a business accounts for inducement-related costs and the level of transparency around them can have a significant bearing on the transaction itself. Such payments will either be unsupported or ’legitimized’ by improper or ‘acquired’ supporting documents.

The buyer-side due diligence team should bear in mind the possibility such transactions are occurring. Typically, there is no requirement to take an investigative approach toward identifying such payments.

However, if transactions related to illegal inducements are noticed in the due diligence the due diligence reviewer is required to report these transactions and seek direction from the potential buyer on the depth and type of further analysis it requires.

If the buyer is subject to US or UK law, with strong specific provisions relating to such payments and the obligation for ‘disgorgement’ of profits derived through such payments, the buyer will most likely need to commission a special review of inducement-related transactions.

Reliance on audited accounts

Overseas buyers often struggle to rely on accounts prepared under local GAAP and reported on in terms of local audit standards.

The differences may range from:

- variations in GAAP – between the policies and principles that the buyer is subject to and needs to adopt for consolidation reporting, and what the seller is following under local GAAP
- differences in stipulations, perceptions, and implementation of audit and reporting standards.

These differences are by themselves the subject of a dedicated examination of underlying issues and warrant a dedicated article on the subject.

At the present time, it is suffice to say that reliance on accounts and audit reports should be done after obtaining a solid understanding of the accounting policies, financial statements, financial reporting and disclosure observations, and audit reporting and disclosure observations. The perceptions and expectation levels on reporting obligations and disclosure methods can vary and it is important to get an understanding of the local situation.

From the viewpoint of each of these three major issues, it is advisable that local professionals in the country where the target entity is located should be involved in the assignment. They have a much better understanding of the local regulations and practices and can provide solid insight. Local advisors also have a greater ability to spot payments or potential situations of unreported or misreported transactions, and to help assess or comment on the genuineness of supporting documentary evidence. It is equally important that the local professionals engaged have detailed knowledge of cross-border due diligence requirements and expectations, so they can concentrate on the appropriate material elements.

For more information:

Vijay Thacker is a Director at Crowe Horwath Consultants India Pvt Ltd. He can be reached at +91 22 6631 1480 or vijay.thacker@crowehorwath.in.

Regional GCA Leadership

China & Hong Kong
Delores Teh
delores.teh@crowehorwath.hk

East Asia
Mok Yuen Lok
yuenlok.mok@crowehorwath.net

Eastern Europe
Igor Mesenský
igor.mesensky@tpa-horwath.cz

Indian Subcontinent / Middle East
Vijay Thacker
vijay.thacker@crowehorwath.in

Latin America
Roberto Pérez
roberto.perez@crowehorwath.com.ar

Oceania
Brad Higgs
brad.higgs@crowehorwath.com.au

Southeast Asia
Alfred Cheong
alfred.cheong@crowehorwath.com.sg

USA / Canada
Marc Shaffer
marc.shaffer@crowehorwath.com

Western Europe
Peter Varley
peter.varley@crowecw.co.uk