ERA Convention 2011

“Growth Again”

REVIEW OF FINANCING

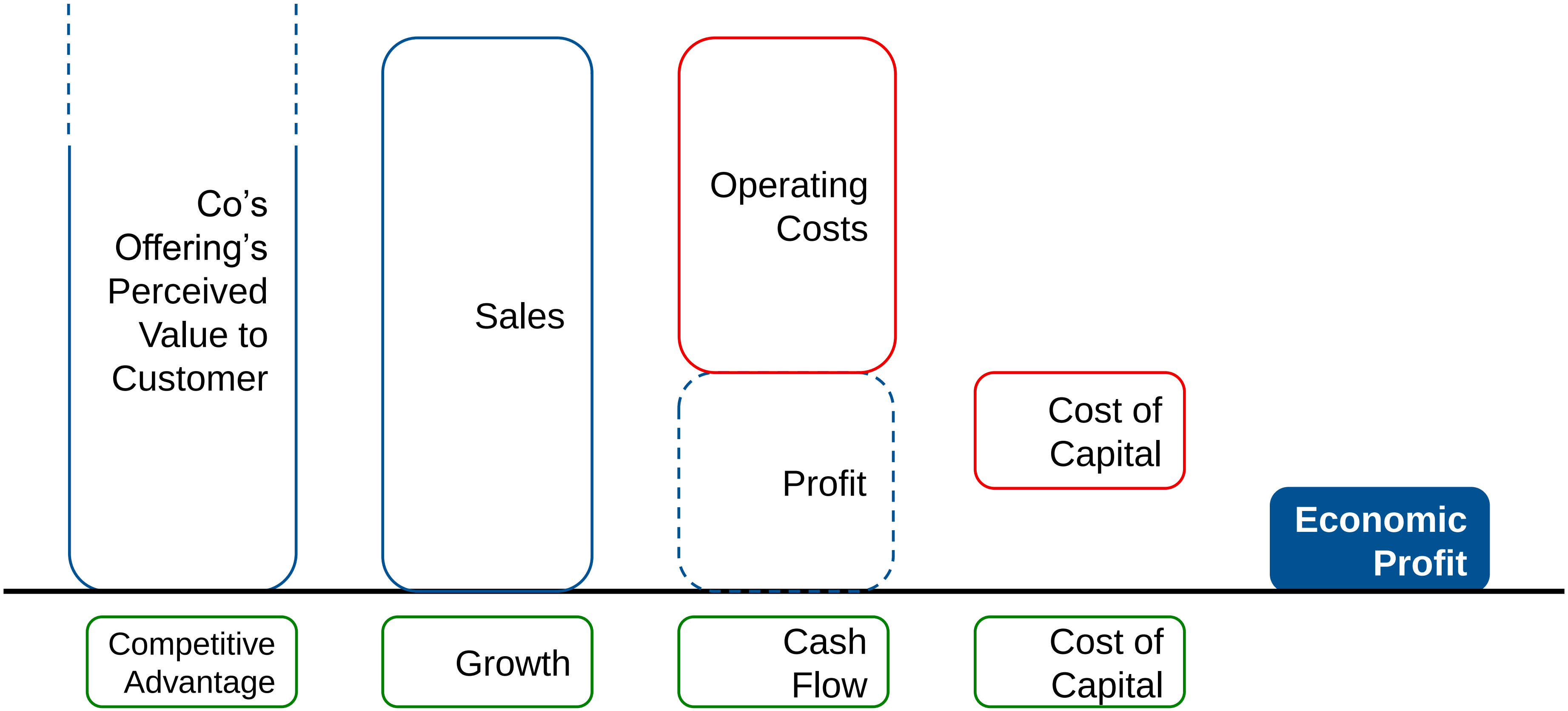
COST OF CAPITAL AS A VALUE DRIVER AND COMPANY VALUATIONS

Martti Ala-Härkönen
CFO, Cramo Plc

May 9, 2011, Amsterdam

WWW.ERARENTAL.ORG

The four “value drivers” driving shareholder value



The same value drivers appear in the basic Discounted Cash Flow (DCF) valuation model

Cash Flow

Growth

$$\text{Value} = \frac{FCF_{t=1}}{WACC - g}$$

Competitive Advantage

Cost of Capital

<u>Financing</u> = cost of capital breaks further into:

1. Amount and types/sources of capital
   = Capital invested
2. Cost of capital; including cost of equity and cost of debt

While operating in a capital-intensive industry, <u>the right management</u> of "cost of capital" is fundamental for a rental company's success

What makes valuations challenging? Cost of capital issues

1. Company ownership structure
   - Listed companies have wide sources of capital available:
     - Equity / stock market: New equity
     - Capital market: different types of corporate bonds , commercial papers, mezzanine
     - Wide sources of debt financing
     - Financial and operational leasing
     - Rental sharing
     - Free cash flow
   - Privately held companies more constrained , often ocus on:
     - Financial and operational leasing (note: vendor-related financing models may also include special clauses)
     - Rental sharing
     - Free cash flow
2. Different accounting treatment and transparency
   - European listed companies follow mainly IFRS
     - Same accounting principles …but still …a lot of subjectivity in bookings
   - Privately held companies give typically limited financial information
     - Local accounting policies have major deviations with IFRS, limited transparency
3. How to cope with the problems
   - Look for long trendlines in performance
   - Spend enough time in converting financials to common accounting standards, e g, IFRS
   - Understand off-balance sheet liabilities, e g, operational leasing

EUROPEAN RENTAL ASSOCIATION

What makes valuations difficult? Own experiences from rental company valuations

- EV / EBITDA
  - EV = Enterprise value (=equity value + net debt; ”debt-free value of business”)
    - Understanding / communicating difference between enterprise value and equity value
    - Leasing conversion into IFRS
      - Financial leases are capitalised under IFRS
      - Private companies typically have all leasing debt off balance sheet
      - The division between financial and operational leasing
    - Assets in the BS: What is the market value of fleet vs. book value?
    - Assets in the BS: Is the fleet well-maintained or requiring write-offs?
    - Assets in the BS: Any ”softness” in other assets?
    - Equity part of EV: How has goodwill been impairment tested?
    - Working capital: Normalised level of working capital vs. at closing?
    - Investments: What is the level of investment commitments at closing?
  - EBITDA
    - Estimating the normalised EBITDA level
    - Accrual levels, e g, bad debt provisions, pension provisions, others
    - Quality of monthly vs. yearly financials when mid-year used as a basis for valuation
    - Provisions provide major opportunity to influence the true operative performance also under IFRS, e g, restructuring provisions, level of bad debt provisioning
    - EBITDA fails to capture a fundamental element of the rental business, investments

EUROPEAN
RENTAL
ASSOCIATION

What makes valuations difficult?
Own experiences from rental company valuations

- EV / SALES
  - Sales
    - Revenue recognition: Does the company record used equipment sales in sales revenue or not?
    - Structure of sales: How much of sales is rental and how much rental-related sales?
    - How much is from top-10 customers and largest individual projects?
    - Structure of sales: Do the sales include trading?
      - Equipment trading may give a lot of low margin volumes
      - Trading volumes less predictable, bigger one-off deals/high periodic fluctuations, higher cyclicality in general
- P / BV
  - Is the equity ”hard equity”; any softness in assets or accrual levels at a too low level?
  - Often a multiple being overlooked … but
  - … if one looks at performance long-term, P/BV is quite often the least riskiest valuation component … how much future earnings value over BV is the company worth?

EUROPEAN RENTAL ASSOCIATION

SUMMARY

1. Understand the value drivers and among them cost of capital (financing) being one of the key value drivers for a rental company
2. Valuations highly difficult because of differences in:
    - Company ownership structures leading to
        - Different types and sources of capital available
        - Different cost of capital
    - Accounting treatment: Local GAAP vs. IFRS
        - Different levels of financial information provided
        - Also IFRS leaves high room for subjectivity
3. Look for long trend lines in performance
    - P/BV actually better valuation multiple than its common usage
      → how much future earnings value over BV is the company worth?

Warning signal: Growth again vs. risk management

- In the previous high cycle 2006-08, rental companies notoriously ”overinvested” over their financial capacity → oversupply of rental equipment across markets
- Which rental companies follow (or understand) their true and required returns over capital invested (ROI)?
- Excessive financing available (e g, through banks or vendors) may also be ”dangerous”, leading to overinvestments

The cure:

- Achieving stability between the supply and demand of rental equipment more important than growth → focus on utilisations
- Focus on price increases; recover the pre-crisis price levels
- Consolidation in fragmented markets