PN-AAY-828

CORPORACION FINANCIERA NACIONAL (CFN)

ECUADOR

SPEECH BY

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Project No. 28 September 5, 1986

BUREAU FOR PRIVATE ENTERPRISE
U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

TALK GIVEN ON SEPTEMBER 5. 1986. IN QUITO. ECUADOR. AT THE CORPORACION FINANCIERA NACIONAL (CFN). TO MEMBERS OF THE DEPTO. DE EMPRESAS Y REHABILITACION (DEPARTMENT RESPONSIBLE FOR MONITORING/REHABILITATING /MARKETING CFN'S EQUITY INVESTMENT PORFOLIO).

Ladies and Gentlemen:

I have been asked to talk with you about valuation -for the purpose of setting sales prices on shares of private sector companies.

INTRODUCTION

I understand that CFN is about to embark on a program to divest of its holdings in commercial companies and properties. The point of departure is the setting of appropriate prices for these holdings. One can anticipate that if the price is set too low it may attract the wrong kind of interest and risk criticism that the State's (and hence the public's) patrimony was sold too cheap. If priced too high. it may discourage the serious investor and may cause a no-sale on the initial offering. If it is then re-priced. the risk is that the market may simply sit back and wait for further lowering of price.

This conference will discuss some of the key issues in valuation.

At the outset, it is well to point out that valuing is very important for setting the sales price. But it is also an important first step that provides information for a range of other important decisions concerning the timing of a sale, the market to seek, as well as such questions as whether and how to prepare the company for sale.

CREDENTIALS

My credentials consist of several years working as a commercial banker in Latin America followed by 5 years as Chief Executive Officer of an investment company operating in Latin America in the same field as CFN. In fact, that company and CFN held many of the same investments in Ecuador. During my years with the company, many of its investments in Latin America were put on the market and sold. More recently, I have been engaged in helping the Government of Honduras, through the Center for Privatization of Washington DC, under contract with AID, to study and develop a plan for privatizing almost 70 state-owned entities in that country.

PREMISE

The basic premise of valuation is that value is transactional: i.e. it arises out of a transaction. The value of a private business asset, whether shares in a company, a piece of equipment, land or a building, is what it is actually sold for in the market. Until then, the value is strictly someone's estimate of the price it might fetch sometime in the future.

In valuing an asset for sale, what we are doing is simulating the market environment in order to get as close as practicable to what the market is likely to pay for the item.

The key consideration is to put ourselves in the place of the buyer and ask how much we can expect to earn from the asset. Forecasting future earnings really is the heart of the process. We then calculate the present worth of this future stream of income and relate that to how much risk is involved and how much we could earn in alternate investments of similar or lesser risk.

THEORY OF VALUATION

Most people would agree with the theory of valuation which states that the value of a business is in direct relation to the future benefits it will accrue. They may have differing ways of how to calcuate the benefits, i.e. of translating the theory into practice. But the generally accepted theory, stated more technically, is that the value of a business depends on the future benefits that will accrue, discounted back to a present value at some appropriate rate.

This talk will discuss some of the ways to estimate future benefits, with specific relevance to the Ecuadorean environment. Also, we will have in mind CFN's desire to have a procedure which provides reasonable assurance that it is setting the right price for the shares that it intends to divest. Also -the point must be repeated- valuation is only part of the divestiture process, an important one and the starting point, but only part. There is an equally important part which is to find the right buyer and offer the right terms and conditions to conclude the sale. This talk cannot treat it in detail, but it is important to mention it, in the

Ecuadorean settino. To make a successful divestiture of CFN's oortfolio. in the Ecuadorean market. it mav be necessarv to do more than correctlv calculate a sellinq orice.

GOALS OF VALUATION

The qeneral qoal of valuation should be to achieve a businessman's valuation -that is. what a businessman thinks it is worth to him. for it is a businessman who is qoinq to buv it. I believe that this kind of valuation is what is called "fair market value". the amount for which an asset would likelv be sold bv a knowledqeable seller who is willinq but not obliqated to sell to a knowledqeable buver who is willinq but not obliqated to buv.

Such an aporoach should establish hiqh and low parameters and avoid two mistaken aooroaches: One. the use of book value (to recover the Government's investment in troubled comoanies) which would onlv drive buvers awav. and the other -the fire sale aoproach- to qet rid of the asset once and for all. which would insoire the wronq kind of interest and earn criticism harmful to the whole process. Buver and seller are much more likelv to aqree on a sales orice that is develooed in a rational. open wav. Price, then, may not be the biq issue. More likelv. it will be the terms offered.

CFN'S GOALS

The aoproach which I have just described should be consistent with CFN's qoals. In reachinq a valuation and in neqotiatinq a sale. CFN. because it is disoosinq of National patrimonv. must be concerned with the wav the valuation is oroduced and the means bv which a sale is effected. Otherwise. if the transaction is not sanctioned bv public opinion. the whole privatization process could be harmed. Moreover. it must be concerned with who the eventual purchaser is. at least in the case of the large troubled firms. For, the whole point of privatization is to get such firms into the hands of those who can restore them to economic efficiency.

THEORY AND PRACTICE OF VALUATION

There are no formulas. mathematical equations or models to use which will automatically produce the right price. You can use a computer to help you perform a rational, logical sequence of steps to reach a working estimate. In fact, a computer program can be very useful, as we will see. But there is nothing precise about setting values. It is a series of judgements. and highly subjective. Moreover. one simply cannot come up with the right price which guarantees the right sale. This is not to say that there are not formula approaches to setting the price; and occasionally they can be helpful. Service businesses such as insurance agencies and travel agencies are examples. They are susceptible to formulas because their gross margins are usually fixed and known. Once the buyer plugs in the sales volume he more or less knows what will be available to cover his costs and can make a calculation of the potential profitability of the business for him.

The common formula approaches are based on the balance sheet. the income statement or both. For example. there is:

ADJUSTED BOOK VALUE -This is more useful when the company has a high proportion of its assets in current assets.

CAPITALIZATION OF EARNINGS - this is useful when the company has a steady earnings stream. but it has to be adjusted to eliminate extraordinary items.

PERCENT OF GROSS REVENUES -the idea is that especiallv in service businesses. as we have seen. a certain amount of gross revenue ought to be able to produce a certain amount of net profit.

The problem with formula approaches in general. it is said. is that the result usuallv turns out to be unfair to one partv or the other. The valuation process should reflect a complex set of factors usuallv too complex to be embodied adequately in a formula. A formula might produce an appropriate value in one year. it might not do so in another.

Again, stated brieflv. the value of a business depends on the future benefits that will accrue. discounted back to a present value at some appropriate rate.

The starting point is the appraisal. The appraisal must document preciselv what is possessed. its ownership. location and value. This must be done either on a going-concern basis or a liquidation basis. Moreover. if it is a fixed asset. a determination has to be made as to what is its highest and best use and a value assigned correspondingly. A major problem in valuing assets is obtaining current information on replacement cost. You are well aware of this.

There are three basic approaches to valuation. Actually thev all depend in one wav or another on a market price. And thev are performed in order to arrive at the fair market value.

MARKET APPROACH

INCOME APPROACH

COST APPROACH

Which approach to use depends on what is being appraised. as this chart shows:

ITEM APPRAISED	APPROACH SELECTED
LAND	MARKET
IMPROVED PROPERTY	INCOME
GOING CONCERN	INCOME
MACHINERY & EQUIPMENT	COST

When applicable. the market approach is considered preferable in most appraisals since it reflects the informed judgement of those active in the marketplace. However, one has to consider each approach in each appraisal and finally select a single one based on his judgement. rather than make an average of the values derived. Wall Street uses average values on occasion. as we shall see. but in a very limited specialized way. They are averages of values that are all calculated in the same way.

MARKET APPROACH

In the market approach. you compare the sales prices of similar companies or similar assets, or the asking prices for some that are for sale at the time. Since no two are the same. the appraiser has to make adjustments for the differences: -for example. differences in physical characteristics, terms and conditions of sale. location. etc..

INCOME APPROACH

This approach calculates the present value of future cash streams which will be produced over the life of the item. First you have to make a projection of the cash flows which can be expected to be generated. You have to estimate future incomes and expenses. Then you have to convert these cash flows to a present value equivalent which accounts for the time value of money. The fair market value is the sum of the discounted cash flows and the discounted residual value at the last year of the cash flows generated. The discount factor is adjusted to reflect risks in attainment of future income streams.

The valuation of the future earnings potential of a going concern is not an exact science. Considering the same relevant factors, experts may differ widely in their appraisals of value based on potential earnings; there are so many factors involved, and the weights assigned to each is a matter of judgement. The factors include not only the business itself, and people, but economic conditions, competition, government actions, etc.. The key point, in my opinion, is to put more weight on future projections than on historical results.

COST APPROACH

This approach uses the replacement or reproduction cost as an indicator of fair market value. It is based on the idea that an investor would pay no more than what it would cost him to replace or reproduce the item. In fact, that would be the highest amount he would pay. If the item being sold would not provide all the utility as the new one, then its price would be lowered to adjust for deterioration -wear and tear- and obsolescence.

BOOK VALUE

Book Value is useful because it provides a basis for arriving at a rate of return. By itself it does not tell you what the market may be willing to pay for the shares. But, to the extent that revaluations of assets are performed regularly, in accordance with Ecuador's rate of inflation. it can be a rough benchmark of current market value.

The NOMINAL value per share is similar to the par value concept used in other markets. It shows the value assigned to the shares when originally issued and, as such, shows the original cost per share. Here in Ecuador, there appears to be more attention paid to this figure than might be wished.

YOUR METHOD OF VALUATION

I was pleased to collaborate in a reformulation of your pricing methodology. As it is now configured. it takes into account the important factors that bear on values in Ecuador today, yet stays within the basic principles of valuation. The key factors of your methodology, as I see them, are:

NET WORTH - By adjusting assets and liabilities to current worth you remove from the balance sheet assets which are not needed to produce the expected stream of earnings. You also adjust for other known changes in the status of both assets and liabilities, and you revalue assets in accordance with current value. You also establish a residual value for the assets at the end of the holding period when an investor presumably might sell his holdings. Considering Ecuador's inflation and devaluation of approximately 18-20% and 13-15% per year respectively and the fact that the Ecuadorean investor looks for "total return", and thus purchases not only for earnings but for appreciation as well, this seems to be a procedure which "fits" the circumstances.

As to the problem of obtaining current information on the cost of imported machinery and equipment, I believe that it is not simply a question of having access to price lists and estimates of inflation rates. With all due respect for your considerable abilities in valuating, I would nevertheless encourage you to retain independent appraisers for the complex and important cases. This is an expensive and often time consuming process, but worth it because you get the benefit of professional training, experience and third party objectivity. Moreover, these appraisers bring with them an encyclopedic knowledge of current replacement costs.

FUTURE EARNINGS - You analyze historical earnings as a point of departure for estimating future earnings, but make an independent estimate of future earnings based on consultation with the management of the company involved. And you place it in the perspective of the general business environment. Your decision to limit earnings estimates to five years seems about right for the changing Ecuadorean scene.

I would comment that since both the estimate of future earnings and the estimate of future residual value is based on valuing future events, your analysts will want to come up with a range of reasonable values for each company. I would suggest three ranges: pessimistic, optimistic, and a mid range, which we might call "most likely".

OPPORTUNITY COST - The fact that an investor can earn 30% on his money with normal risk and liquidity, makes it appropriate that this figure be used in discounting future earnings back to the present.

A GENERAL COMMENT ON YOUR VALUATIONS APPROACH

While I support your idea to have a single approach for all companies, it may prove in practice that you have to alter your approach in some cases to weigh more heavily the valuation of patrimony (assets less liabilities) and in other cases weigh more heavily the estimate of earnings. My reasoning is that in cases where the asset base is negligible, compared with earnings, as in the case of a service business, you would want a capitalization of earnings approach, and in cases where there are heavy assets and the earnings are negligible, you would want an asset value approach. However, all in all, I believe that your method is suited to your particular environment, but the test will come in the market place.

I would really want to end this comment on your valuation method by emphasizing that formula or method is not as important as the care and judgement in obtaining the figures to put in it.

OTHER METHODS AND PROGRAMS

VALUE SOFT PROGRAM

As an alternative method, which you can use to test your own method, I have given you a copy of a computer-aided appraisal method, "Expert Witness" by Valusoft. The kit includes an instruction manual and a diskette which you can use on your computer. Also, you will note that it contains samples of actual valuations.

There are additional examples in the book which I have left with you which also contains much basic material pertinent to your activities. The book, of course, is "Valuing A Business", by Shannon Pratt, published in 1981 by Dow Jones-Irwin. This is a widely acclaimed text on the analysis and appraisal of closely held companies.

I have discussed with you, during my visit, some techniques and rules of thumb used elsewhere. One example is the rule of thumb that a share in a cement company ought to be worth the value of annual sales divided by the number of share outstanding. These are useful as benchmarks against which to check your own calculations. I would suggest that you make a collection of such guides, for they tend to be universally applicable in a broad sort of way. Another technique which I have described to you is a method used in the U.S. for leveraged buyouts where comparisons are made with the prices per share at which other companies (especially those in the same business) have been sold recently. The U.S. and Ecuadorean markets obviously differ, but the techniques which may be transferrable are those which calculate, on a per share basis, average book value, earnings, sales and cash flow; assign multiples to them based on market transactions or rules of thumb for the industry; and then derive a range of prices per share from which to calculate an average. I have left with you material describing this technique.

But the point that I wish to underscore is that the best approach, whenever possible, is the market approach because it reflects informed judgement practiced by those who are in the market. The use of more than one approach is valid -with the caveat, however, that the object is to come up with one price.

<u>GOODWILL</u>

Before finishing, I would like to respond to the question that some of you have asked me about how to estimate the value of good will or other intangibles. My comment is that they are reflected in the results of the bsiness. Sometimes, as in the case of a franchise, like McDonald's or Hertz in the U.S., there is a market price for the franchise which can fairly easily be obtained and plugged into your calculations. But for most, if they have value, they have already provided it in the form of higher earnings and need not be calculated again.

CONCLUSIONS

In conclusion, let me say that I am impressed with your knowledge of the companies that you monitor, and with your understanding of valuation techniques. It is refreshing, too, that several of you continue to seek more information. I would encourage you to seek as much information as you can, especially about commercial transactions of any type taking place in your market because they give you a feel for the current value of things. Your market does not have a broad base of transactions, but transactions are occuring, and whether trading in real estate or debt instruments, they do have a relation to your transactions.

I sympathize with your problems of getting information from abroad and have suggested to A.I.D. how they might help you in this regard. I also suggest that you establish contact with the Commercial Attache at the U.S. Embassy so that he can channel to you information on price trends.

If I could leave you with one message it would be this: There is no business decision bigger than deciding the price at which a company is sold. Few expenditures are more worthwhile than those necessary to get it valued properly. It costs money to have appraisals done. It is hard work, as you well know. Outside consultants may be needed because the know-how to do it properly is not readily available. But, with a properly selected outsider what you get, as I have said, is the benefit of professional training, experience, third party objectivity and a knowledge of values.

I should mention that I do not expect that you will find it easy to sell your share holdings to the public. Most companies think that it will be much easier to sell stock to the public than actually turns out to be the case. My advice is not to be daunted but to learn from your difficulties and try to work more and more closely with brokers, banks, investment companies and other intermediaries who can put you in touch with investors. The intermediaries should also be valuable in advising how to select companies for sale, prepare them for the sale, and even package groups of them.

As a parting thought, I must say that you have a good, basic methodology. Use it, refine it, check it. And keep your focus on the buyer. He is the one you need to complete the transaction.

I thank you sincerely for the fine reception that you have given me. It has been a pleasure working with you, and I enjoyed the feeling of being part of your group. If I can be of help to you in the future, I am at your service.

Joseph J. Borgatti September 30, 1986