



Fair Value : A Financial Point of View on an Accounting Measurement | Brussels

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The views set out herein represent solely the views of the speaker and not necessarily those of Houlihan Lokey or the IVPB

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Agenda

- The Fair Value Measurement Exposure Draft (“**FVM ED**”) ...
 - A clear improvement in IFRS ...
 - ...with still some areas of uncertainty
- ... has reached its limits:
 - In retrospect, FV has put a brake on valuation as a management tool ...
 - ...and constitutes an overreaching

FV is a Thriving Scapegoat

- Valuation has been at the centre of the debate on the current financial crisis
- However
 - Weak requests from the G20
 - An enhancement of the guidance for valuation (in Nov.08)
 - An improvement of the standards for valuation (in Apr. 09)
 - Cosmetic changes requested by the authorities
 - Guidance on inactive markets
 - Reclassification of some financial instruments
- FVM ED, just released, is a “cut and paste” from SFAS 157 (issued in Sept. 06)

FVM ED Improves IFRS

- A clear definition largely consistent with that of the valuation profession
 - Price that would be received or paid...
 - ... in an orderly transaction between market participants...
 - ... on the most advantageous market
- Key points
 - Adapted to either financial or non-financial assets or liabilities
 - Hypothetical transaction
 - Highest and best use of the asset
 - Multicriteria valuation approaches
 - Market perspective
 - Use of relevant observable inputs
 - Transparency of assumptions

Still Has Some Areas of Uncertainty

- Confusion between price and value
 - No distinction between fair value and investment value
 - Identification of the most advantageous market
 - Nature of market participants
- “Value in use” is still alive
- Belief that financial valuation logic should be applied to individual assets (e.g. purchase price allocations)
- Implementation of the concepts by auditors and regulators
 - Market primacy
 - Methods consistency
 - Reluctance to accept the subjectivity of the measurement

FV Put a Brake to Valuation as a management tool

- Back in the 90's,
 - Valuation was a strategic tool
 - Alfred Rappaport: Creating Shareholder Value
 - McKinsey: Valuation: Measuring and Managing the Value of Companies
 - Bennett Stewart: The Quest for Value
 - Cash flows vs. shortcomings of accounting numbers
- With the ever expanding use of FV in accounting, valuation became too frequently a mechanized and fossilized compliance process...
- ...and several inroads remain unexplored in valuation
 - Treatment of risk
 - Multiple scenarios simulation
 - Heterogeneity of financial behaviours and agents' interactions

FV's Overreaching Ambition

- Accounting standards assumes that FV reflects company's performance
 - Market efficiency hypothesis
 - Information processing
 - Rational agents
 - Valuation convention : market consensus on how value is created and should be calculated
- This assumption is assailed by :
 - The increasing complexity of value creation mechanisms
 - The iterative dynamic between market value and intrinsic value
 - The widening gap between our intellectual models and the new value paradigm

Value Creation is More Complex

- A company's intrinsic value depends on its assets in place and the value of its future growth opportunities
- Value creation depends on competitive advantages...
- ... which are difficult to identify and sustain...
 - General economy uncertainty
 - Blurring of companies' boundaries (Coopetition, alliances ...)
 - Intangible nature of the offer and the assets
 - New competition due to globalization and information technologies...
- And result in systematic, specific and systemic risks changing drastically over time
- As a consequence, classical valuation methodologies are not sufficient

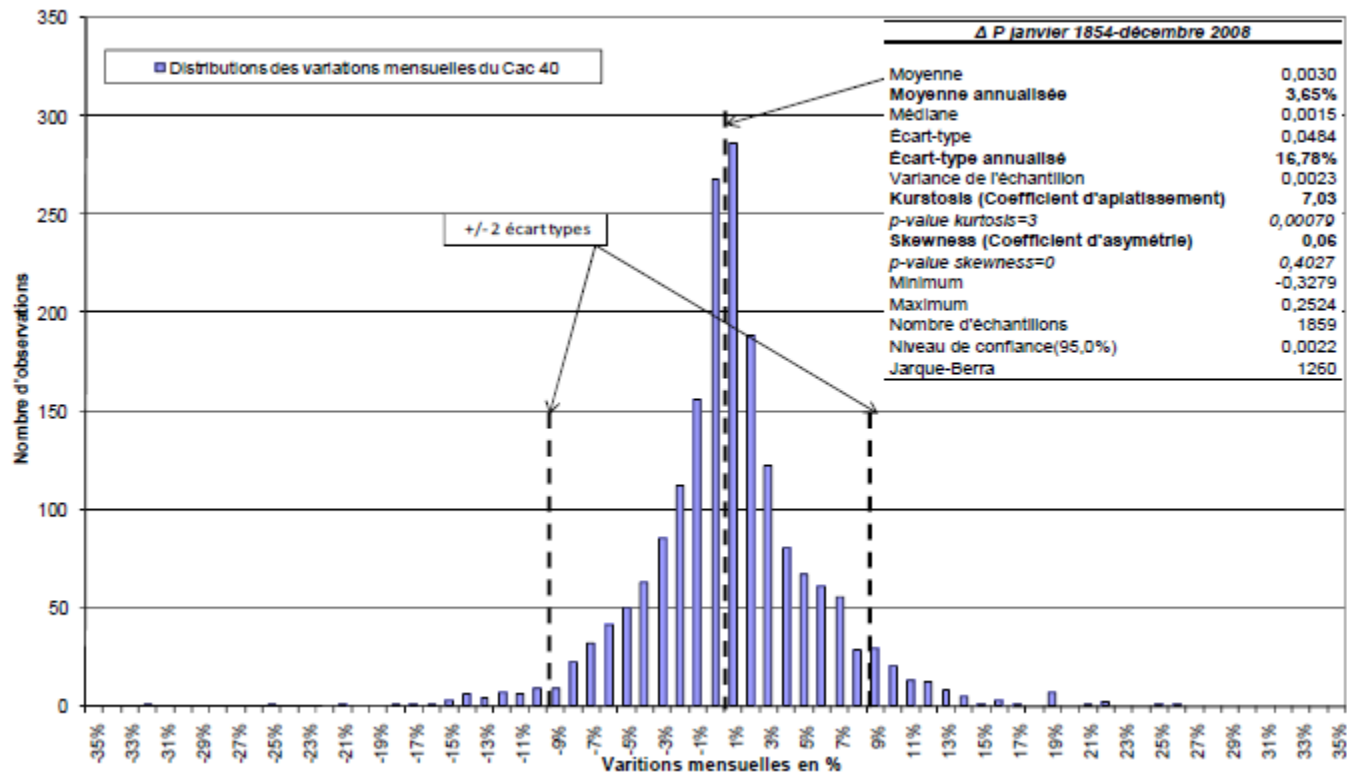
Market and Intrinsic Values are Interacting

- Share prices are the result of a complex anticipation process (multiple scenarios envisaged by investors)
- Share prices are influenced by market psychology
- The environment of the investor is critical (“Millennium Bridge” syndrome)
- Complex feedback loop between market value and fundamental value
- Sometimes, market value is impacted by the lack of liquidity of (certain) market participants

The Foundation of our Models must be Revisited

- Traditional models (CAPM, B&S, VaR) are based on an assumption of normality, but we live in an “economy of extremes”.
- Since the early 60’s share price fluctuations have not followed a Gaussian distribution:
 - American market : from 1983-1992 (2526 days)
 - Annual performance: 16.2% compared to
 - 11.6% when excluding the 10 best days
 - 8.6% when excluding the 20 best days
 - 6% when excluding the 30 best days
 - 3.6% when excluding the 40 best days
 - 2% of the days explains 4/5 of the returns
- Our models should be revisited as returns do happen to be skewed and fat-tailed

The French Example



Source : Le Bris, David, What is a Stock Market Crash? 20 French Crashes Since 1854 (January 15, 2009).

Conclusion

- FV is a an accounting progress, but sometimes a management regression:
 - Valuation innovation frozen
 - Compliance over substance
 - Shorttermism
 - Accounting is not useful to manage company
- Investors care for information on competitive advantages as much as financial reporting
- Priority should be put on valuation as a tool to understand :
 - Financial and strategic dynamics of the company
 - Shareholders' expectations