An inside-out perspective to valuation

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Firm valuation is the foundation of numerous decisions, all of which vary in their level of magnitude and impact. Individual investors rely on stock valuations to identify an investment opportunity, firms evaluate their financial health and value-generating sources when deciding on their dividend policies, and acquiring firms value potential targets and estimate their prices to make a value-creating acquisition. At the heart of all these decisions lies the attempt to obtain an estimate of the true value of a firm. Yet, firm valuation is a very complex and challenging task because it is affected by many factors, which often make it difficult to accurately estimate a company's intrinsic value. Information asymmetry, the various sources of information and the incentives and attributes of different parties responsible for the disclosures of relevant information are only a few examples. The accuracy of an estimate of a firm's value, and consequently the quality of an investment decision or acquisition, is not only relevant to various capital market participants, but is also of great importance to the economy as a whole. For instance, the total value of mergers and acquisitions announced by a U.S. acquirer in 2015 reached $2.5 trillion, which is 13% of GDP.[63] While successful mergers create value for shareholders, misguided acquisitions, which are those that incorrectly determined the offer price or the potential for synergies, can lead to a substantial misallocation of capital and destruction of shareholder value. Hence, it is pivotal to continue expanding our knowledge on what drives the accuracy and precision of valuation, and how it can be improved.

This dissertation has social, economic and scientific relevance as it provides insights on the factors related to the performance of valuation from perspectives that have been so far unexplored. The findings from this dissertation are relevant to investors for their valuations, investments, and ultimately capital allocation decisions, to firms engaged in mergers and acquisitions, and to standard-setters, in terms of the requirements for valuation disclosures.

The insights from Chapter two should be of particular interest to investors, the provider of forecast tracking services I/B/E/S and investment community in general. The findings reveal that while the use of street earnings impacts the identification of comparable firms, surprisingly, this different peer selection does not, on average, improve the performance of valuation when using the warranted multiple approach. Street earnings' added value seems to materialize mostly for complex and difficult-to-value firms. This suggests that investors might optimize their investment strategies and use the various information sources in a more efficient and less costly way, depending on the complexity of the firm to value. In addition, my dissertation has a scientific impact as it shows that the warranted multiple approach itself is a robust and efficient valuation model, and thus, street earnings do not unconditionally outperform GAAP earnings in terms of

63 Retrieved from: https://evonomics.com/corporate-mergers-strangle-economy-jordan-brennan/

valuation performance. Given that the warranted multiple approach is a regression-based approach that allows to consider the simultaneous effect of various variables, it already by itself yields more accurate valuation estimates than relative valuations using industry or size matches (Bhojraj, Lee and Ng, 2003). Hence, whether for portfolio management purposes or acquisition analyses, this study encourages the use of the warranted multiple approach to increase the accuracy of obtained valuation estimates and ultimately the efficiency of investments and capital allocation decisions.

The insights from Chapter three and four are particularly relevant for the key players in the merger and acquisition industry since they address a relevant and timely phenomenon of fairness opinions. First, the findings of Chapter four should be of interest to the firms obtaining a fairness opinion and their shareholders given that fairness opinion fees are ultimately costs borne by shareholders. Typically, firms pay a substantial fee to obtain a fairness opinion, and as evidenced in the setting of tender offers, these fees have substantially increased over time. For instance, in 2010 firms paid on average approximately $9 million for a fairness opinion, while in 2016 they paid approximately $16 million. Yet, these substantial investments in fairness opinions are not always value generating since they might contain imprecise valuation information. This is not particularly useful for the board of directors and shareholders when assessing the attractiveness of the offer price. The findings in this dissertation show that while boutique and bulge bracket advisers, on average, charge similar fees for a fairness opinion, the former tend to provide more precise valuations. Therefore, holding fairness opinion expenditures constant, firms can increase their return on investments in fairness opinions by hiring a boutique adviser and obtaining valuations that are more precise. Hence, my dissertation has also a social and economic impact as it provides insights into how to maximize the value created during mergers and acquisitions. This has positive implications for social welfare since the created surplus ultimately circulates back into the community and economy.

Second, the findings of Chapter three might be of special interest to shareholders and standard-setters. One of the main findings of the study is that the incentives of the board and the CEO are related to the imprecision of valuations in a fairness opinion, which in turn can trigger shareholder class action lawsuits. One explanation for shareholder class action lawsuits is that it is often difficult for shareholders to disentangle valuation uncertainty from strategic motives. It is often not clear to fairness opinion users to what extent the imprecision in valuations reflects the inherent uncertainty of the target (and thus the different sets of projections) as opposed to the incentives of the parties involved in the preparation of the fairness opinion. According to the current state of fairness opinion disclosure requirements, neither Delaware courts nor the SEC perceives the review or receipt of projections by the board or financial advisers to be material

for purposes of disclosure.[64] In general, during the course of an acquisition, boards often provide some disclosures of financial forecasts to fulfill their duty of disclosing material information within the board's control. Yet, even if boards disclose financial projections in fairness opinions, the assessment of the materiality of various projections, and thus their disclosure, is highly subjective. Based on the findings in this dissertation, one suggestion to standard-setters is to mandate and harmonize the disclosure of financial projections, which are used as primary inputs in fairness opinion valuations. To increase transparency and credibility of fairness opinion valuations, a more extensive and transparent discussion of the underlying factors responsible for the precision of valuation estimates is needed. Financial advisers and boards of directors should be more transparent about the financial projections underlying valuations and provide more information on the impact of various projections, valuation factors and assumptions on the precision of valuations disclosed in a fairness opinion.

Overall, this dissertation provides interesting and relevant insights into the drivers and consequences of valuation properties. Specifically, the relation between the nature of valuation inputs, corporate governance and institutional attributes, and the precision and accuracy of valuation estimates is examined. This dissertation provides several suggestions on how to improve valuation outcomes, which is of interest not only to capital markets and investment community in general, but also to regulators and standard-setters, who guard the economic wealth of a society.

64 Retrieved from: http://media.straffordpub.com/products/financial-projection-disclosure-requirements-in-manda-deals-preparing-using-and-disclosing-projections-2016-07-20/presentation.pdf