Valuation of Companies in emerging markets
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Valuation of Companies in emerging markets

A Practical Approach

LUIS E. PEREIRO

John Wiley & Sons, Inc.
To Nori, Fede, and Rochi
Valuation is the point at which theoretical finance hits the harsh road of reality. You may be one of the many managers, advisors, or researchers faced with appraising the economic value of a new investment project, a merger, an acquisition, or a corporate divestment. You may have attended formal finance courses; you may even hold an MBA or an MFA; and still you are puzzled and frustrated when you attempt to implement the elegant theories of corporate finance in a real-life valuation exercise. This is hardly surprising, for financial theory and practice have formed an uneasy partnership that often ends in dissolution. On one side of this partnership are the academics, who wave their sophisticated risk-return models; on the other side are the practitioners, who stand by their expertise in crafting real-life acquisition deals. The professional appraiser sits uneasily between the two groups, often being squeezed uncomfortably by both. All the while, the crucial problem—how to sensibly and plausibly value a real asset—remains at best only partially solved.

In developed markets, valuing public or closely held real assets is an exacting task: the classical models of corporate finance must be carefully considered and adapted when dealing with real-life valuations. In the United States, for example—the epitome of a well-developed, highly efficient financial market—the use of well-established frameworks such as the capital asset pricing model (CAPM), arbitrage pricing theory (APT), or real options, poses serious challenges to the practitioner. No agreement exists among academics and practitioners concerning many crucially important issues—issues as basic as deciding on the market risk premium to be used, whether an option is truly embedded in a real asset, or how precise the multiples method is compared to discounted cashflow analysis.

These difficulties only magnify in emerging markets. Typically volatile arenas, their transitional nature adds a thick layer of complexity to the task of valuation, and raises such elementary questions as: Where do we get reliable financial data for an emerging economy? What is the risk-free rate there? How should country-related risk be introduced into the valuation model? What is the size of the market risk premium? How do we compute average betas in stock markets that are tiny and provide very few value references? What is the cost of capital in a country with no stock market? Are
value multiples equivalent across national borders? How do we value a privately held company in a country for which no empirical evidence on unsystematic risk is available?

Such questions must be answered, because emerging markets are tremendously attractive operating arenas for investors, managers, and entrepreneurs alike. The end of the twentieth century has seen these economies open their doors to foreign trade and investment; and as foreign direct investment has flooded the business arena, they have liberalized, deregulated, and invigorated their financial markets, and restructured their companies. Mergers, acquisitions, joint ventures, and strategic alliances have grown exponentially in these settings. All of these factors have raised the demand for sophisticated valuation techniques.

The purpose of Valuation in Emerging Markets is to bridge the gap between the theory and the practice of company valuation in transitional markets. It provides investors, managers, and entrepreneurs with specific tools and data in conjunction with step-by-step, down-to-earth practical examples for valuing both new ventures and established companies in volatile arenas. The book is relevant to anyone for whom the answers to the following questions are important in their jobs:

- What is an emerging market; what are its relevant features? What are the drivers that push an economy to emerge, and how does this process evolve along time? What are the investment dynamics in emerging markets, and why is it so important for managers, investors, and professional appraisers to understand them?
- Why must traditional valuation techniques be carefully scrutinized, revised, and adapted to deal with the appraisal of both real and financial assets in emerging markets?
- What does a fundamentals-based valuation model look like in an emerging market? How should cashflows be adjusted in volatile economies? What are the most popular practices of professional appraisers concerning this issue?
- What are the special problems of the classical asset pricing model in emerging markets? What are the available CAPM-based and non-CAPM-based variants for defining the cost-of-equity capital? How should a specific variant for an emerging market be chosen? How are the risk-return parameters that are plugged into a particular CAPM variant computed? What are the current practices in the real world of valuation?
- How important is unsystematic risk in company valuation? What are the specific drivers behind unsystematic company risk? How is such risk computed by U.S. practitioners? What is the size of private company risk in non-U.S. markets, and how can such a premium be
computed in an emerging market? How can unsystematic risk adjustments be introduced directly into the discount rate?

How is a synthetic company value computed when multiple DCF-based valuation frameworks have been used? How can we perform a multiple-scenario valuation in order to gauge the downside risk involved in a project?

How can the value of a real option be computed in a transition market? How do we determine the parameters of the Black-Scholes valuation model there? When does a real option really have value?

How should a relative, multiples-based valuation exercise be structured in an emerging economy? Where do we access information on comparable companies and transactions? How should comparables be selected—and their financial data be normalized—to ensure reasonable consistency in the comparisons? And once the group of comparables has been assembled, how do we compute an aggregate value metric?

How can U.S. multiples be adjusted for use in a transitional market? How can multiples be adjusted for unsystematic risk when appraising a closely held company? How do we reconcile the figures obtained from a relative valuation with the numbers computed from other techniques, for example, discounted cashflow analysis?

How is it possible to appraise the value of a startup that is operating in a highly volatile technology industry in an emerging economy that is also riding a marketwide speculative bubble? How can this quadruple challenge be solved in practice?

As can be deduced from those questions, this is a professional finance book, written for three primary groups of readers. The first group includes the following:

- CEOs and finance directors of multinational companies and large domestic groups involved in corporate acquisitions
- Managers and financial analysts who need to appraise the value of corporate mergers and acquisitions
- Professional investors, both individual and institutional
- Value appraisers in large consulting firms
- Research analysts in investment banks and private equity and venture capital funds
- Entrepreneurs who need to understand the mechanics of venture valuation when dealing with financial or strategic investors, whether their ventures are brick-and-mortar or web-based businesses.

The second group of readers includes graduate students in business and finance, who can use Valuation in Emerging Markets as they would a
textbook for a course on this topic. The book assumes a basic knowledge of corporate finance—equivalent to a first-year MBA course on financial analysis. Advanced undergraduate students in banking and finance may also benefit from the information contained in this book.

Academics interested in valuation issues in emerging markets make up the third group of readers for this book. In the last 10 years, as companies began globalizing their operations and investing heavily in other countries, the study of emerging economies has grown enormously. The managers of those companies are asking important questions about how to price cross-border acquisition deals, and they deserve good answers from academics. To start that dialog, this book lays out a common conceptual foundation.

Valuation in Emerging Markets is distinct from other valuation books in the following salient features:

- **It is devoted entirely to emerging markets.** Eighty-five percent of the book addresses the theory and practice of valuation in volatile markets; the remaining 15% provides a review on valuation in developed economies, as relevant to emerging economies.
- **It develops theory and discusses best practices.** Theoretical models are introduced; problems in applying them are addressed, along with recommended solutions. Arguments are supported with descriptions of the best valuation practices used in both developed and emerging markets.
- **It provides international coverage.** The techniques described can be applied to any emerging market. In particular, the book contains hard data and practical examples for eight benchmark emerging economies in the four continents: Argentina, Brazil, Mexico, Russia, Turkey, Indonesia, South Korea, and South Africa.
- **It provides specific tools for dealing with the valuation of technology companies in emerging markets.** A large number of regional technology firms, including Internet ventures, have opened in these markets, and the valuation tools provided in this book will be of prime interest to international investors, venture capitalists, and entrepreneurs who are crafting deals in such economies.
- **It is packed with valuable features unavailable elsewhere, including:**

  **Charts and tables.** The book contains 186 charts and tables that cite actual valuation parameters for use in both mature and transitioning economies.

  **Practical examples.** The book provides 62 detailed examples that help the reader understand the actual implementation of valuation techniques in emerging markets.

  **Case studies.** Three case studies on both brick-and-mortar and online firms are fully developed and discussed in the text; the reader is engaged
in a step-by-step valuation process, using the supportive data contained in the appendices.

**Technical appendices.** Six appendices provide the reader with sources of information and specific valuation parameters for eight reference emerging markets and the U.S. market.

**Links to relevant Internet resources.** A long list of links to websites and databases related to the valuation of real assets gives readers easy access to enormous amounts of data on companies and M&A transactions all over the world.

The idea for this book came to me while I was writing another—yet to be finished—book on entrepreneurship in Latin America. While working on the fourth chapter of the entrepreneurship manuscript, I was faced with a thorny issue: the cost of capital determination. How could I convince a prospective Latin American entrepreneur to appraise a new venture using a discounted cashflow valuation when it was not at all clear how to compute a discount rate in the region? Traditional finance provided few clues on how to do this; furthermore, hard data was lacking on the best practices employed regionally by financial experts. Though I knew full-blown research on the topic would mean putting aside the entrepreneurship manuscript, I met the challenge with excitement.

Sixty seconds of discussion were enough to convince Jorge del Aguila, director of the Argentine Institute of Financial Executives (IAEF) to sponsor a joint project with Universidad Torcuato Di Tella (UTDT) on the topic: We would survey in detail how the most sophisticated financial advisors were computing discount rates in Argentina, and then contrast their methods with those of U.S. analysts. Thanks to Jorge, the IAEF team, and the many financial executives who participated in the survey (and the people at Bloomberg’s, Standard & Poor’s, Fidelitas, and Nosis, whose information services were instrumental in building the empirical data), I wrote a paper that today is widely consulted in Latin America.

From that paper the idea for this book naturally unfolded. I asked myself, why not extend the work to include the whole gamut of valuation techniques—DCF, multiples, real options—in emerging markets? Why not study in detail the valuation of technology startups, at a time when Internet activity was exploding? This book is the answer to those questions—and more.

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Luis Pereiro
Albuquerque, New Mexico
Buenos Aires, Argentina
Jouy-en-Josas, France
La Paloma, Uruguay
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