

For a strategic rehabilitation of financial valuation¹

*Jean-Florent Rérolle, Managing Director at Houlihan Lokey
Christian Walter, Actuary, Institut des Actuaire*

The current economic crisis makes value a key issue for companies' managements. In the wake of the banking and insurance sector, many companies will carry out important asset write-downs in order to comply with the accounting standards. The pro-cyclical nature of IFRS rules as well as the exaggerated precaution applied by regulatory bodies and statutory auditors will of course be criticized. However, the real question remains: how to create value and inspire trust? Notwithstanding its accounting implications, this situation generates an increasing uneasiness among board of directors, creates opportunities for activists investors, and destabilizes managements.

Valuation is experiencing a double crisis impacting both the concept of value and the tools used to measure it. It must be renovated so that managements can use it as a strategic tool.

A value crisis reinforced by a rising obsolescence of valuation tools

The principal reasons for the crisis impacting the concept of value are associated with the uncertainty around the notion of "fundamental value"² and its impact on market behaviors (imitation, retroaction)³. Keynes showed that psychology of investors and collective behaviors causes the development of precise and pathogenic cognitive patterns when facing the difficulty of determining with precision a shifty fundamental value. In this perspective, the current crisis of valuation is a strengthening factor for mimetic behaviors.

In order to address this reality which is much more complex than the one depicted by the classic valuation tools, it becomes essential to review and complete those tools. The "modern" valuation techniques were designed in the 1930s by Irwin Fisher and John Burr Williams⁴. The discounted cash flow method slowly spread among companies in the past 30 years to become a universally applied method today. Presented as a strategic tool in the 1990s⁵, the nature of this method has changed since then: although its original advantage was to be based on economic rather than accounting principles, it has been progressively trapped by IFRS standards within the application of fair value adjustments.

This extremely important aspect results from the representation of stock market fluctuations (at an appropriate rate) using martingales⁶. Under the influence of

¹ This article has been published in La Revue Banque in September 2008

² See Jean-Florent Rérolle, *From the value of uncertainty to the uncertainty of the value*, Sociétal, septembre 1999, available on line at : <http://www.rerolle.eu/category/publications>

³ See Christian Walter and Eric Brian, *Critique de la valeur fondamentale*, Springer, 2007

⁴ Irwin Fisher, *The theory of Interest*, 1930. John Burr Williams, *The Theory of Investment Value*, 1938

⁵ The three basic textbooks present a strategic orientation: Alfred Rappaport, *Creating Shareholder Value*, McKinsey, *Valuation: measuring and managing the value of companies*, and Bennett Stewart, *The Quest for Value*

⁶ Regarding this fundamental question for the understanding of the impact of IFRS standards, see Christian Walter, "Les martingales sur les marchés financiers", *Revue de synthèse*, 2006, #2

accounting standards and thanks to computing innovations (spreadsheets, database...), valuation became too frequently a mechanized and fossilized process. This fixation on 1930s concepts validated by 1980s financial mathematics and solidified into accounting standards didn't let companies take full advantage of relevant progresses in research on the functioning of financial markets.

Numerous tools or analysis guidelines enable a better approach of value creation issues, but companies rarely know them today. For example, the treatment of risk in valuations hasn't really progressed, despite the regulatory constraints imposed on companies in terms of internal control⁷, and despite the interests around the concept of ERM (Enterprise Risk Management). The simulations of different scenarios remain rarely used. At the same time, companies tend to use classic models like CAPM or Black-Scholes too often, without taking into account the fact that their underlying assumptions are strongly contradicted by observations. The contribution of economic research on the heterogeneity of financial behaviors and agents' interactions (in particular, the role of conventions) remains unused by professionals although it offers interesting perspectives allowing a better understanding of the behavior of financial markets.

The valuation crisis creates a risk of condemning valuation to artificiality. It is thus essential to give valuation its strategic significance back, as well as the meaning it originally had for the management of a company. But to do so, valuation must integrate new analytical tools able to decode value creation mechanisms more efficiently.

The necessity of redefining the function of valuation and of using appropriate tools

Giving valuation its strategic meaning back consists in using it to build a real conviction on the company's value and to understand the behavior of the market in order to compare market expectations with the ability of the company to deliver on them. Once these objectives reached, it will be possible to adapt this framework in all valuations performed for accounting purposes. This strategic rehabilitation of valuation presupposes a modernization of the tools used when analyzing companies.

The capacity of forming an opinion on the value of a company is based on a realistic analysis, thorough and without kindness, of the impact of different financial and strategic scenarios on fundamental value. Typically performed during the process of strategic planning, the sensibility analysis on the key assumptions (more enlightening than the traditional sensibilities to discount rates and long-term growth rates), as well as the estimation of risks threatening the activity along with their consequences on value enable the identification of the company's strengths and weaknesses.

On the basis of this work, management can at any time evaluate the potential consequences of a new situation, develop alternative operational and financial strategies, and elaborate relevant arguments to convince the investors or the board of directors that the choices made are actually creating value. The cash flow models available (most adapted to this valuation work) can be usefully completed by Monte

⁷ Sarbanes-Oxley in the United States and Loi de Sécurité Financière in France

Carlo simulations or by the use of real options models, which conveniently measure the strategic flexibility of the company.

On the basis of that conceptual framework, investors' expectations can be approached in different ways. The most immediate is the one consisting in reviewing sell-side analysts' research reports, and, ideally, in having discussions with buy-side analysts and portfolio managers. A more direct analysis of the market is necessary as well. It can be performed by a stock price pattern analysis and by reengineering process which, on the basis of the model used to determine the fundamental valuation, enables the identification of different scenarios compatible with the market value. This approach will be all the more useful as it will have been conducted for the principal competitors of the examined company as well.

When the difference between the company's and market's points of view is too broad, it's useful to question the relevance of the current value creation strategy, the governance mechanisms or the financial communication of the company.

At the same time, a renewed vision of the company's risk is essential. Volatility is insufficient to quantify adequately the real risk because it doesn't take into consideration two important phenomena: the dissymmetry between stock price increases and decreases, and the regularity or irregularity of given performances. It is very different for a stock price to increase by 30% over 3 months or over 2 or 3 days. These two aspects (dissymmetry or regularity) show the *form* of risk, whereas volatility only shows the *size* (amplitude).

The study of the skewness and kurtosis of the distribution of historic returns has multiple interests: enrich the factual analysis performed on the historic share price, put into perspective the different parameters explaining volatility (nature of assets, efficiency of financial communication, existence of dominating valuation conventions, investors' ecology, heterogeneity level of opinions...), identify the degree of abnormality of a market behavior and, consequently, measure the amount of effort to be done for the valuation analysis of a company.

This type of analysis can also be used to study the financial dynamic of the competitors of the company and identify their own investors' expectations. The study of the financial market behavior of a competitor enables the company to better position its financial brand on the financial markets. The competitive character of this market imposes the choice of a positioning that is differentiated from those of the competitors and that seduces the investors of the sector better. These new indicators then become useful helps in the determination of eventual weaknesses of competitors, as for instance their inability to satisfy their shareholder's expectations in the long term.

The value is theoretically an essential indicator of the performance of a company. It is at the heart of the financial communication of most of the listed... companies. The compensation systems aiming at aligning managers' and shareholders' interests are inspired by that philosophy. The accounting standards have put value at the center of their system. But it requires market and fundamental value to be aligned. The rehabilitation of the strategic vocation of valuation is an essential condition in order to take full advantage of the financial market.