October 2012

The Global Corporate Advisor

The Corporate Finance newsletter of Crowe Horwath International

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

This month, Olivier Grivillers from the Crowe Horwath Paris office explores the issues around valuing options used as part of executive compensation packages. Options help ensure that executives have a clear financial interest in company performance. However, they can be complex, and executives, remuneration specialists and valuation experts need to understand the different ways of valuing options.

We also examine the challenges presented by non-core businesses. Some company managers are keen to divest these business lines – particularly if they act as a drag on the overall operations. But the process can take significant effort and planning to prepare a non-core business line for sale. Fintan Connolly, Liam Hawkswell and the Crowe Horwath team in Brisbane provide their insights into this complicated subject.

One challenging part of any business sale is settling on a sale price. In this edition, Stefan Jansen from Crowe Horwath's Netherlands office takes us through two methods of calculating the price of target business: locked box and completion accounts.

The GCA team is here to respond to your needs relating to M&A transaction support, valuations, M&A advisory services and related services. If there is something you'd like to see in future issues of the GCA newsletter, don't hesitate to contact me or a member of the team to discuss your ideas.

Here's hoping the year closes out strong for all of us!

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Valuing Options in Executive Salary Packages

By Oliver Grivillers, Paris

Introduction

Company managers are compensated in a variety of ways. According to a 2009 study of Fortune 100 companies, salary and bonuses account for less than 50% of an executive's total compensation (Figure 1).

Top-tier executive pay also consists of significant financial instruments such stock options and warrants. This makes it important for executives, remuneration specialists and valuation experts to understand option valuation methods.

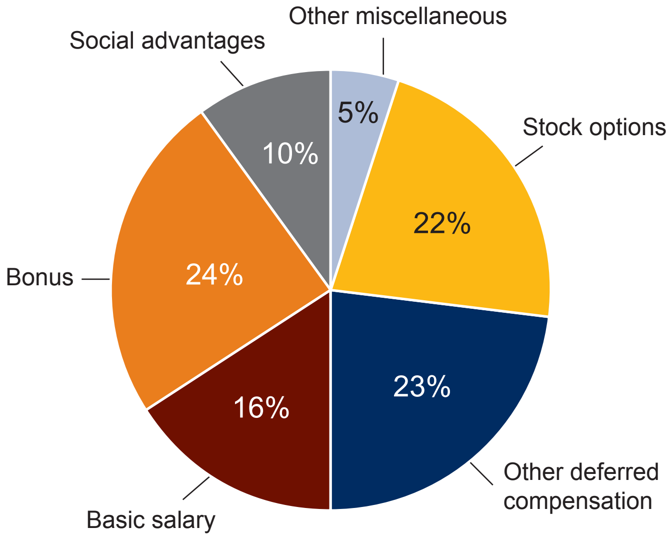
In developing remuneration strategies, companies need to view executives as 'investors'. Options ensure that executives have a clear financial interest in how a company performs. However, the issues surrounding options can be quite complex.

To accurately value the deferred compensation of executives, companies may need to modify their current option valuation models – including the widely used Black-Scholes model. Options that are issued on a non-transferable basis should have a discount applied to their value. Based on research undertaken to date, this discount should be in the order of 20% to 40%.

This article will cover three issues:

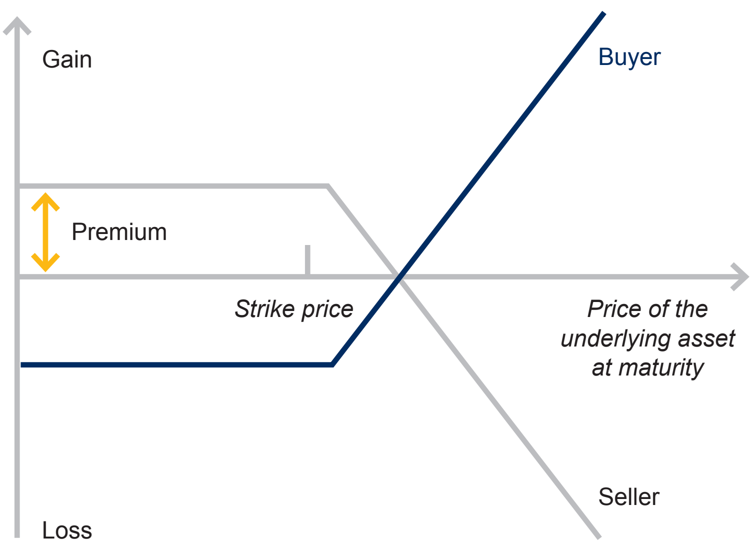
- valuing options
- the Black-Scholes model
- non-transferable options valuation.

Figure 1: How executives are compensated



Source: Financial incentives for executives, Economica (2010)

Figure 2: Option gain profile



Valuing options

An option is a contract between two parties, where one party gives the other the right (but not the obligation) to buy (known as a call option) or sell (a put option) an asset in exchange for the payment of a premium.

This asset will be bought or sold at a predetermined price, called the strike price. The option can be executed during a period of time (in the case of US-style options), or on a precise date (European-style options).

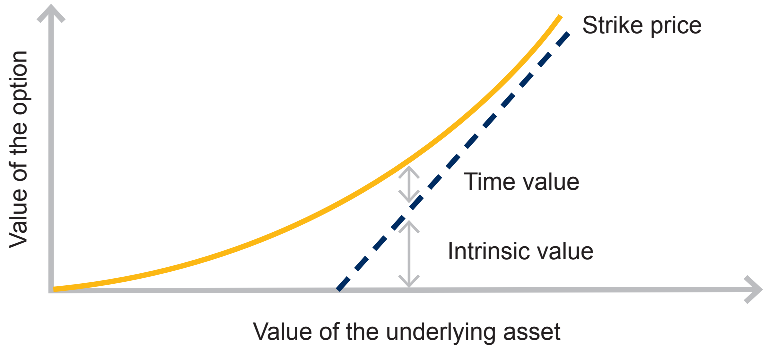
Under a call option, the buyer will experience a loss limited to the amount of the premium if they forgo the option. Or they may stand to gain a potentially unlimited profit (see Figure 2).

Calculating the option's value

An option's value comprises two components (figure 3):

- **Intrinsic value:** this represents the value of exercising an option now. If the price of the underlying asset is greater than the strike price, an executive can make a profit. If the price of the underlying asset is below the strike price, an executive will make a loss amounting to the premium price.
- **Time value:** the current price of the option minus its intrinsic value. Time value will vary based on movements in the price/value of the underlying asset, and the amount of time remaining before the option expires.

Figure 3: The value of a call option



The Black-Scholes model

There are a number of different models for option valuation, including the Cox-Ross-Rubinstein model, the Monte Carlo, and the most famous model, the Black-Scholes model.

The Black-Scholes model can be used to value simple options, such as stock options and warrants. The model calculates the possible prices of the underlying asset at maturity, and the probabilities of these prices occurring. This is based on the fundamental assumption that prices are a random variable with a standard normal cumulative distribution.

The Black-Scholes formula is complicated sets of formulas that considers:

- the current price of the underlying asset;
- the option's strike price;
- the time remaining until maturity (in years);
- the continual annual risk-free rate (a theoretical rate of return with no risk);
- the instantaneous standard deviation of the return on the underlying asset (volatility); and
- cumulative standard normal distribution.

Using Black-Scholes to determine option values

Under this model, there are six factors that affect the price of an option. Table 1 shows how call and put option prices are affected by movements in the listed factors (shown by the green and red arrows).

These factors are explained in more detail below.

- **The underlying security price:** as this price changes, so does the value of an option. For instance, as the value of the underlying asset rises, the value of a call option will typically increase and the value of a put option will fall.
- **The strike price:** the higher the strike price, the lower the value of a call option (assuming a constant value of the underlying asset). The higher a call option's strike price, the less chance the price of the underlying asset will exceed it.

Table 1: Determining movements in option prices

Evolution of the factors		Call option price	Put option price
Underlying security price	↗ ↘	↗ ↘	↘ ↗
Strike price	↗ ↘	↘ ↗	↗ ↘
Volatility of the underlying asset	↗ ↘	↗ ↘	↗ ↘
Time to maturity	↗ ↘	↗ ↘	↗ ↘
Risk-free rate	↗ ↘	↗ ↘	↘ ↗
Dividends or coupons	↗ ↘	↘ ↗	↗ ↘

- **Volatility of the underlying asset:** the value of both a call and a put option rises with the volatility in the value of the underlying asset. The more volatile the underlying asset, the more likely its value will rise or fall sharply. As options reward risk, the greater that risk is, the greater the potential financial upside – equating to a higher option value.
- **Time to maturity:** the longer the time until an option matures, the greater the likelihood of fluctuations in the price of the underlying asset. This increased risk raises the option's value.
- **The risk-free rate:** is a theoretical rate of return on an investment with no risk – generally taken to be the yield on AAA-rated government bonds. If the risk-free rate rises, the value of the call option will too. The further away the maturity date on a option is, the further away the payment date of that cost. The holder of a call option will thus have a cash advantage that depends on the level of the risk-free rate.
- **Dividends or coupons:** the payment of a dividend or coupon lowers the value of the underlying asset. This lowers the value of a call option and raises the value of a put option.

In this example (Table 2), an investor pays €1.11 today for the right to buy a share at €4.39 in seven years time. This share is currently worth €3.92. In seven years, the underlying stock price will be worth between zero and infinity Euros. If the underlying stock price is higher than €4.39, the gain for the holder will be the difference between the underlying asset price and the exercise price (€4.39), less the option price (€1.11). If the underlying stock price is below €4.39, the holder will lose the option price (€1.11)

Table 2: Example of a call option

Underlying asset's price (in €)	3.92
Strike price	4.39
Time to maturity (in days)	2,555.0
Volatility as a %	25.0
Risk-free rate as a %	3.97
Dividend rate as a %	0.80
Value of the call	1.11

Non-transferable options valuation

A number of recent studies show that many stock option–based executive management remuneration packages mainly include non-transferable stock options. The term 'non-transferable' means that the option is neither tradable nor exercisable during a certain period.

As this option cannot be transferred to another party, it is worth less than a classic option.

To value these options, the valuation model must take into consideration an option's non-transferability (that is, the option holder has to deal with a liquidity constraint on the financial instrument) and the option's non-exercisability (the option holder suffers from an opportunity cost during the period the option cannot be exercised).

The studies below show how the non-transferable nature of some options affects their value.

Accounting approach

International Financial Reporting Standards 2 (IFRS 2) does not always consider the non-transferability of the option valuation from an accounting point of view. However, it does take into account the effect of the early exercise of options in accounting valuations. The impact of this is to decrease the time value of the option. The decrease in the total value of the option depends on the option's maturity, and can vary between 20% and 40%.

Academic studies

Restricted stocks have many of the characteristics of non-transferable options, and many studies on these stocks have been conducted in the US. The studies listed in Table 3 can help measure the extent to which stocks have been discounted due to the restrictions imposed.

Table 3: Academic studies and stock discounts

Author	Year	Average discount*
US Securities and Exchange Commission	1971	23%
M Gelman	1972	33%
J M Maher	1976	35%
R R Trout	1977	34%
W L Silver	1991	34%
B A Johnson	1999	20%

*The price gap between a non-restricted stock and a restricted stock.

A 2001 study by Brenner examined the impact of non-transferable exchange options on the Israeli money market. The options were issued by the Israeli central bank, the Bank of Israel, and were not transferable before maturity.

These options were compared to similar options issued by commercial banks and negotiated on the financial market. The non-transferable options traded at a discount of around 20% over the options issued by commercial banks with six months of maturity.

Empirical studies

Another study was conducted on the French warrant market. In particular, it looked at the restricted capped warrants issuances that took place between 2008 and 2010. The non-transferability discounts observed are shown in Table 4.

Olivier Grivillers is one of five authors of Financial Incentives for Executives, Economica (2010). This book deals with option valuation issues for executive compensation packages.

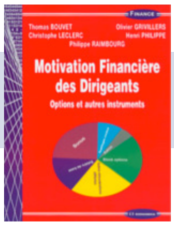


Table 4: Non-transferability discounts in French warrants

Discount levels observed by operation				
Date	**Issuer**	**BSAAR (warrant) maturity (in years)**	**Non-transferability period (in years)**	**Non-transferability discount (in years)**
December 2010	Aedian	7	2	30.5%
June 2010	Mersen	7	2	29.0%
May 2010	Eurofins	7	2	32.5%
October 2009	Monsieur Bricolage	5	2	29.5%
September 2009	Ausy	7	2	32.3%
July 2009	Orpéa	6	2	28.8%
April 2009	Bonduelle	7	1.5	25.0%
December 2008	Overlap Group	7	2	34.0%
October 2008	Nextradio TV	5	2	30.0%
August 2008	STEF-TFE	7	2	34.0%
July 2008	Keyrus	6	2	20.0%
June 2008	Assystem	7	2	24.6%
May 2008	LVL medical	7	2	20.9%
January 2008	Akka Technologies	5	2	32.0%
January 2008	Proméo	7	2	19.3%
January 2008	Espace production	7	2	25.3%
Median discount				30.0%

Source: Transaction note available on the Autorité des Marchés Financiers (French financial markets authority) website

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Getting Your Ducks in a Row: the Virtues of Preparing a Non-core Business Line for Sale

By Fintan Connolly and Liam Hawkswell, Brisbane

Companies face many choices around what to do with non-core businesses. If these lines are underperforming, they may drag on the overall operation's success by diverting limited resources and distracting management attention. In some cases, it may be time to sell these divisions.

However, management should not rush to sell non-core businesses. It takes careful effort and planning to get a non-core division ready for sale. Vendors need to be prepared for a potentially complex and involved sale process. As Chinese philosopher Sun Tzu said: "To ... not prepare is the greatest of crimes; to be prepared beforehand for any contingency is the greatest of virtues".

This article – targeted at private and listed businesses – explores three overarching questions the management of corporations ('sellers') should consider when deciding whether to divest a non-core business (the 'business line'):

- Is the business line truly non-core?
- How can we maximize the sale price?
- How do we create an efficient sale process?

Is the business line truly non-core?

To answer this question, management needs to drill down and consider the business line in the context of the company's overall operations. To do this effectively, we recommend management uses the following divestment checklist:

- What is our core business?
- Is the business line integral to the core operations?
- Do the costs associated with carving out these operations outweigh the potential benefits?
- What return to the buyer will the business line provide, either as a stand-alone business or bolted on to a buyer's operation?
- Is the business more valuable to a potential buyer than to the seller? Are there any likely target buyers for the business line, and what potential synergies could they derive from the acquisition/ purchase?
- Does the business line have growth potential?
- Are there any external factors that may adversely affect the sale of the business line, including negative perceptions of the industry, regulation and the threat of litigation?

Ensuring the non-core business line can stand alone

Potential sellers must make sure the business line can be successfully carved out of their operations. In some cases, a revised operating structure or business model will be required if the business line is removed. Further, additional infrastructure may be required to effectively support and manage this business line once it is separated (e.g. management and accounting systems).

Weighing up the potential proceeds of the sale

A seller needs to have an idea of how the sale of a business line will affect its capital position. In the case of a listed company, how could the sale of a business line and its capacity to generate value and profits affect the core business's valuation? Further, does the business line generate value in its capacity to produce profits and assist the seller's other business lines in creating shareholder value?

Divesting business lines that make a significant contribution to company value and profits will invariably have a negative impact on valuations.

How can we maximize the sale price of a business line?

The key consideration in determining the sale price is often whether another party can obtain greater value from your non-core business line than your company can. This is what makes a business line attractive to others.

Clearly explaining historical and forecast financial performance

Prospective buyers of your business line will typically consider its historical and forecast financials to determine its true value. As such, management needs to make sure prospective buyers:

- understand the historical performance of the business line
- receive clear projections about future financial performance
- are informed of any discrepancies in the historical financial performance that are not reflected in forecasts. This includes explaining how adjusted profit is calculated historically, and how this has been used as a basis for forecasts.

Developing a clear financial model

Using financial models can help sellers and prospective buyers determine the potential future growth and profitability of the business line. Detailed analysis is required to ensure all underlying drivers are identified and captured within models.

To develop an effective financial model, sellers also need to define the assumptions that underpin the business line's financial projections across the areas of revenue, expenses, working capital, financing, capital expenditure and balance sheet.

When preparing a financial model that projects the performance of a business line, a number of 'normalizations' will need to be made to the historic financial performance of the business line. The process of normalizing projected financials involves identifying income and expenditure items that will be irrelevant to the business line, and which are unlikely to re-occur or continue post-sale of the business line (e.g. the writing off of a bad debt). It is important to identify and properly explain these normalizations when preparing the financial model.

Dealing with financial and other risks

To perform well during the sale process, sellers need to identify and resolve any issues before prospective buyers raise them. There are a number of ways sellers can do this, and build the value of a business line, such as:

- hiring key management for the stand-alone business line
- restructuring to eliminate overhead costs
- resolving outstanding disputes (if any)
- ensuring the business line will have its own legal agreements in place (transferred/assigned or newly entered into/novated) to properly function after its sale (e.g. customer and supplier agreements)
- identifying intellectual property that is required by the business line and ensuring it is properly licensed to/ owned by the business line.

How do we create an efficient sale process?

To ensure the sale of a business line proceeds as smoothly as possible, management needs to understand the type of information potential buyers require, and have this information readily available.

Complete a sell-side due diligence report

Commissioned by the seller, this report identifies issues potential purchasers may have with a business line, allowing the seller to prepare for and mitigate against such problems. In addition, the report may highlight the business's potential strengths and opportunities, which can be used to the seller's advantage during the sale process.

Establish a data room

A data room is a physical or virtual space where a potential purchaser can access the key documents of a transaction target, including legal documents, accounting information, and client or customer details. This information can be provided in the form of printed documents or through an online facility. Generally, the lead advisor to the sale process will help the seller set up a physical or electronic data room.

Having a well-prepared data room is an essential element of every competitive sale process. The data room allows the seller to make sensitive information available to potential buyers in a controlled environment. This is particularly important when multiple buyers exist.

Understanding likely tax and legal issues

Sellers should also address any tax and legal implications arising from the sale of a business line, including understanding:

- tax/deferred tax liabilities which may be trigged by the transaction
- the terms of existing legal commitments, such as employee contracts and bank loan covenants
- likely contractual commitments of the seller, that the buyer may require the seller to maintain for a period after the sale (e.g. warranties and undertakings, such as a commitment by the seller that there are no undisclosed liabilities for which the buyer of the business could become liable).

Prior to undertaking a sale process, sellers should also ensure that existing legal documents are reviewed and up to date, such as shareholder agreements, company constitutions and share registers. These documents will typically be included in the data room.

Set up separate accounting infrastructure

Sellers may also need to separate the accounting information of the business line from its main operations. This can make it easier for sellers to meet the information requests of potential buyers, who will require separate accounting records for the non-core line – typically going back at least three years. Further, the presence of separate accounting records restricts the ability of potential bidders and competitors to access information about the core business.

Avoiding traps in the sale process

No two sale processes are the same. Negotiations over companies and assets can vary greatly between single- and multiple-party negotiations, and auctions.

To avoid management becoming distracted during the sale process, it may be useful for sellers to identify a separate management team for the non-core business line, which can operate independently of the core business. This will help ensure that the core business does not lose key management in the process of sale, and that the business line being sold will be adequately staffed to operate on a stand-alone basis in future.

This step also ensures that the operational performance of the non-core business line is closely monitored so that the core business does not suffer during the sale process. This also ensures resources are efficiently allocated.

Understand your potential buyers

It is important to prequalify potential buyers before commencing the sale process. The seller and its advisors should carefully select potential bidders to avoid 'tire kickers' and fishing expeditions by competitors.

In some instances, the seller may want to keep the sale process confidential. One way to do this is to use confidentiality undertakings and non-disclosure agreements. Because the seller will be exchanging commercially sensitive information with potential competitors, these measures can help minimize the risks associated with a breach of confidentiality.

Choose your advisors carefully

Sellers should seek expert advice before contemplating any corporate transactions, whether they relate to shares, assets, undertakings or capital raisings.

Your choice of broker, accountant, lawyer and lead advisor will affect the efficiency and outcome of any intended transaction. Meeting with your advisors as early as possible can help you plan and identify issues, and leave enough time to effectively resolve problems.

It's always a good idea to ask your advisors to explain how their experience and expertise is relevant to your business line and its planned sale.

Complete the sale process within a defined timeframe

A structured sale process requires careful planning. It should include agreed timelines and the requirement for a non-binding offer (for the purchase of the business line) to be lodged before due diligence takes place.

When entering any negotiation, you need options in case the sale process does not unfold as planned. You also need to be prepared to walk away from the deal if necessary.

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Getting the Price Right: Comparing the Locked Box and the Completion Accounts Approaches

By Stefan Jansen, Netherlands

When a business is sold, vendors and buyers must agree on a purchase price. This price is often based on earnings multiples or cash flow–based valuations, and adjusted for factors such as debt and working capital. However, the true picture of a business's financial position can change between when a buyer agrees on a price and signs the deal, and when it takes control of the company.

As a result, both buyers and sellers should take steps to protect their position and maximize value. This article looks at two common methods for calculating the price of a target business: locked box and completion accounts.

In theory, these two methods should arrive at a similar value for the business. But in practice, the choice of method can affect which party maximizes value. This makes it important for buyers and sellers to be aware of the issues surrounding each approach.

This article also discusses the relationship between an initial business valuation and the final sale price.

The locked box method

A locked box transaction calculates the value of a business based on its balance sheet at a certain point in time. The price of the business is 'locked' from this date, and there are no adjustments after the deal has been completed. A buyer assumes all economic ownership, risks and rewards from the locked box date.

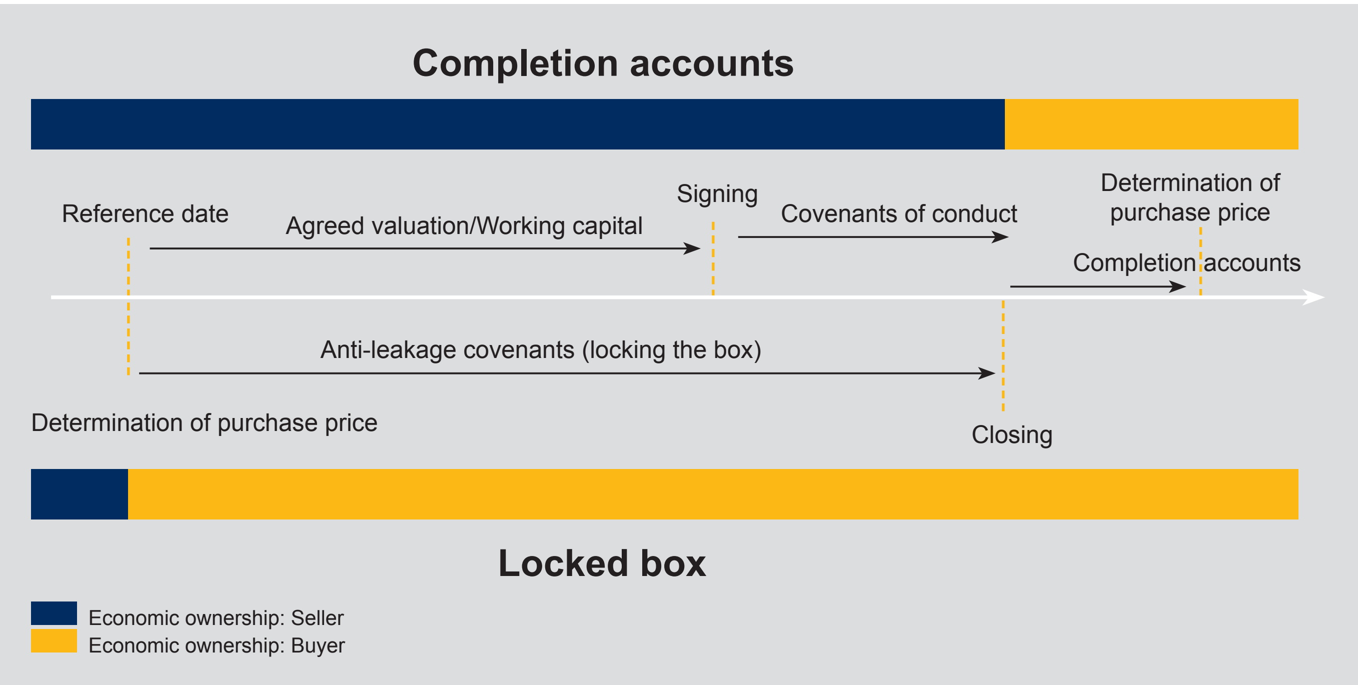
The advantage of this approach is that it gives buyers and sellers a fixed price, and no completion accounts or completion audits have to be undertaken. This can prevent disputes over the purchase price and reduce transaction costs.

Managing leakage in locked box transactions

However, because there is no adjustment process, the parties need to address the potential for value to 'leak' out of the business between signing the deal and its completion. These leakages include management payments, dividends and bonuses. Buyers will likely request covenants, indemnities and warranties to guard against this situation.

Of course, some leakages, such as wages, are unavoidable in the normal operation of a business. So buyers and sellers should agree on a list of permitted leakages. And a buyer must receive assurances that the seller will run the business properly between the locked box date and deal close.

Figure 1: Completion accounts and locked box



A particular issue can arise when a buyer intends to acquire a business that needs to be carved out from a larger entity. In this case, it may be hard for a buyer to identify the leakages specific to the individual business line.

In a locked box transaction, parties usually agree on a fixed period where a buyer can raise leakage claims. This period can be as short as a couple of months, and is typically shorter than a warranty period.

The completion accounts method

An alternate approach is to allow the parties to agree on a purchase price that is subject to adjustments after the deal has closed. This is known as the completion accounts method.

The final purchase price will include an adjustment to take into account factors such as cash, debt, working capital and assets. The precise factors will depend on the sale and purchase agreement negotiated between the two parties.

One issue with this method is that it can involve protracted talks – and disagreements – between buyers and sellers over the final purchase price. This could mean the ultimate price is not determined for months.

The differences between locked box and completion accounts are shown in Figure 1.

Continuing popularity of the locked box approach

Typically, completion accounts have been seen as a way for a buyer to protect its financial position during a transaction. This is because the buyer has recourse to negotiate an adjusted purchase price after the deal is closed. Despite these advantages, industry sources suggest around 50% of merger and acquisition transactions use the locked box method.

As the global financial crisis began, use of the locked box method declined sharply as buyers sought protection against exposure to risk. (The locked box method traditionally favours sellers, as they can lock in a fixed purchase price and limit their downside risk.) However, during 2009 locked box transactions rose in popularity, especially in France, Germany, Belgium, the Netherlands, and Luxemburg due the rebound in confidence in these economies.

Key considerations in pricing approaches

There are a number of important considerations for buyers and sellers in determining a final purchase price on a business sale. For instance, a buyer wants to know that the target's financial statements are reliable and valid. Under either approach, a buyer is paying a price based on the business's value at a particular date. So it requires access to management to identify any pricing or resource issues.

In addition, a seller must ensure that, regardless of the pricing approach, the business's financial position is accurate and will not lead to a buyer resorting to litigation. The seller may also need to produce sound financial information in short timeframes – including in potentially complex carve-out situations.

Further, as part of a transaction, a seller may request a buyer pays interest on the equity value of a company, as it only receives payment after closing off the accounts. In a locked box deal, a buyer is entitled to the benefits of owning the business after the locked box date, and so it usually makes interest payments on the equity value of a company to the seller.

Deal example: equity valuation

To understand how the value of a company relates to its eventual purchase price, we have provided a worked example below (Figure 2). We will discuss the factors of bridging value to price, and positive and negative valuation adjustments.

Bridging value to price

In this example, a buyer has valued its target at US$27 million (the enterprise value). This value has been reduced by US$3 million due to valuation adjustments, which include unrecognized pension liabilities and adjustments to earnings.

Further, after the accounts have been closed off, differences may arise between the pricing parameters negotiated during the deal and the actual amounts. These adjustments – sometimes referred to as the 'equity bridge' – mostly relate to net debt, working capital and capex adjustments. They are grouped together as 'Adjustments finalized at completion accounts' in Figure 2.

Positive valuation adjustments

In this example, cash and current working capital balances add positively to the enterprise's value. For cash, the assumption is that cash balances are not trapped. Cash can be trapped where restrictions exist on remittances back to the parent company's country. In this situation, a buyer would discount the value of the cash on the balance sheet.

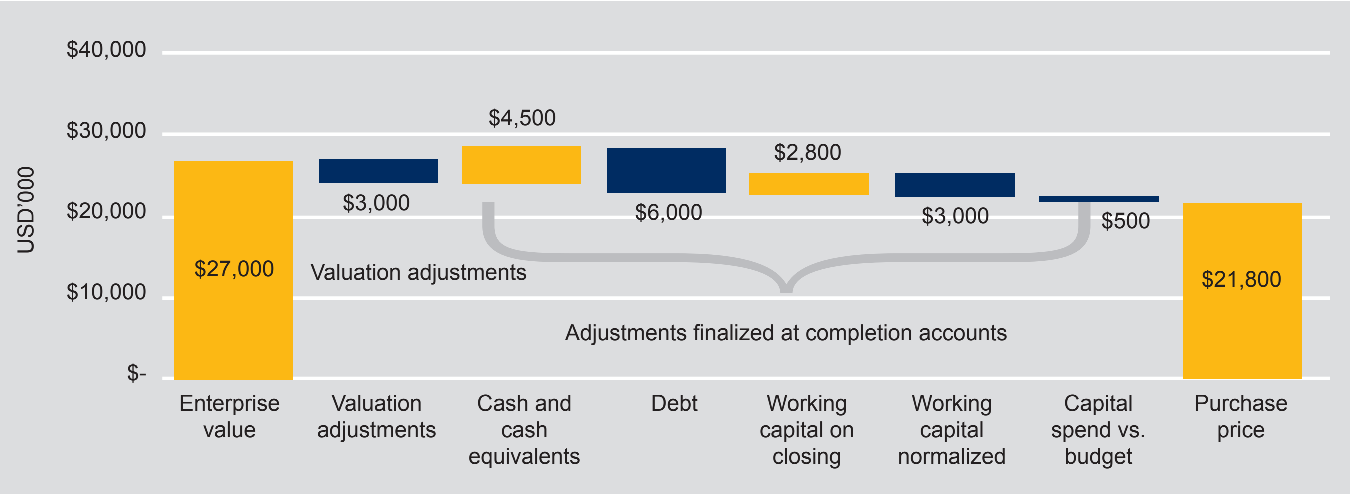
Negative valuation adjustments

A business's valuation will be dragged down by debt, shortfalls in the required level of working capital and unplanned spending.

In this example, working capital totals US$2.8 million on closing, while normalized working capital is valued at US$3 million. The buyer subtracts US$200,000 from the company's value as this amount must be invested by the purchaser to maintain required levels of working capital.

The working capital mechanism is based on a target working capital amount that a buyer intends to acquire in a deal, assuming that this amount of working capital is sufficient to operate the business. Any deviations from the

Figure 2: Equity valuation



target amount of working capital will lead to adjustments in the purchase price.

The working capital mechanism should be used in conjunction with a:

- net debt mechanism: which adjusts the purchase price for differences in actual net debt position compared to the target net debt position
- capex mechanism: which is used to control investment spending between the signing and closing of a deal.

By using these mechanisms, a seller can protect its balance sheet position right up to the close of a deal. For example, if a net working capital mechanism is applied without a net debt mechanism, a seller could pay all its creditors. This would lead to an increase in net working capital, but it does not take into account the negative impact on the debt position. In this way, it allows a seller to manipulate the purchase price.

Further, in the example, the buyer needs to include US$500,000 for delayed expenditures. Together, all these adjustments mean the purchase price is calculated at US$21.8 million.

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