Asset Valuation Bulletin

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GROUP INTRODUCTION

RHL International is one of the pioneering professional valuation and real estate consultants in Asia. Established since 1972, our group offers high quality professional services on Corporate Valuation & Advisory and Real Estate Solution & Surveying Practice. As an active participant in exchanging ideas and experience with regulators, government institutions and corporations, our group maintains vigilant to the dynamic changes in the market. Leveraging our extensive track record, technical resources and market intelligence, we are dedicated to provide tailored services to meet with the unique needs of our clients.

EDITOR'S MESSAGE

Welcome to the Asset Valuation Bulletin issued by RHL Appraisal Limited. In this knowledge-based economy, a successful corporate management and investor need to be versatile to capture business opportunities, whilst understanding in accounting and finance is imperative to deal with the dynamic market. In response we launch this bulletin with the aim to share with you a wide range of useful knowledge and information, including but not limited to insight on current rules, and regulations, technical knowledge, market news and practical experience relating to asset valuation. We hope this bulletin could become one of your preferred knowledge update platforms.

TOPICS

- **Understanding Callable Bull Bear Contract ("CBBC") (Part 1)**
- **Business Valuation: Enterprise Value or Equity Value?**

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Financial Instruments Valuation

““Am I making a gain or loss?” As business expands, the proper use of financial instruments is the best way to facilitate investment, financing and risk management needs.”

UNDERSTANDING CALLABLE BULL BEAR CONTRACT (“CBBC”) (PART 1)

In the coming series of AVB, we are going to discuss CBBC, a very popular leveraged financial instrument in the market.

WHAT IS CBBC?

BBC is a type of structured financial instrument. Its inputs include strike price, maturity date and conversion ratio etc., resemble to an option. The trading of CBBC is similar to future contract. The finance cost of CBBC serve as the fee paid to the issuer and the premium of leverage. CBBC has a mandatory redemption feature. Once the underlying asset price touches the redemption price before maturity date, the CBBC is redeemed by the issuer. Investor might lose part or even all of the investment cost. The lowest possible value of CBBC is zero. It means that investor does not need to cover the position of CBBC. The maximum loss is all the investment in CBBC.

CBBC can be further categorized into Bull Contract and Bear Contract. If investor expects rise of underlying asset price, he should buy bull contract. If investor expects fall of underlying asset price, he should buy bear contract. As mentioned before, the CBBC will be redeemed if the underlying asset price reaches the redemption price. The residual value of the CBBC depends on whether it is N type or R type.

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Real Estate Valuation

"With 45 years of experience in handling multifarious cases, we have developed expertise in valuating real estates for a broad range of properties."

WHY CBBC?

When investor expects a rise of the underlying asset price, he can enlarge the profit by buying a bull contract. For example, if stock price rises from \$100 to \$110, the return of the stock is 10%. For the bull contract with strike price at \$50, it will rise from \$50 to \$60 (ignoring the finance cost). The return is 20%. Comparing both, bull contract earns twice as much of the underlying. However, higher return implies higher risk. If the stock price drops from \$100 to \$50, the returns are -50% and -100% for stock and bull contract respectively (the bull contract is called in this case). The loss from bull contract is also doubled.

On the other hand, if investor expects a drop of the underlying asset price, he can buy bear contract to earn from falling market price. The bear contract can also serve as a hedging tool given that an investor holds a large amount of stocks and expects the stock price will rise after a transition period. However, he may be adverse to the slump of underlying stock price. He can buy bear contracts to protect his holding from any unexpected drop in price. If the underlying stock price falls, the bear contract hedges the loss.

In the next issue, we will further discuss the characteristics and features of CBBC.

From the Editor:
Thank You for Ms. Helen Ly, our prestigious reader who had identified a typo in our past issue on "Getting Familiar with Decumulator (Part II)". One of the passage should be correctly stated as follows "Typically, the decumulator also incorporates the "step-up" feature so that investor has to sell more shares if the stock price is **higher** than the strike price." We welcome comments and interaction between the readers with us. If there are any topics of interest in related to valuation do feel free to inform us at info@rhl-int.com

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Business Valuation

""What is the value of a business?" Whether you are an executive, an investor or a stakeholder of a corporation, knowing the value of a business and its assets is critical in formulating sound and reasonable business decisions."

BUSINESS VALUATION: ENTERPRISE VALUE OR EQUITY VALUE?

In some cases, a management would like to have a business valuation for a reference of his decision making, however, has no idea about the Enterprise Value nor Equity Value. Sometimes, the management mixed up the concept of the Enterprise Value and Equity Value. A company's value could be measured using Enterprise Value or Equity Value, which will be calculated differently and may give the management different picture of the company's value.

International Valuation Standard defined Enterprise Value as the total value of the equity in a business plus the value of its debt or debt-related liabilities, minus any cash or cash equivalents available to meet those liabilities; Equity Value is the value of a business to all of its shareholders. In other words, the Enterprise Value refers to the total value of the business attributable to both of its equity owners and its debt owners, whilst, the Equity Value refers to the value attributable to the equity owners of the company. The calculations of Enterprise Value and Equity Value could be simplified as below:

Enterprise Value* = Equity Value*+ Debt Value*

Enterprise Value* = Common Stock* + Debt* – Cash* + Minority Interest* + Preferred Stock*

* Normally, it is measured at market value or fair value.

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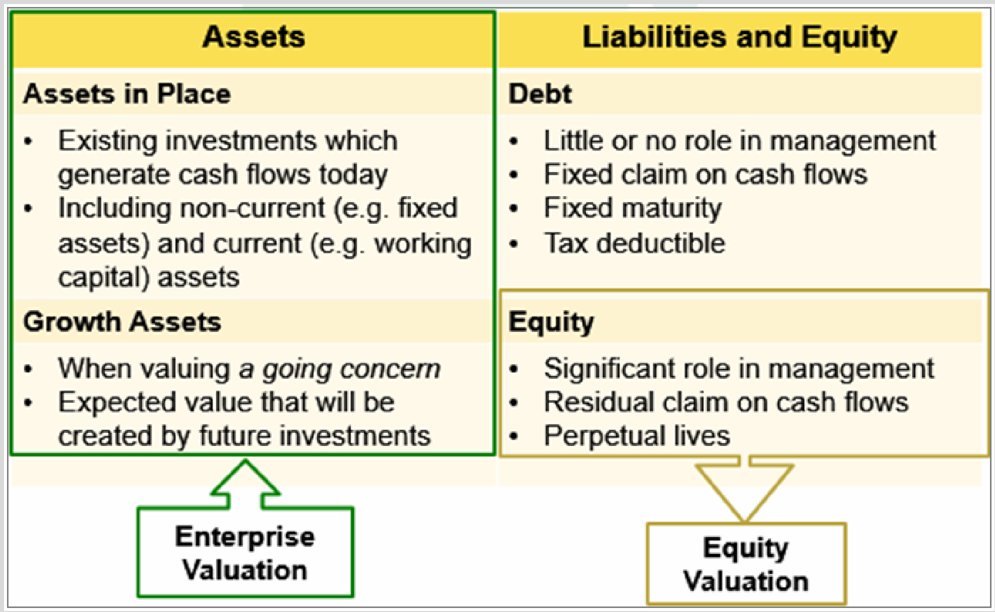
Corporate Restructuring

"To improve the performance of a business, it is necessary to go through reorganization of the corporation. Realigning the core business may involve divesture, spin-off or privatization."

When using valuation techniques, both of Enterprise Value and Equity Value could be valued by one or more of three generally accepted valuation approaches, namely Asset Approach, Market Approach and Income Approach. In this article, Income Approach will be discussed.

Under Income Approach, the Enterprise Value considers how the company finances the existing assets and future assets by all sources of fund including equity and debts. It could be illustrated as below using the presentation of balance sheet.



Source: Damodaran Online

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Plant & Machinery Valuation

"With our technical expertise and up-to-date knowledge on the current industrial environment, we can accurately appraise the values from manufacturing machinery to specific infrastructure facility."

Based on the valuation principle of Income Approach, when valuing the Enterprise Value, Income Approach estimates the future economic benefits generated by the company, that is Free Cash Flow to Firm ("FCFF"), and discounts these FCFF to its present value using a discount rate appropriate for the risks associated with realizing those benefits. Normally, the discount rate is calculated using the weighted average cost of capital ("WACC") by weighting the rate of returns required by equity and debt holders using the proportions of the firm's value attributed from each source of capital (equity and debt). After obtained the Enterprise Value, we could use the foresaid formula to calculate the Equity Value. Alternatively, if the Equity Value is estimated using Free Cash Flow to Equity ("FCFE"), the discount rate adopted should be cost of equity instead of WACC. Since a privately held company is theoretically worth less than a public company with the same business given other things being the same, marketability discount should be applied to reflect the ability of converting shares into immediate cash when valuing Equity Value. However, it is not required when valuing Enterprise Value.

The difference between Enterprise Value and Equity Value could be simply summarized as follows:

Areas of Comparison	Enterprise Value	Equity Value
Meaning	Total value of the business attributable to both of its equity owners and its debt owners	Value attributable to the equity owners
Cash Flow for Income Approach	FCFF = Net Income + After-tax interest + Depreciation & Amortization – Working Capital Change – Capital Expenditure	FCFE = Net Income + Depreciation & Amortization – Working Capital Change – Capital Expenditure – Net Debt Paid
Discount Rate for Income Approach	WACC	Cost of Equity
Lack of Marketability Discount	Applicable	Not Applicable

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About Us

Professional Team

Our team comprises of professionals who have finance and/or real estate related academic background and internationally recognized qualifications, such as CPA, FRM, registered professional surveyors, and with diverse experience and up-to-date knowledge of the current market environment. We committed to provide our clients with high standard services.

The Group is committed to provide high standard of professional services in compliance with international standard and Government Statutory requirements.

Corporate & Valuation Advisory

Our experience in operating businesses in the mainland China and cooperating with overseas parties has become our competitive advantage in offering comprehensive client solution to overseas as well as mainland clients. We cover real estate as well as other industries such as natural resources, green energy and finance area.

- Valuation (including Real Estate, Business Valuation, Plant & Machinery)
- Real Estate Solutions and Surveying Practice
- Industry Market Research & Analysis
- Project Feasibility Study and Advisory
- Financial Analysis
- Investment Advisory
- Due Diligence
- Portfolio, Asset and Facilities Management

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