

## WACC: Practical Guide for Strategic Decision-Making - Part 7: Keep Track of Your Company's Valuation Gap!



*THE SEVENTH ARTICLE IN THIS SERIES ON THE WACC DISCUSSES HOW THE COMPANY'S VALUATION GAP MIGHT BE USED AS A POTENTIAL SOURCE OF SHAREHOLDER VALUE CREATION. IT EXPLAINS WHY CURRENT MARKET PRICES, AS OBSERVED ON STOCK MARKETS, MIGHT TEMPORARILY DEVIATE FROM THE INTRINSIC VALUE OF THE COMPANY AND WHAT THE IMPLICATIONS ARE FOR STRATEGIC DECISIONS, SUCH AS SHARE BUYBACKS, EQUITY ISSUES, DIVIDENDS, MERGERS AND ACQUISITIONS, AND IN/DIVESTURES.*

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One of the goals of any company's financial strategy should be to optimise the capital structure, which should be managed in such a way that the weighted average cost of capital (WACC) is minimized, therefore maximizing the value of the company. WACC-based management is also important for the CFO managing the company's valuation gap, which is another potential source of shareholder value creation.

The valuation gap is defined as the difference between the current market price (as observed in the stock market) and the intrinsic value that equals the present value of future cash flows, based on realistic forecasts by the executive management of the company. Whether strategic decisions about share buybacks, equity issues, dividends, mergers and acquisitions, and in/divestiture contribute to enhancing shareholder value depends on whether this valuation gap is positive or negative. It is therefore crucial that you measure your company's valuation gap to guarantee that your decision-making is in line with shareholder value creation.

### Current Market Price Versus Intrinsic Value

This raises questions about the efficiency of the capital markets and whether investors make rational decisions or not. There are three different grades to describe the level of efficiency in the capital markets:

1. The weak form is when current share prices fully reflect all past price changes.
2. The semi-strong form is when publicly available information is used to establish the share price.

3. The strong form is when all information, privately and publicly held, is used to price shares.

Looking at how share prices move, it is easy to conclude that shares have volatile price movements, which leads to the creation or destruction of shareholder value instantaneously. The fact that major price movements are often not accompanied by major strategic decisions or changes in the economic environment is a sign that there is not a strong form of efficiency in the capital markets. Instead, it indicates that investors are guided by market sentiment and irrational behaviour when determining current market prices.

Furthermore, it is clear that there is an imbalance between an investor who only has access to public market information and the executive management of a company with access to privately held information, such as superior knowledge about the risks and prospects of their business. The current importance of insider trading prevention and investor relations management also supports the view that information is not evenly distributed among all players. Therefore, the current market price of a company might temporarily deviate (substantially) from its intrinsic value.

### The Intrinsic Value of Your Company

The treasurer's skills and access to private information play an important role in measuring the intrinsic value of the company. As stated earlier, the intrinsic value is calculated by discounting the company's

future cash flows, based on realistic forecasts, at the WACC. The treasurer is well positioned to provide realistic estimates of the company's projected cash flows through access to, for example, the budgeting cycle, forecasting models, margins, growth rates, productivity and future investment opportunities.

In addition, the treasurer is well positioned to evaluate the company's risk profile, such as access to market data information systems and corporate risk management models, where information from these sources will be used as input for valuation model(s). There are various methods available to measure the intrinsic value, including discounted cash flow (DCF), adjusted present value (APV) and real options.

The DCF method discounts risky cash flows at the risk-adjusted WACC. The APV approach calculates the present value of operational cash flows discounting them at the cost of common equity (KE), adding the value of the tax shield by discounting the interest on debt that is deductible at the cost of interest-bearing debt (RD) and subtracting the initial investment. Both of these methods should result in the same value when carried out properly.

A more advanced approach for estimating the intrinsic value of your company, which is often more realistic but also more complex, is the use of real options. A real option is defined as managerial flexibility to adapt and revise future decisions in order to capitalize on favourable future opportunities or to limit losses. The method uses the option pricing theory to discount risk-adjusted cash flows at a risk free interest rate.

Whether you use a DCF, APV or real options method, one should be able to calculate an estimate for the company's intrinsic value. Subtracting the intrinsic value from the current market price results in an estimate of the valuation gap.

### **How to Benefit from Insight into the Valuation Gap**

Having derived an estimate for the valuation gap, there are different ways to create shareholder value. Dependent on whether the current market price lies below or above the estimated intrinsic value, companies could use methods such as changing leverage via share buybacks, equity issues or dividends; changing the business profile via mergers and acquisitions or in/divestures; or investor relations management.

#### *Changing leverage*

Information about the valuation gap is important when deciding whether to leverage your company via a share buyback program or super dividend. For instance, when the company's shares are trading above intrinsic value, it might be better for the shareholders to use a super dividend to pay back excess cash to shareholders rather than a share buyback program. Using excess cash to buy back overvalued shares can result in shareholder value destruction for the shareholders who choose to keep

shares in the company because, in the long term, current market prices will become more equal to intrinsic value. A super dividend would benefit all shareholders equally.

A share buyback program creates value when the share is trading below its intrinsic value. In this case, the company might use excess cash to buy back shares. This type of buyback program is itself a positive net present value project and creates shareholder value for the shareholders who decide to keep their shares in the company. A prerequisite to capitalizing on an opportunity like this is that the company is aware of its valuation gap.

An equity issue is a value creating strategy for a company who wants to de-leverage when the company's share is trading above the intrinsic value, which provides the opportunity for value creation for existing shareholders. The value that is paid by new shareholders above the intrinsic value is distributed equally among existing and new shareholders. The reason that value is transferred from new shareholders to existing shareholders is that new shareholders pay too much to get a stake in the company. The current market price will eventually become more equal to the intrinsic value while leaving the new shareholders with a stake that is purchased at a price that was initially too high. This strategy assumes that the money that was raised will not be invested in projects that destroy shareholder value and it assumes that the equity issue does not take place via a rights issue where existing shareholders buy the equity that is issued. Furthermore, one needs to investigate the impact on the WACC when changing the leverage of the company.

#### *Changing the business profile*

Information about the valuation gap is important when assessing possibilities to change your business profile through mergers and acquisitions or in/divestures. The valuation gap changes over time due to changes in internal and external factors; estimating your company's valuation gap should therefore be a recurring process. As the value of your company moves over time, insight into the valuation gap can play a vital role in mergers and acquisition or in/divestiture decisions. If your company is, for example, relatively more overvalued compared to a takeover target, which means you have a bigger positive valuation gap (the current market price is above your estimate of the intrinsic value), you increase the opportunity to acquire this target by issuing your own shares. Remember that current market prices eventually become similar to intrinsic values.

A recent example that could turn out to be an example of this strategy is the acquisition of YouTube by Google. Google is one of the biggest success stories in corporate history, which is also visible in their share price performance. Having recently crossed the barrier of US\$500 a share it is possible that Google used its knowledge about the valuation gap as one of the reasons to finance the US\$1.65bn acquisition fully in shares.

### *Investor relations management*

When the valuation gap turns out to be negative, which means that the current market price is below your estimate of the intrinsic value, it might be possible to increase shareholder value (with the benefit of limiting the risk of shareholder activism) via investor relations management. Investor relations management can be introduced to adjust the market's expectations, bringing them back in line with the company's own expectations about the risk profile and outlook of the company. It is obvious that a thorough analysis of the intrinsic value together with a clear communication plan are required to attempt to convince the market.

An example of this strategy is Philips, who is currently putting a lot of effort into changing its profile within the investment community. After the recent sale of the chip division to a consortium of private equity investors, Philips' profile has changed dramatically from high tech to a profile with an emphasis on healthcare and lifestyle. The changed risk profile - together with the growth opportunities in healthcare - convinced Philips that it is facing a negative valuation gap.

### **Corporate Objective: Shareholder Value Creation in the Long Run**

Many people think that there is a difference between a shareholder model and stakeholder model of value creation but, in the long term, shareholder value creation is equal to maximizing the benefits to all stakeholders. The reason being that shareholders, as residual claimants, will only be satisfied after satisfying all other stakeholders, therefore the value of other stakeholders is maximized by the attempt of the shareholders to maximize their own value. For example, in the long run a shareholder might benefit from a corporate policy of focusing on ethical values

and proper corporate governance.

Shareholder value creation as a corporate objective often encounters criticism because it is often confused with current market price creation. This occurs as executive management sometimes favours investments that create little shareholder value (current market price) in the short term above investments that create more shareholder value (intrinsic value) in the long term. An obvious reason why this happens in practice is that the executive's remuneration scheme is often, in some way, partly linked to the company's share price. Another reason is the focus of the investment community on quarterly financial results. However, the only sustainable form of shareholder value creation in the long term is the creation of intrinsic value. The goal of the company should therefore be to create shareholder value, in the sense of intrinsic value, in the long term. This objective will automatically satisfy all stakeholders of the company.

### **Conclusion**

Temporarily, a gap might occur between the current market price and the intrinsic value of a company. This is possible as current market prices are driven by market sentiments and irrational behaviour while the intrinsic value is measured by a company's management who have access to private information. Knowledge of the valuation gap is important, as it is a potential source of shareholder value creation. Depending on whether the current market price lies below or above the intrinsic value, strategic decisions such as share buybacks, equity issues, dividends, mergers and acquisitions, and in/divestures might either increase or destroy shareholder value. Whether these strategies are going to create or destroy shareholder value for your company depends on your knowledge of your company's valuation gap.

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