Teach Yourself: Economic Evaluation:

Step 3 of Evaluating the Business/Project

2c: What business entity do I evaluate?

www.economicevaluation.com.au peter@economicevaluation.com.au

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The purpose of this module is to …

Level 3: De

explore the range of
possible business entities
that could be evaluated

Level 2: Evaluating the business/project

Level 1: Hands-on economic modelling

Spend only a few seconds on most slides.

Level 2: Evaluating the business/project

Step 1: Find out what is required

Step 2: Create the hands-on model

Step 3: Compute the basket of powerful economic measures: NPV, IRR, Payback, four cash streams, key drivers, break-evens, uncertainty, risk, optionality

Step 4: Assess alternatives, flexibility, options, risks, the business, the industry

Step 5: Communicate your message

Generally the evaluation will require you to …

Step 1: Find out w

Step 2: Create the ha

But first you must decide what business entity you are evaluating – and where

Step 3: Compute the basket of powerful economic measures: NPV, IRR, Payback, four cash streams, key drivers, break-evens, uncertainty, risk, optionality

Step 4: Assess alternatives, flexibility, options, risks, the business, the industry

Step 5: Communicate your message

Let’s use an example to illustrate …

Say you are looking at building a project or buying an existing business

- In another country.
- Your company will be taking a 70% share.
- Two other companies will be taking up 20% and 10%
- The other two companies will pay for the feasibility studies
- Your company will help these two get financing to construct.
- Once commercial operations start the other two companies will pay your company a management fee of 2% of their sales revenue FOB.
- Your company will fund it share of construction through 80% equity and 20% debt.

Where do you start?

It really is quite simple →

Always start by assessing 100% of the underlying business/project in its host country regardless of ownership and funding.

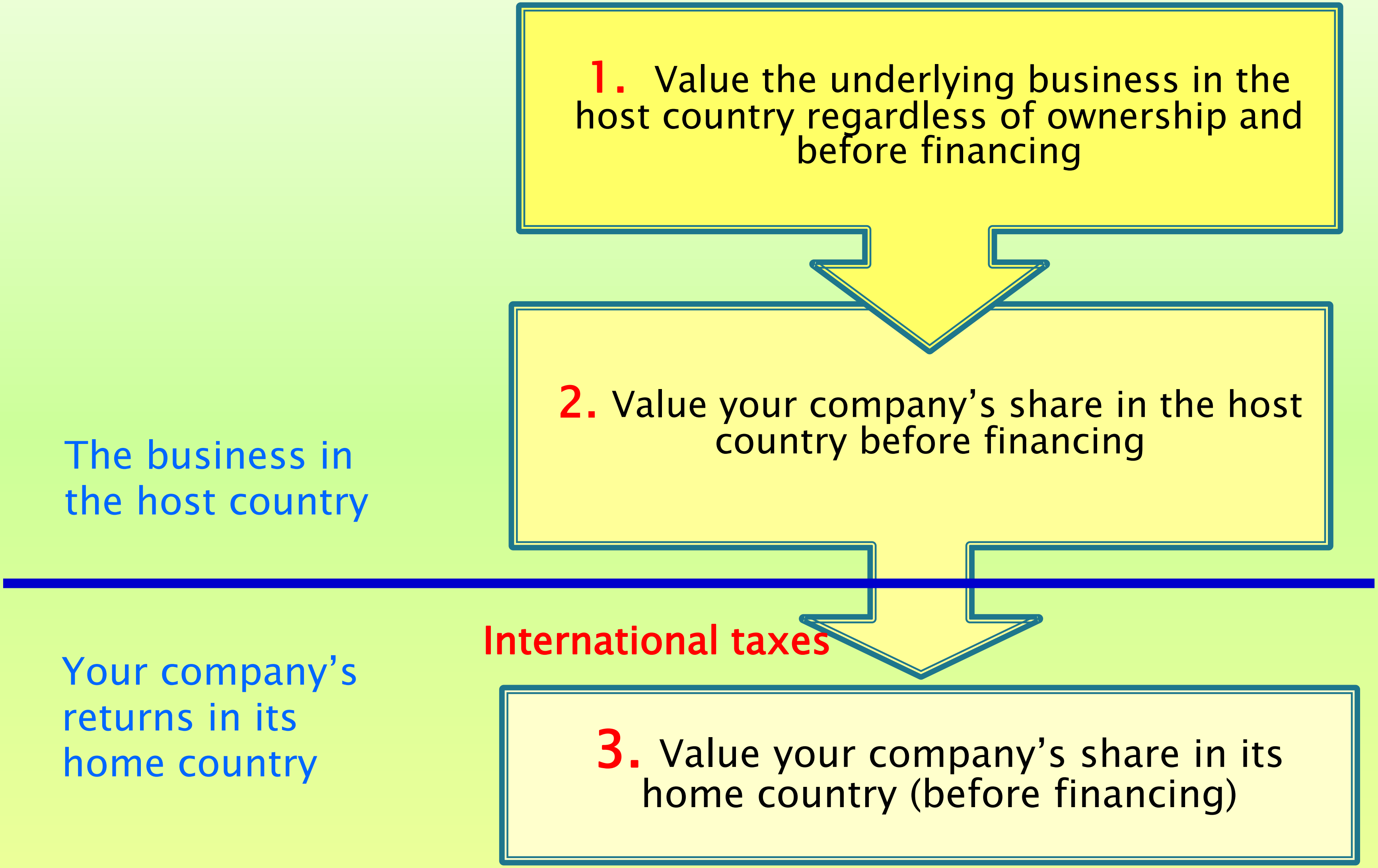
Is it healthy as a stand-alone?

Then work back in steps to your company's ownership in the host country regardless of funding….

then your company's returns back in its home country after international taxes and regardless of funding.

And concurrently do the same for your co-owners.

Graphically it may look like →



1. Value the underlying business in the host country regardless of ownership and before financing

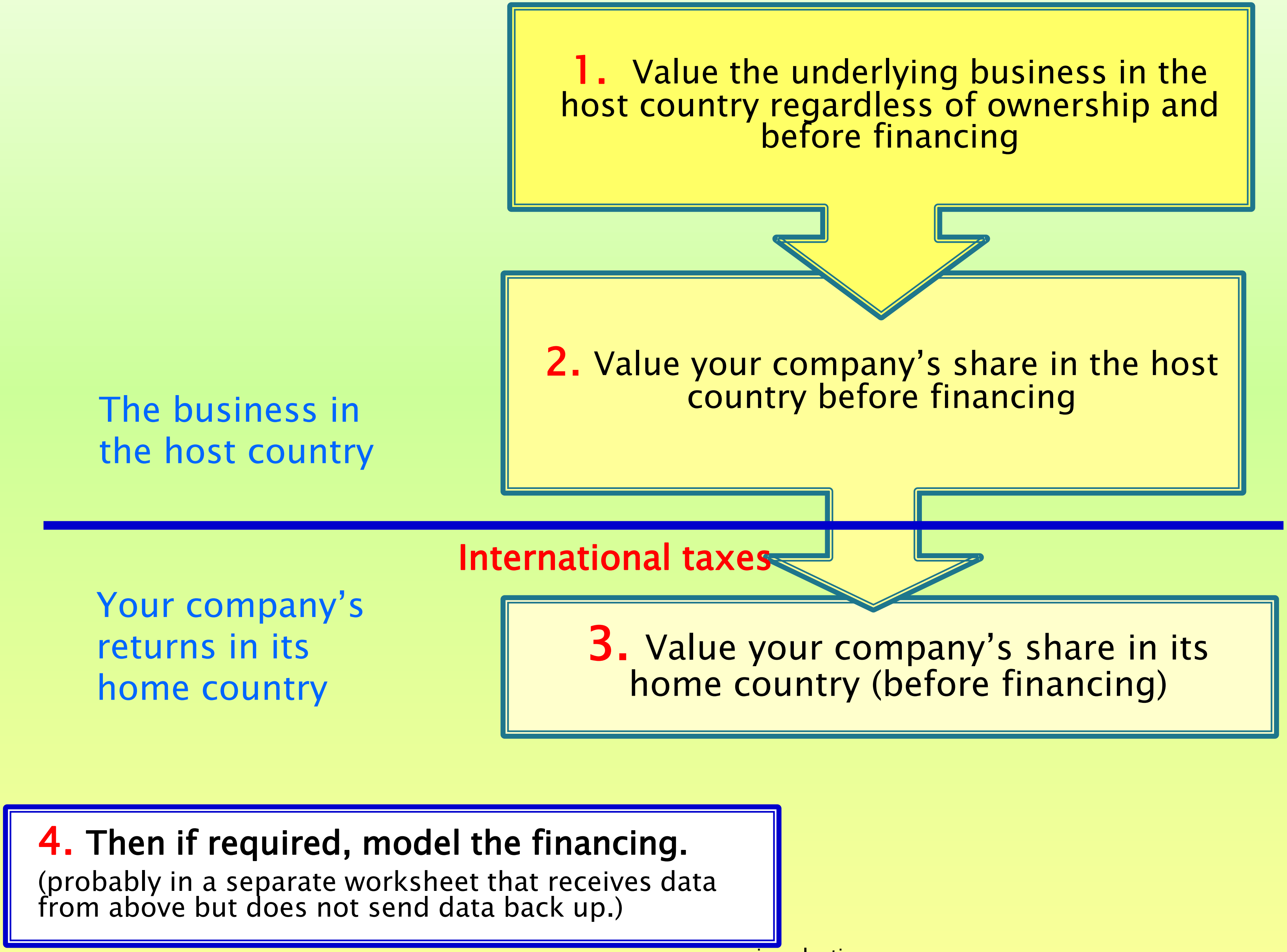
The business in the host country

2. Value your company’s share in the host country before financing

International taxes

Your company’s returns in its home country

3. Value your company’s share in its home country (before financing)



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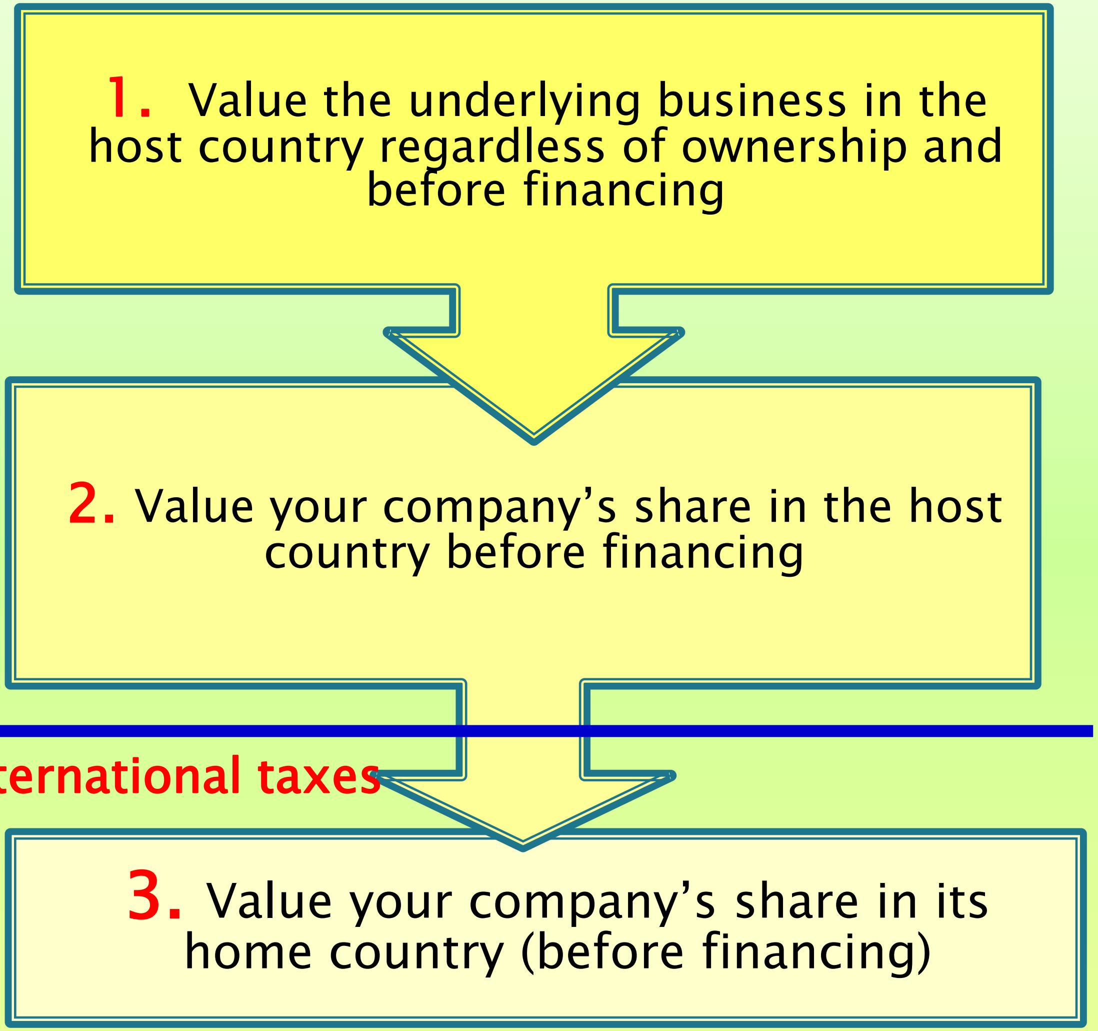
Your company's returns in its home country

3. Value your company's share in its home country (before financing)

4. Then if required, model the financing.

(probably in a separate worksheet that receives data from above but does not send data back up.)

Remember: If people tell you that the NPV will increase significantly by employing debt funding then they probably do not understand financial theory.



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2. Value your company's share in the host country before financing

International taxes

3. Value your company's share in its home country (before financing)

Financing's tax benefits should not flow back up to the valuations

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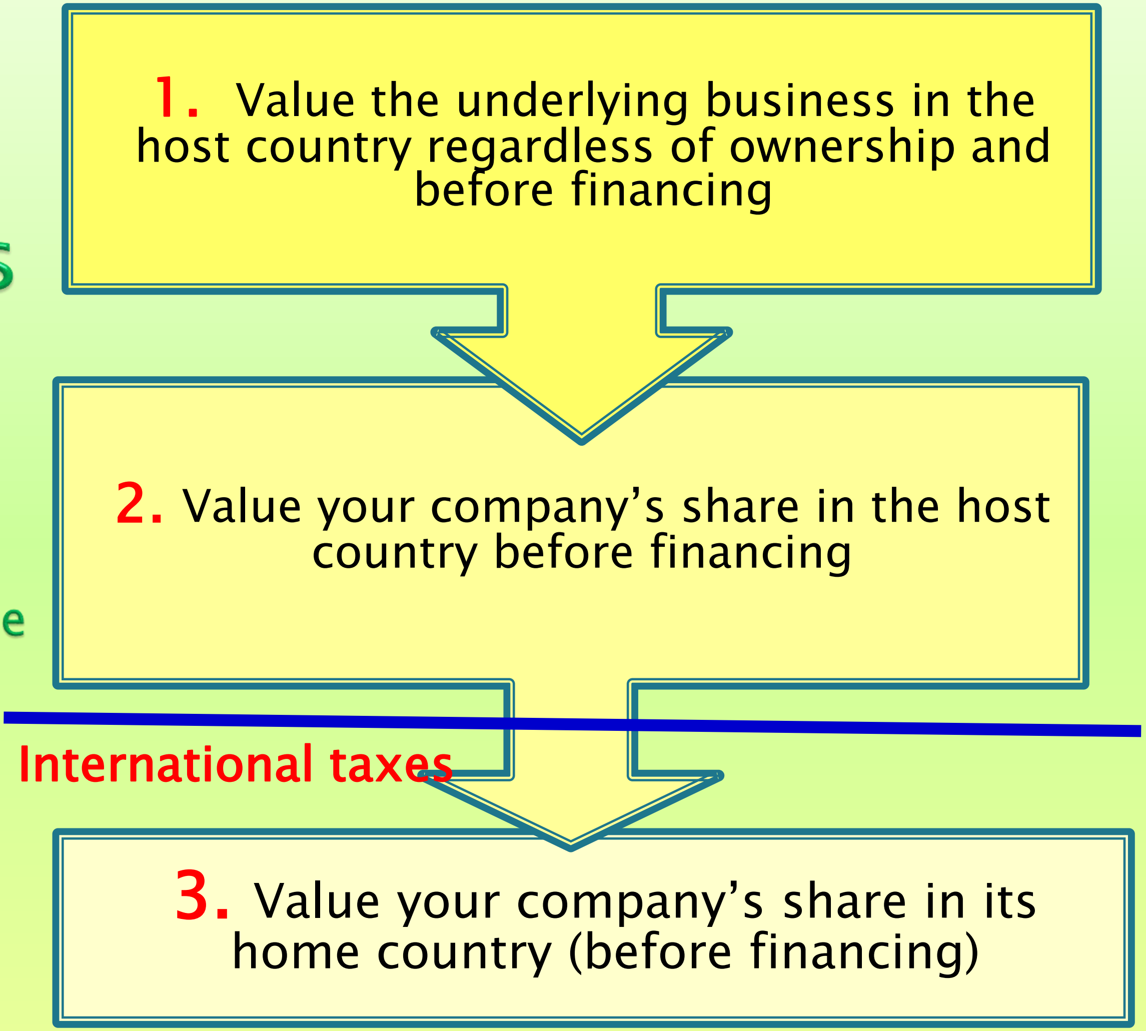
Be very cautious about deals…

where the underlying business is in poor health but your company gets a good return – at the expense of the minority parties. The other companies may be better off giving up and leaving you with the mess.



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compute the position of all stakeholders.

especially before negotiating with them.

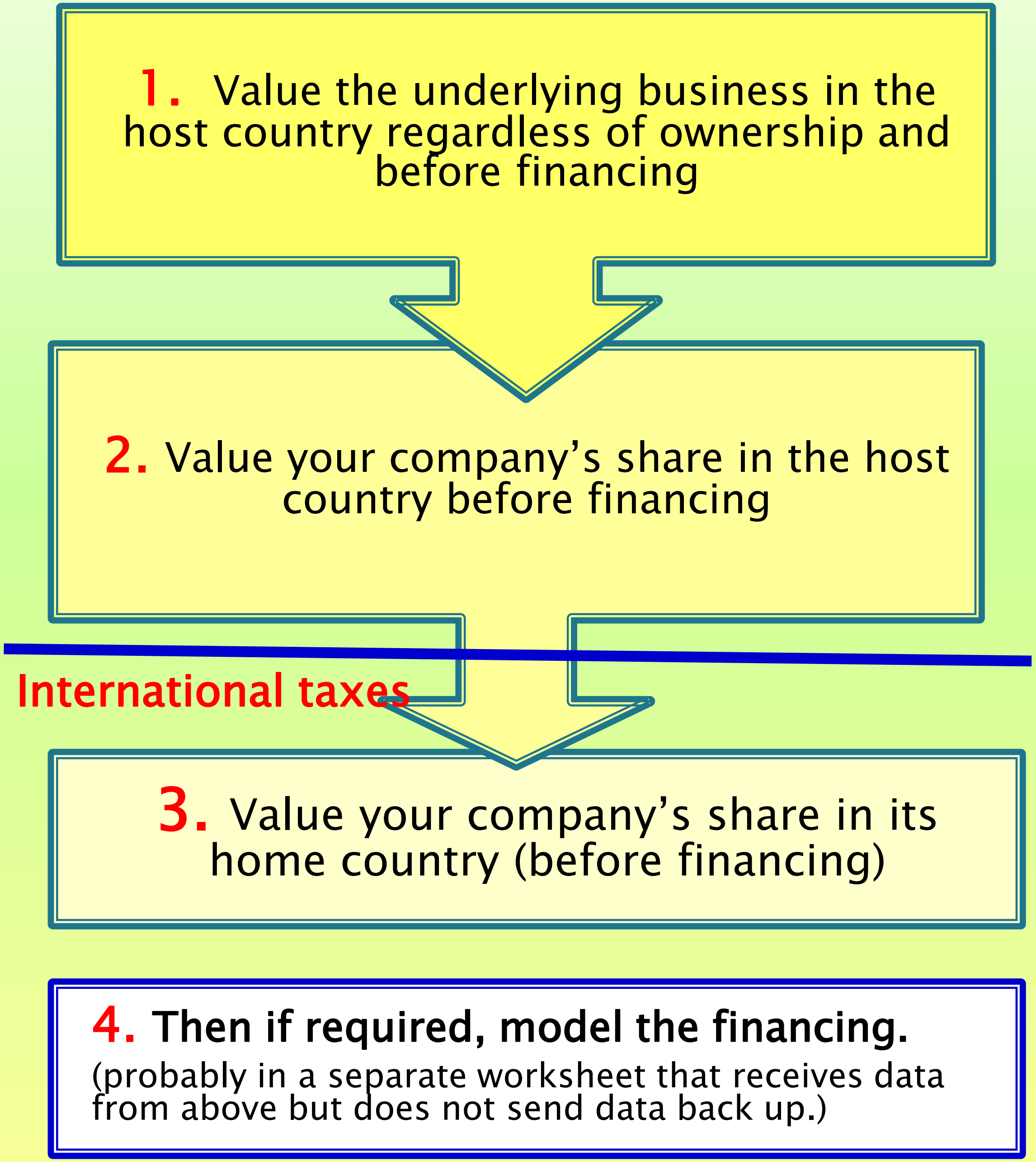
1. Other owners – You should do the a full evaluation.

2. Governments – taxes and royalties

3. Community groups – royalties and payments

4. Other key stakeholders

What will each gain/lose from business success and business failure?



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2. Value your company's share in the host country before financing

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3. Value your company's share in its home country (before financing)

4. **Then if required, model the financing.**
(probably in a separate worksheet that receives data from above but does not send data back up.)

1. Value the underlying business in the host country regardless of ownership and before financing

I would start by modelling the underlying project (or the underlying existing business) inside the host country regardless of ownership and before debt.

- Evaluate 100% of the underlying project/business as a stand alone entity in the host country, paying host country taxes.
- Do not include debt financing. Delete any interest payments incorporated in the construction costs. Do not include any interest payments on debt. (Some people call this a '100% equity valuation' – which is a misnomer)
- Do not worry about who owns what, who pays what operating expenses and who gets any surplus cash. Just see it all as flows of cash in and flows of cash out.
- Compute results under a few wide-ranging scenarios and start discussing with your colleagues/managers how the underlying project/ business entity behaves. Does it look healthy in its own right? How does it handle adverse markets and can it exploit booming markets? Strengths and weaknesses? Use this opportunity to influence colleagues and become a key team member!
- Be very wary of deals where one company squeezes the other so that one wins and the other loses. Chances are that the loser will pull out/fail/rebel so everyone loses. Advise you team not to buy 70% of an unhealthy business unless everyone has eyes wide open.

2. Value your company’s share in the host country before financing

There seem to be two common ways of holding the 70% interest: –

1. 70% equity
2. 70% joint venture

This website is not expert in company structures and financing but will give some thoughts.

Equity Share …

My understanding is that if my company had a 70% equity share then it would hold 70% of the shares in the company that was building the project or buying the business.

Let's call it "Company A".

- My company would buy 70% of the shares of Company A for which it might pay $2 or $200 million.
- My company would have to wait until dividends were paid by Company A.
- So my company would not be directly contributing 70% of construction costs and would not directly receive 70% of surplus cash flow each year once operations and sales commenced.
- .

The project/business would be run by "Company A", which would need to raise 100% of the cash to build the project or buy the business. It would use its own mix of equity and debt. Company A would manage the project/business from Day 1 to closure.

Each year any surplus cash flow in Company A would be used to pay interest, reduce its debt and eventually pay dividends to its shareholders.

- Being 70% shareholder my company probably would nominate the majority of directors of Company A, help it obtain debt, perhaps provide senior management and special advice.
- If Company A used say 80% equity to fund construction (or purchase) then my company probably would contribute the 70% of that 80%.
- My company should eventually receive 70% of the dividends paid by Company A inside the host country.
- My company would then have to decide what to do with the dividends received inside the host country – perhaps repatriate and pay international taxes.

Joint Venture

My understanding is that if my company had a 70% interest in an unincorporated joint venture then it would be a lot simpler.

My company or its subsidiary would hold a stand-alone 70% slice of the project or existing business. It would be as though my company had its own wholly owned business that is 70% the size of the underlying business.

My company/subsidiary would directly contribute 70% of construction costs. Through its life my company would pay 70% of capital costs, 70% of operating costs, take 70% of each product and sell it to receive its own revenue stream.

My company would set up its own equity/debt financing and submit its own tax returns for its 70% slice.

The 20% and 10% joint venturers would be similar and so have their own financing and tax returns.

My understanding is that joint venturers are not ‘partners’ but ‘participants’.

This joint venture interest would not have the complications of working through dividends from Company A.

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2. Value your company’s share in the host country before financing

So this step might be straight forward if ownership is 100% or a simple joint venture. I would hope to be able to add a worksheet to the right hand end of the core model and compute my company’s share inside the host country with relatively few computations.

If there were material side deals between the various owners in a joint venture – as in the example at the beginning of this module – then I may have to make extensive adjustments to capex and opex and hence need to calculate of tax for each company.

If my company owns 70% of the shares, then the computation of cash paid in and cash eventually received as dividends (before financing) are likely to be long and detailed, perhaps needing the help of an experienced Accountant.

3. Value your company’s share in its home country (before financing)

This third step should be similar in complexity to the second step above depending on whether the ownership is 100%, a joint venture or as a shareholding.

As in all evaluation work you need to keep the big picture in mind.

It may be sensible to approximate outcomes so as to eliminate hundreds of rows of computation if it is agreed with tax experts and accountants that the result will satisfactory for decision making. (You are not computing the Company’s tax returns nor its Accounts, but a business profile.)

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