Crowe Horwath

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The Global Corporate Advisor

The Corporate Finance newsletter of Crowe Horwath International

Welcome to 2014 and the January issue of *Global Corporate Advisor*. I hope you were able to enjoy some time with your family and friends in December, and are ready to launch into what promises to be a prosperous and active year ahead.

Our opening article is an overview of M&A activity in Central and Eastern Europe, presented by myself and my colleague from Prague, Karel Tezner. The article offer insights into M&A trends as well as predictions for 2014 with the help of a poll conducted within our Crowe Horwath Central and Eastern European colleagues. I'd like to thank my GCA colleagues Bogdan Acatrinei, Bogdan Djuric, Krzysztof Horodko, Krzysztof Kajetanowicz, Cristina Petrescu and Roland Strauss for their contribution to the research.

Also in this issue, Olivier Grivillers from our Paris office examines the application of premiums and discounts within the framework of a business valuation. Olivier includes an explanation of commonly used valuation methods.

Next month, we will start a short series of articles focused on achieving maximum value from due diligence in an acquisition process.

We hope that the malaise of the past few years of M&A will finally make way for increasing activity.

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Contact Us

The GCA team is here to respond to your needs relating to M&A transaction support, valuations and M&A advisory services. If there is a topic you would like us to cover in future issues of the GCA newsletter, don't hesitate to contact Peter Varley, Chairman of GCA at *peter.varley@crowecw.co.uk*. Alternatively, please contact your local member of the GCA team to discuss your ideas.

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A Round-Up of M&A Activity in Central and Eastern Europe

By Igor Mesenský and Karel Tezner, Prague

This article provides an overview of recent M&A activity in the Central and Eastern European (CEE) region.[1]

This month, we uncover regional M&A trends and present our forecast for 2014. Our findings are based on quantitative data from 2013, and qualitative research based on a poll of GCA experts in Austria, Czech Republic, Poland, Romania, Serbia and Slovakia, where more than 73% of M&A transactions in the CEE region took place. Austria, the Czech Republic and Poland accounted for 61% of the transactions.

We are proud to note that in 2013, Crowe Horwath achieved the most transactions in the Czech Republic for leading buy- and sell-side services according to market data.

Snapshot of the CEE region

In 2014, we expect the CEE market to continue to head toward meeting the region's pre-GFC M&A volume. Key facts include:

- The total number of M&A transactions increased by 28% from 378 in 2012 up to 485 in 2013 (Figure 1).
- Total deal value increased proportionately by 26% year-on-year (Figure 1).
- The number of transactions in 2013 constituted 88% of the region's pre-GFC market performance, up from 68% in 2012 (Figure 1).
- All GCA specialists we interviewed in the CEE region believe that 2014 will be 'more vivid' in terms of number and/or volume of M&A transactions.
- Aside from general improvements in market expectation, the key drivers of M&A activity in the CEE region are being generated locally. Examples include a growing number of organizations from the United Arab Emirates investing funds in Serbia, the growing attractiveness of private equity in Poland, and planned investments in both the Czech Republic's electricity transmission network and district heating systems. These constitute a robust platform for a latent demand of more than €5 billion to be poured into modernizing this crucial energy infrastructure over the next 10 years and, more importantly from M&A's point of view, an appealing opportunity for market consolidation.

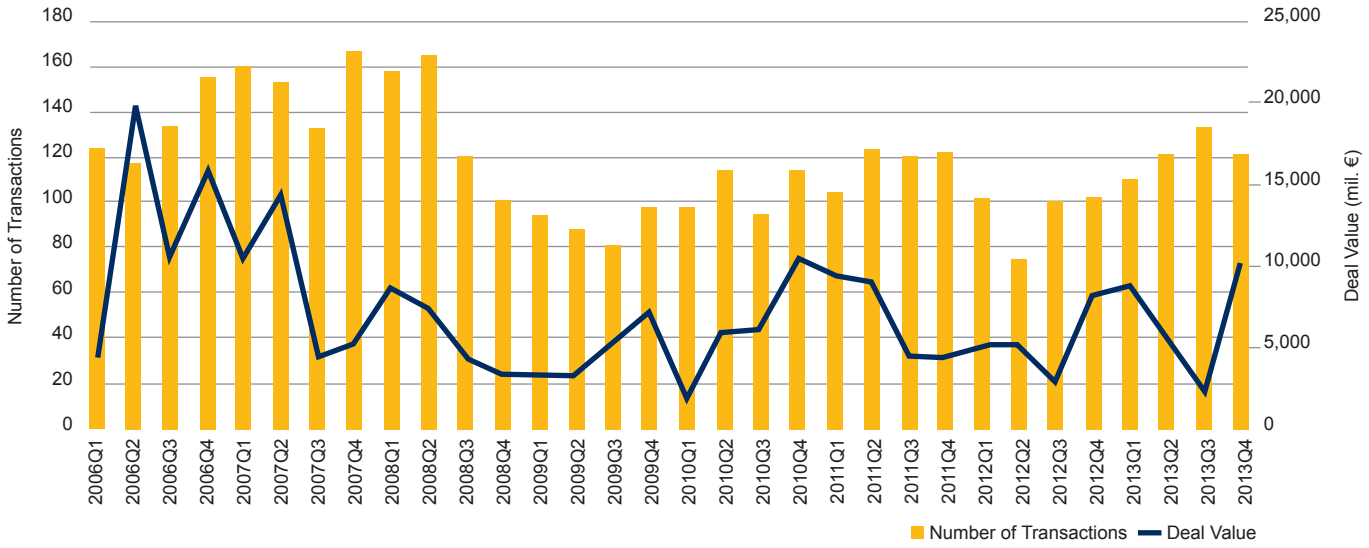

Figure 1: Distribution of the number and volume of M&A transactions in the CEE region

Source: TPA Horwath Corporate Finance Czech Republic and mergermarket

1 GCA defines the CEE market as Albania, Austria, Bosnia-Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Montenegro, Poland, Romania, Serbia, Slovakia and Slovenia.

Number and volume of M&A transactions

The wave of growth in the number of M&A transactions initiated in 2Q/2012 continued up to Q3/2013. We believe this increase results from the positive market expectations of investors, who are pouring their funds into the CEE region.

In 2013, 21.7% of M&A deals were valued at less than €15 million, making up the biggest portion of the M&A market. This compares with 15.3% of deals in 2012. The increase in attractiveness of these relatively small deals might be attributable to improved market perception and market prospects. The smaller the company size the greater the exposure or vulnerability to external factors, such as unexpected change in demand, intensity of competitive rivalry, more stringent regulation enacted, to name a few.

The proportion of high-value transactions (i.e. those valued at more than €500 million) remained relatively flat at 3.5% in 2013, compared to 3% in 2012. Generally speaking, these transactions relate to either privatization or spin-off/ divestiture of high-value entities which tend to occur from time to time. Still, the deal value of more than 53% of transactions was not disclosed.

Deal size

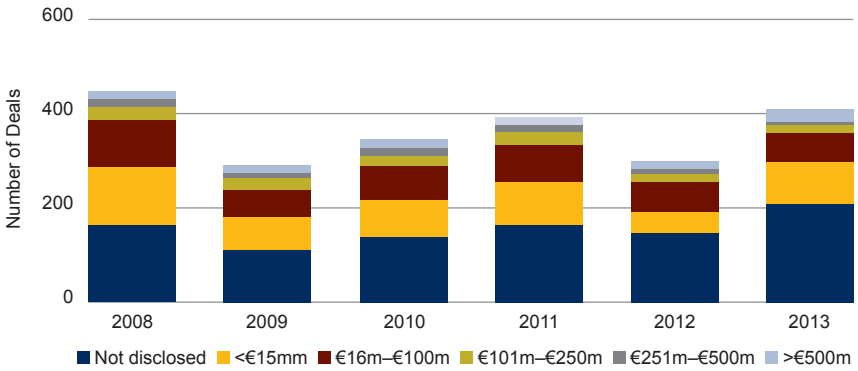

Figure 2: Breakdown of deal size in the CEE region

Source: TPA Horwath Corporate Finance Czech Republic and mergermarket

Transactions by country

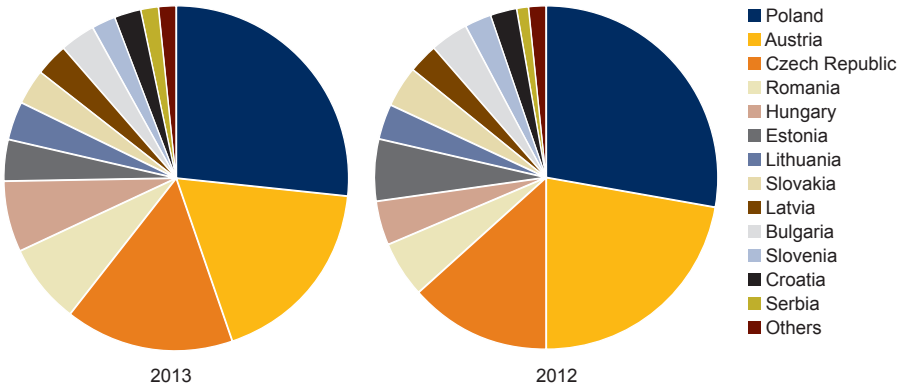

Figure 3: Number of transactions by country

Source: TPA Horwath Corporate Finance Czech Republic and mergermarket

Top five transactions by value

Target company	Country of target	Deal value (€ mil.)	Industry/Sectors	Announced date	Bidder	Bidder country
Polkomtel Sp. z o.o. (83.77% Stake)	Poland	3,649	Telecommunications: Carriers	11/2013	Cyfrowy Polsat SA	Poland
Slovensky Plynarensky Priemysel AS (49% Stake)	Slovakia	2,600	Energy	09/2013	Energeticky a Prumyslovy Holding, a.s., Government of Slovakia	Czech Republic, Slovakia
Telefonica O2 Czech Republic, a.s. (65.9% Stake)	Czech Republic	2,467	Telecommunications: Carriers	11/2013	PPF Group	Czech Republic
NET4GAS, s.r.o	Czech Republic	1,600	Energy	03/2013	Allianz Capital Partners GmbH; Borealis Infrastructure Management Inc.	Germany, Canada
Poslovni sistem Mercator dd	Slovenia	1,513	Consumer: Retail	06/2013	Agrokor d.d.	Croatia

Figure 4: Top five transactions by value in the CEE region in 2013

Source: TPA Horwath Corporate Finance Czech Republic and mergermarket

Breakdown by sector: number of transactions and deal value

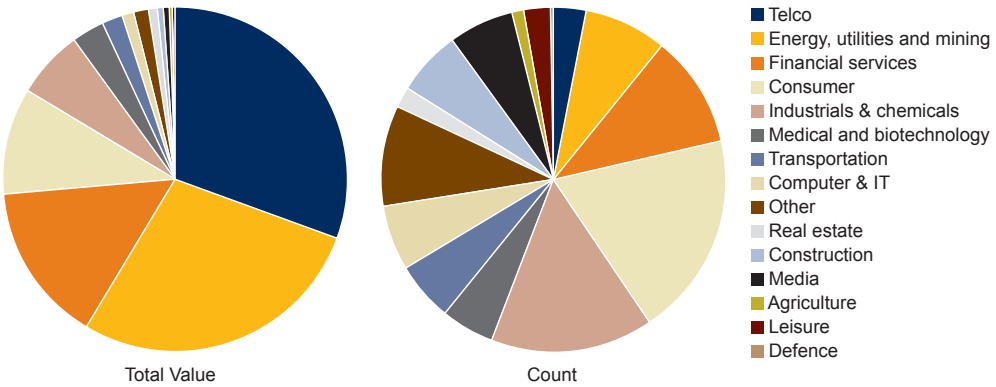

Figure 5: Sector breakdown by number of transactions and deal value in the CEE region in 2013

Source: TPA Horwath Corporate Finance Czech Republic and mergermarket

The number of transactions and their deal value was disproportionately spread between sectors in 2013. For example, investment in the telecommunications sector accounted for just 3% of transactions, but constituted 31% of the total deal value.

An inverse relationship is evident in the consumer (retail) sector, which accounted for 19% of transactions in 2013, but just 10% of total deal value.

Qualitative research poll

To forecast the year ahead, in January 2014 we conducted a poll among GCA experts in Austria, the Czech Republic, Poland, Romania, Serbia and Slovakia. The findings indicate an improvement in market perception and anticipate an increase in the number of M&A transactions in the CEE region.

Austria

Number of transactions: Will increase compared to 2013.

Source of increase: Cash overflow in the market left over from market and legal uncertainty in 2013.

Attractive sector: Renewable energy and unique-value entities (having unique production sites and know-how) in various sectors.

Main drivers in 2014:

- Renewable energy plays an important role in the mix of national energy providers and influencing investor appetite. Legal uncertainty in the CEE region's renewable energy market, particularly in relation to subsidies, combined with the prudence of renewable project developers, means investors may be less willing to spend their money.
  - In 2013, investors in renewable energy tended to consolidate or exit projects in their portfolios. Established energy companies such as Wien Energie und Verbund exited from its activities in Poland and Romania due to the deterioration of project economic reliability stemming from the adverse change of regulatory framework.
  - As historical investors are divesting in the renewable energy space as regulations have become more stringent and less predictable, this provides opportunities for other investors who are more comfortable investing in unstable environments.
- Growing investment appetite and the positive expectations of corporate, institutional investors and individuals should trigger a new wave of investment.
- Generally speaking, Austria is an appealing country to international investors as it has a high level of legal and economic stability.

Czech Republic and Slovakia

Number of transactions: Will increase compared to 2013.

Source of increase: Improved market perception, and succession from retirement-age owners/managers of businesses founded during the early post-Communist transformation period.

Attractive sector: Project engineering.

Main drivers in 2014:

- Domestic investors will have a greater willingness and acquisition ability, similar to that experienced in 2013. Approximately 60% of transactions in the Czech Republic were closed by local investors.
- Several companies in the construction sector are expected to close as a result of the critical state of the industry, which has resulted from a surplus of production capacity, frequent insolvency and murky sector prospects.
- Transactions in the food sector are likely to remain negatively affected by competition from supermarket chains and similar sales channels (low margin accompanied with long day–payables).

- Strong demand for project engineering entities in the electricity, energy and utilities sectors are expected due to the Government announcing significant investment projects, such as investments related to the Czech electricity transmission system, and the modernization of district heating systems.
- Succession issues will be the most important drivers of sell-side transactions. This is because many retirement-age owners often fail to find a successor from family or the company's management team.

Poland

Number of transactions: Will increase compared to 2013.

Source of increase: Succession from retirement-age company owners/managers of businesses founded during the early post-Communist transformation period.

Attractive sector: Construction.

Main drivers in 2014:

- The tendency for large transactions to dominate seems to have run its course, so investors will need to look for relatively smaller targets.
- The middle market offers significant opportunities as many of the proprietors of family business founded during the early post-Communist transformation days of the 1990s are nearing retirement.
- As the IPO market has been disappointing for many investors, private equity (both in terms of exits and investments) will demonstrate its potential in 2014.
- Funds will be more willing to settle for less-than-perfect targets. Sellers will come to terms with realistic valuations, notwithstanding previous discrepancies between expectations on value from the seller's and buyer's point of view.
- As there is plenty of talk about pouring fresh EU money into a finance renovation and expansion of the country's infrastructure, related sectors may ride this wave (for example, suppliers of construction materials and other indirect beneficiaries).

Romania

Number of transactions: Will increase compared to 2013.

Source of increase: Stabilization and macroeconomic improvement.

Attractive sector: Wind energy, agriculture, industrial production, and construction.

Main drivers in 2014:

- Stabilization of amendments to Romania's Fiscal Code, and regulations affecting several industries implemented in 2012 will smooth investment activity in 2014.
- In November 2013, Standard & Poor's raised Romania's credit rating from 'stable' to 'positive'. There is potential for another upgrade in the second half of 2014. A 2.2% GDP increase is expected in 2014 (IMF and EC). However, ahead of next year's presidential and European parliamentary elections, the budget deficit could widen, which may downgrade the S&P's outlook back to 'stable.'
- Some investors are likely to attempt to sell wind energy projects (both those commissioned and those yet to be commissioned) predominantly due to certain unfavourable changes in regulation. Some renewable energy projects remain profitable and attractive to investors.
- In 2013, Automobile Dacia, the largest local car producer, entered new markets such as the United Kingdom, and increased its market share in traditional external markets such as France and Germany. The company intends to expand spare-part deliveries to new areas such as Russia.
- Good agricultural production in 2013 is likely to attract the attention of new investors and remind others of the agricultural sector's potential in Romania.

Serbia

Number of transactions: Will increase compared to 2013.

Source of increase: An increase in expected inflow of foreign investment, particularly from China and the United Arab Emirates.

Attractive sector: Agriculture and energy.

Main drivers in 2014:

- Fast progress in negotiations for Serbia to join the EU. According to the Council of the European Union, accession negotiations are expected to start in January 2014.
- Investment funds from the United Arab Emirates are prepared to invest heavily in Serbia's agriculture and other primary and secondary industries.
- Infrastructural investments are flowing from China.
- Improvements are being made to Serbia's regulatory framework, providing legal certainty for foreign investments (for example, land ownership issues).

For more information:

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The Discount Application Within the Framework of a Business Valuation

By Olivier Grivillers, Paris

The value of a company takes into account all accounting, financial, industrial and commercial data along with the company's current and future profitability.

Common valuation models often refer to observable market data (risk premiums, multiples) for comparable listed companies and require the application of premiums and discounts to valuate companies of different sizes or that aren't listed.

Valuation methods

Several methods can be used to value a business depending on the objectives pursued. However, the methods which remain the most regularly used are the income approach and the market approach.

Income approach

This refers to the Discounted Cash-Flow (DCF) method in which the company is valued based on the net present value of the sum of all future cash flows.

Under the DCF method, the value of a business is determined by performing a prospective financial analysis of a business to estimate future available cash flows which yield a value that is available to the invested capital holders.

Free cash flows are defined as follows:

Free cash flow

= earnings before interest and taxes (EBIT)

– taxes

+ depreciation & amortization

– capital expenditures

–/+ change in working capital

These cash flows are discounted to present value at a rate that reflects both current market return requirements and the risk inherent in the specific investment. If the cash flow stream is to continue beyond the projection period, an estimate of the terminal value or residual value of the company is developed. The sum of the discounted cash flows and the discounted terminal value provides an indication of the invested capital value of the business.

The discount rate used within the DCF method is the rate of return required to compensate an investor for undertaking an investment in a company. It corresponds to the weighted average of both cost of equity and cost of debt, commonly referred to as weighted average cost of capital (WACC).

The equation for the weighted average cost of capital is:

WACC = (Ke x %E) + (Kd x %D x (1-T))

Where:

Ke = cost of equity capital

%E = proportion of equity capital to total capital

Kd = cost of debt capital

%D = proportion of debt capital to total capital

T = income tax rate

Cost of equity is determined with the help of the capital asset pricing model (CAPM) which is defined as follows:

Ke = Rf + (Rp x B) + Rs

Where:

Ke = cost of equity capital

Rf = risk-free rate of return

Rp = common stock risk premium

B = beta

Rs = specific risk premium

Determining the cost of equity remains a difficult task, especially when the company to be valued has a specific risk due to such factors as size, stock illiquidity, market location, and field of activity.

Among all these specific risk premiums, the small stock premium remains the most commonly used. It highlights the greater level of risk borne by investors in small stock companies.

Market approach

The market approach is mainly based on the market-comparable companies method where the prices of publicly traded stocks in the same or similar industry as the company being valued are taken as objective evidence as to values at which investors are willing to buy and sell interests in companies in the given industry.

According to this method, the valuation of a company must take into consideration the market price of stocks of corporations engaged in the same or similar line of business whose stock is actively traded in a free and open market. Competing companies operating in the same market are the best comparable companies because their assets are deployed in the same line of business and they are subject to many of the same economic and financial risks. In order for this market comparison of competing companies to be feasible, data detailing financial condition and market-related stock price performance must be available.

Comparable company analysis operates under the assumption that similar companies will have similar valuations multiples, such as Enterprise Value/Net sales, Enterprise Value/EBITDA, Enterprise Value/EBIT or Price Earnings Ratio (Share Price/Earnings per share).

Enterprise value is determined by applying the multiples to the financial data of the company to be valued.

The average market capitalization of companies composing the comparison sample is often higher than that of the company being valued. Thus, a size and illiquidity discount must be applied in order to obtain a more relevant valuation.

Discounts

Small stock premium (income approach)

The small stock discount approach is often used on the basis of an international study performed by Ibbotson Associates. This approach requires calculation of the difference between the risk premium calculated on the equity market, which is calculated on the average of market capitalizations of comparable companies in the industry, and the market capitalization of the company being valued. Figure 1 can be used to determine the small stock discount.

Size and illiquidity discount (market approach)

When a company is being compared to others in terms of market capitalization and security liquidity, a size and illiquidity discount is applied to obtain a more accurate valuation.

The illiquidity discount can be defined as an adjustment on the value of the company based on stock market information (multiples of market peers) in order to take into account the fact that the valuated company is not public. Thus, a minority shareholder would only be able to sell its shares if the majority shareholder wishes to sell its shares as well.

Similarly, the illiquidity discount can highlight low liquidity for a public company where the volume traded is very low. It is much more difficult for those companies to trade a large share volume without significantly affecting the share price.

The size discount is a downward adjustment enabling the valuation of a company through a market comparison with a sample of much larger same-sector companies.

Market Capitalization (m$)				
Decile	**Smallest Company**		**Largest Company**	**Size premium (Return in Excess of CAPM)**
Mid-Cap (3-5)	1,912.2	–	7,686.6	1.12%
Low-Cap (6-8)	514.5	–	1,909.1	1.85%
Micro-Cap (9-10)	1.1	–	514.2	3.81%
Breakdown of Deciles 1-10				
1-largest	17,557.7		626,550.3	-0.37%
2	7,748.0		17,541.3	0.76%
3	4,250.4		7,686.6	0.92%
4	2,772.8		4,227.7	1.14%
5	1,912.2		2,759.4	1.70%
6	1,346.6		1,909.1	1.72%
7	822.1		1,346.5	1.73%
8	514.5		818.1	2.46%
9	254.6		514.2	2.70%
10-smallest	1.1		253.8	6.03%

Figure 1: Small stock premium calculation table

Source: Roger Ibbotson, SBBI Valuation Edition 2013

The size discount concept is tough to rationalize due to arbitrary opinions and lack of significant market references. In theory, this discount is relevant because in any sector a small company may face greater risks than a larger company due to such factors as smaller range of products, more limited geographical locations and single management.

However, reality on financial markets does not always match with theory. In practice, the values attributed to smaller companies can be inflated due to a "fashion effect" or "opportunity effect" or other factors linked with the sector of the valuated company.

The application of size and illiquidity discounts is usually performed on the basis of:

- Several empirical studies (including 'Firm Value and Marketability Discounts' by Mukesh Bajab, David J Denis, Stephen P Ferris and Atulya Sarin) which suggest discounts ranging from 20% to 30%
- The French tax administration guidebook which stipulates that market coefficients selected must be reduced by a discount for illiquidity in order to be able to compare a liquid security and an illiquid security. According to the French tax administration, this discount ranges from 20% to 30%.

Furthermore, reference to a study by Eric-Eugène Grena, a member of the French financial analysts association SFAF, can be considered as an appropriate way to determine the level of discount to be applied. Figure 2 contains a summary of his suggested adjustments.

Market capitalization comparison	Adjustment to be applied	
<2%	-40%	Discount
2%	-34%	
5%	-26%	
10%	-20%	
20%	-14%	
30%	-10%	
40%	-7%	
50%	-5%	
60%	-4%	
80%	-2%	
100%	-	
120%	2%	Premium
140%	4%	
150%	5%	
160%	7%	
170%	10%	
180%	14%	
190%	20%	
195%	26%	
198%	34%	
>198%	40%	

Figure 2: Illiquidity premium/discount determination table

Source: Eric-Eugène Grena, member of the SFAF (French Financial Analysts Association)

Holding discount

The holding discount highlights the difference in value between the market capitalization of a holding company and the sum of values of equity interests minus debts. The reasons leading to the implementation of a holding discount are numerous:

- Opacity and disparity on created value between equity interests
- Lack of direct control of financial and industrial activities
- Existence of an illiquidity discount on shares, which increases closer to the top holding of the group
- Low turnover of strategic assets, in particular in family holdings or similar structured companies
- Operating costs, characteristic of holding companies, for which the amount creates a deduction to the sum of values of equity interests
- Tax frictions, in particular the double taxation of capital gains (holding companies and shareholders) and the slow dividend payments.

The most frequent and relevant method of determining the discount rate is to use market references.

A study performed of six significant holding companies in April 2012 revealed discounts ranging from 23% to 39%, with an average discount of 33%. The discounts were measured by comparing the stock price of respective companies to their restated net asset value published (itself determined through intrinsic methods such as the DCF method or reference to the stock price of underlying listed companies). The results of this study are presented in Figure 3.

Holding	RNAV (€/share)[1]	Discount vs closing price[2]	Discount vs 1 month average[2]
Eurazeo	57.2	-35.7%	-33.6%
GBL	78.3	-28.7%	-26.2%
Wendel	98.6	-38.9%	-34.1%
Altamir Amboise	12.1	-39.5%	-39.4%
IDI	40.0	-37.6%	-38.9%
Exor	25.2	-27.5%	-23.5%
Mean		**-34.7%**	**-32.6%**
Median		**-36.6%**	**-33.8%**

[1] *Last restated net asset value (RNAV) published*

[2] *Data as of April 4, 2012*

Figure 3: Holding discount versus closing price and one-month average

Source: Internal Crowe Horwath study

Conclusion

The discounts implementation is necessary to adapt valuation models (Discounted Cash Flows, market-comparable companies) to the valuated company where size is often smaller. In addition, a holding discount should be applied where appropriate.

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