



International Valuation Newsletter

May 2016



kpmg.ch/dealadvisory

Dear reader

As global connectivity between economies and businesses continues to grow, there has never been a greater need to align valuation and pricing approaches. And as consistency is achieved, so must transparency also be enhanced. Combined, these produce a range of challenges and questions for valuation practitioners and observers.

Contributing to the discussion around key valuation issues, our new International Valuation Newsletter series will address current hot topics and upcoming themes. While some articles may focus on particular sectors or asset classes, all will have one thing in common: The provision of insights into the development and practical implementation of solutions to common challenges when valuing businesses and business assets.

The newsletter is therefore of interest to those involved in valuations for transactions, financing, tax, accounting, restructuring and dispute resolutions, among other areas. It is also highly relevant to academics, lawyers and government or tax authorities. We invite you to forward the newsletter to anyone who is interested in an informed debate on the subjects raised.

In this first edition, we discuss:

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- Restructuring scenarios: How to value a business in distress Page 5
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- Determining the true cost of capital in a low interest rate environment Page 7
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We hope you find this newsletter interesting and useful. Please do not hesitate to contact us if you have any questions or would like to discuss any of the issues raised. Your feedback is also welcome, together with input on any areas you would like to see addressed in future editions.

Yours faithfully



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Transferring functions: Choose the right approach

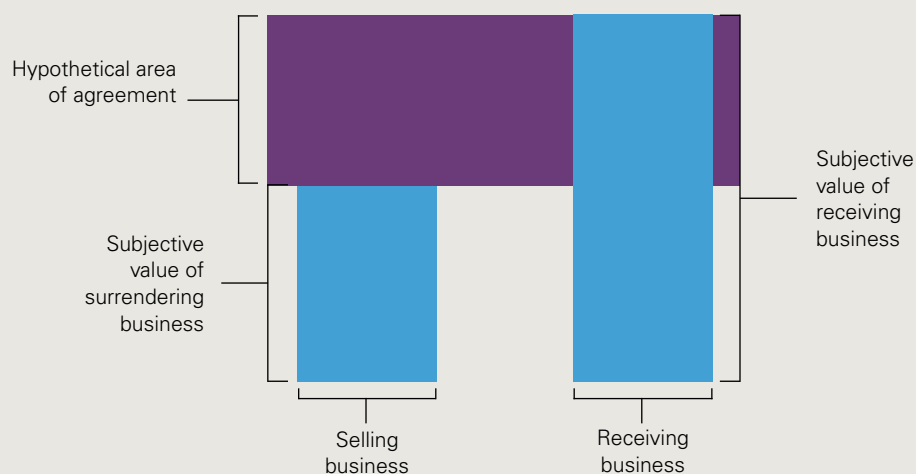
In the restructuring of international corporate groups, the cross-border transfer of functions involves the taxation of hidden reserves or profit potential. Such taxation is calculated based on the arm's length principle. In the absence of a direct price comparison for transfer pricing purposes, however, this test frequently involves calculating the anticipated negotiation range between the selling and receiving businesses.

When transferring functions, the subject of taxation is typically the so-called transfer package – the tangible and intangible assets including related opportunities and risks. In other words, it is the entire profit potential to be relocated. Relevant general transfer price considerations are covered in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations¹; some can also be found in national laws or regulations.

How to determine the anticipated negotiation range?

Recent transaction values can provide comparable or partially comparable amounts when determining the value of the transfer package. As transaction values are often unavailable, an alternative can be to apply a hypothetical arm's length test that seeks to determine the arm's length price for the transfer package from the perspectives of both the selling and the receiving businesses.

Anticipated negotiation range in the transfer of functions



Source: KPMG

¹ Chapter IX Transfer Pricing Aspects of Business Restructurings

Doing so involves identifying the maximum value at which a conscientious businessperson would still buy (receiving business) and the minimum value at which one would still sell (selling business). The two values form the anticipated negotiation range for the transfer, and therefore the value of the transfer package. The taxpayer must demonstrate which value in the anticipated negotiation range best corresponds with the arm's length principle, and how the actual value for the transfer package was decided.

Which valuation approach to apply?

The values should be based on recognized valuation methods, the choice of which depends on the nature of the transfer package. If the transfer package includes an entire business or independently viable parts of a business, then business enterprise valuation principles should be applied. There are essentially no technical differences in valuation approaches when valuing transfer packages as part of the transfer of functions. Generally, income-based valuation approaches (e.g. discounted cash flow (DCF)) are used.

The capital value is calculated by discounting future surplus payments from the transfer package, applying a risk-equivalent capitalization rate as at the valuation date. In principle, the financial surpluses of the transfer packages should be determined from the perspectives of both the receiving and selling businesses to define the anticipated negotiation range.

In contrast to other valuation purposes, additional aspects must be taken into account when determining financial surpluses and the valuation:

- The valuation should not be pursued on the basis of a "Market Participant View". Rather, it should consider specifics from the perspective of the affected businesses such as location savings, synergy effects and tax benefits;
- The conversion to the transfer price system as part of the transfer of functions including the effects on the capitalization rate.

A greater emphasis on documentation

In all cases, it is advisable for transfers of functions to be more thoroughly documented in case of follow-up or challenge by the tax authorities. The facts and circumstances relating to the transfer of function should be collated and studied prior to any relocation. Sensitivity analyses regarding the anticipated tax burdens should also be prepared as a basis for the decision. Together, these actions may help parties benefit from any leeway in terms of the valuation to be carried out and compensation to be paid. Once functions have been relocated, the corresponding transfer pricing documentation should of course be prepared for the respective jurisdictions in a timely manner.

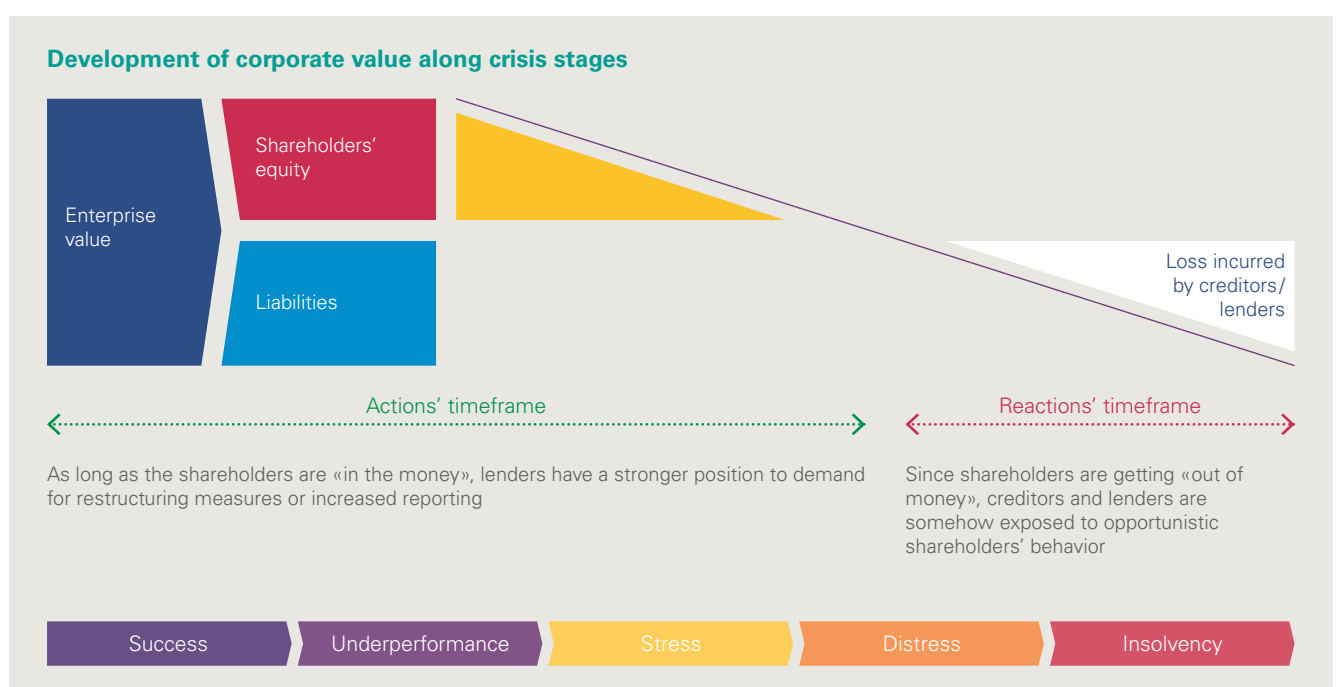
Restructuring scenarios: How to value a business in distress

Deciding on a course of action for a business in distress is undoubtedly complex, with considerations varying depending on the stage of crisis the business has reached. An independent valuation of potential courses of action can help management and stakeholders to objectively assess strategic alternatives, including by assessing the impact of potential restructuring measures on the enterprise value. It can also enhance transparency and facilitate negotiations with third parties such as investors or financing banks.

In valuation practice, discounted cash flow (DCF) is an established method of valuing businesses in restructuring scenarios. The DCF methodology is based on future cash flow projections that usually comprise a detailed planning period of three to five years and the sustainable terminal value thereafter that represents a perpetual income. The traditional DCF valuation is therefore based on the assumption of going concern, implying that the business will continue operating for an indefinite period. This assumption is not always valid in restructuring situations, however; it depends on how far a crisis has progressed.

Which stage is your business at?

A strategic crisis can be where management simply lacks a common understanding of a business's future strategic direction. This can arise from a number of factors, including an erroneous assessment of current or future market positioning, a radical change in the market structure, or by failing to identify and react to industry trends. The lack of clarity can lead to unreliable long-term forecasts, which then make a dependable terminal value difficult to determine. It is also possible to model cash flows to account for uncertainties around the business's long-term situation, such as by using scenario analyses.



If a strategic crisis is not recognized and dealt with, a profit crisis can ensue – ultimately leading to losses and negatively impacting liquidity and equity. The company can find it difficult to raise sufficient funds to remain solvent, creating a question mark over the assumption of going concern. In valuing distressed businesses, the detailed planning period is extended beyond the usual three to five years and must reflect the fact that losses reduce the ability to pay dividends and to make interest and debt capital repayments from free cash flows.

Assessment during a downward spiral

Integrated business planning can help estimate the length of the loss period as well as determine how restructuring measures will affect the enterprise value. If the business continues to generate losses and burn cash, it may enter a liquidity crisis where it defaults on payment terms, requires amendment and extensions of debt financing, and in later stages even delays the payment of operating expenses such as salaries and rent. A further deterioration in creditworthiness and significant reduction in its ability to raise funds can combine with higher financing costs to make the liquidity situation even worse.

If the going concern assumption is applied despite a potential insolvency, the planning period for valuation purposes must be extended to reflect the expected outcomes of stated strategic and operational restructuring efforts. In such situations, it is vital to critically assess liquidity over the entire planning period in the short term and on a weekly basis on a rolling 13 or 17-week basis.

Given the increased insolvency risk in restructuring situations, a going concern valuation is often compared to the liquidation value of the individual assets. The principal challenge in valuing a business being restructured is to appropriately reflect the uncertainties and risks associated with financial forecasts. Also to gauge the effectiveness of restructuring measures and liquidity alongside changes in the terms and conditions of agreements with lenders and other relevant business partners such as suppliers.

Valuations in restructuring situations can not be undertaken using the past business model. Instead, they must be performed based on the mission statement of the restructured (future) business. It is necessary to take into account inherent risks and uncertainties when deriving the cost of capital. And, of course, to undertake a critical assessment of the sustainability of the assumptions underpinning the valuation.

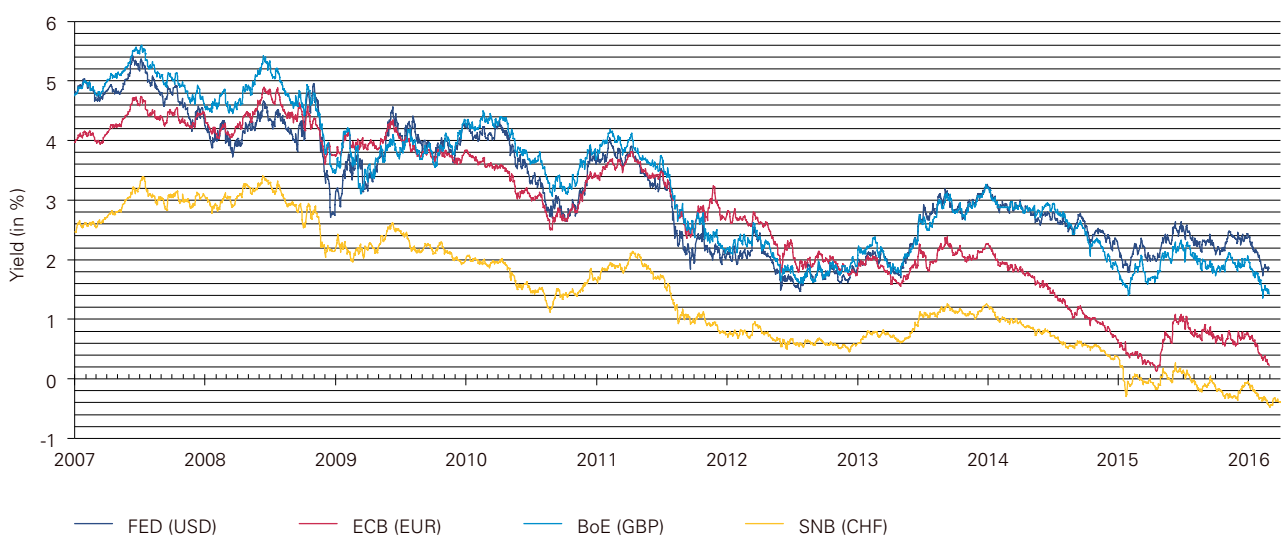
Determining the true cost of capital in a low interest rate environment

The past few years have seen government bond yields in the west hit historical lows. Applying these interest rates to business values would in theory cause corporate values to rise and would lead to simplistic conclusions, as previous interest rate reductions did not lead to higher share prices, for instance. How then to adopt a consistent and reasonable means of determining capital costs to produce realistic valuations and reduce the likelihood of erroneous decision-making?

Since the first signs of the financial crisis in summer 2007, government bond yields in the US, Eurozone, UK and Switzerland have fallen steadily to reach historically low levels. In their search for a safe haven for their investments, purchasers of government bonds have in the past few months even shown a willingness to accept 10-year fixed term government bonds at negative real term yields. Government bond yields in countries with high credit

ratings therefore lie below inflation expectations; something that is especially pertinent in countries like Switzerland, where the 10-year fixed term government bond yield has slipped into negative territory since the Euro / Swiss franc exchange rate control mechanism was abandoned in early 2015. Taking into account inflation, returns on many government bonds no longer offset the loss of the asset's purchasing power.

Yields on 10-Y Government bonds based on Svenson parameter (1 January 2007 to 31 January 2016)



Is discounted cash flow (DCF) redundant as a benchmark?

Yields on government bonds with long fixed terms are regularly used as benchmarks for determining the risk free rate in deriving the cost of capital. The cost of capital would fall if unrefined interest rates were adopted without factoring in observed changes in other capital cost parameters resulting from the crises. This would drive up business values when applying income-based valuation methodologies such as the DCF method or dividend discount models. Such artificially high business values cannot, however, be justified when looking at the development of stock market indices, representing the equity value of listed companies. Share price indices for major western markets such as the Eurozone, UK and Switzerland remain below the record levels registered before the outbreak of the financial crisis. The S&P 500 in the US is an exception to this.

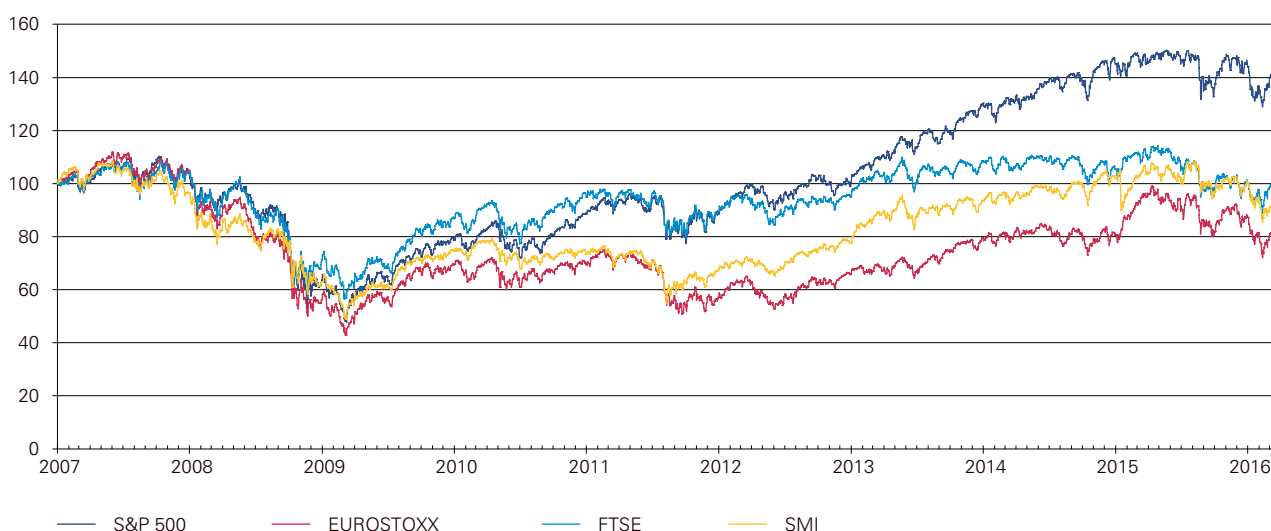
While price and value must not necessarily correspond from an economic perspective, questions arise when theoretical models produce constantly rising values while observed market prices are highly volatile and in certain years have fallen despite a reduction in interest rates. This should compel the conscientious valuer to critically question the 'standard' approach and to examine whether, and to what extent, the crises have distorted the empirical data used. Also whether the standard approach (where applicable) contradicts the applied theoretical capital market models.

Beware the impacts of poor inputs

An unrefined valuation can only produce figures that ignore the economic context, and this distance from reality makes the figures irrelevant. They would result in unforeseen impairments on a balance sheet or a wrong decision whether or not to acquire a business, for example. The valuer is therefore obliged to develop practical solutions in line with the empirical observations and the specific circumstances without significantly deviating from valuation theory.

Assuming investors' yield expectations when purchasing company shares will not change despite the fall in government bond yields, it follows that risk premiums must rise as the level of risk increases commensurately with the fall in government bond yields. This intuitive and understandable assumption regarding investors' increased risk aversion at a time of financial and debt crises can also be proven using current empirical data. In our opinion, when conducting business valuations (including asset valuations), an inflated risk premium appropriate to the valuation date must be applied where current low rates are used. This consistent adjustment of the risk premium guarantees compliance with the underlying principles of equivalence in the business valuation. It resolves the inconsistent trend in the development of business values and prices to which an unrefined interest rate would give rise. Overall, it should help avoid erroneous information and incorrect decisions based on unrealistic business valuations.

Development of global stock market indices in the period 1 January 2007 to 31 January 2016



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