MODUL PRAKTIKUM

ANALISIS KEUANGAN

Universitas
Esa Unggul

Oleh:

Team Dosen ANALISIS KEUANGAN

FAKULTAS EKONOMI
UNIVERSITAS ESA UNGGUL
JAKARTA

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J A K A R T A

KASUS – 1

TEORI

1 Matti, who has just completed his first finance course, is unsure whether e should take a course in business analysis and valuation using financial statements since he believes that financial analysis adds little value, given the efficiency of capital markets. Explain to Matti when financial analysis can add value, even if capital markets are efficient.

2 Accounting statements rarely report financial performance without error. List three types of errors that can arise in financial reporting.

3 Juan Perez argues that "learning how to do business analysis and valuation using financial statements is not very useful, unless you are interested in becoming a financial analyst." Comment.

4 Four steps for business analysis arc discussed in the chapter (strategy analysis, accounting analysis, financial analysis, and prospective analysis). As a financial analyst, explain why each of these steps is a critical part of your job and how they relate to one another.

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Problem 1 The Neuer Markt

Many economists believe that innovation is one of the main building blocks of economic growth and job creation. Not all economic infrastructures, however, arc equally supportive of innovation. In 1995 **venture** capital investments in Europe amounted up to 4 percent of total Gross Domestic Product (OOP), compared to 6 percent of GDP in the **US.** During the second half of the 1990s European and **US** venture capital investments experienced an explosive but distinctively different level of growth. In fact, in 2(KX) venture capitalists invested an amount equal to 17 percent of European GDP in European companies, while investing 7K perceni of **US** GDP in **US** companies." The availability of venture capital can be crucial in the development of innovation. Venture capitalists serve an **importanl** role as intermediaries m capital markets because they separate good business ideas from bad ones and bestow their reputation on the start-ups that they finance. In addihon to providing cap start-ups' success, allows venture capitalists to invest in risky business ideas that public capital markets typically ignore.
To improve young, innovative and fast-growing companies' access to external finance, several European stock exchanges founded separate trading segments for this group of companies at the end of the 1990s. Examples of such trading segments were the Nuovo Mcrcato in Italy, the Nouveau Marche in France, the NMAX in the Netherlands, and the Neuer Markt in Germany. These new markets coordinated some of their activities under the EuroNM umbrella. For example, starting in 1999 the markets facilitated cross-border electronic trading to create a pan-European exchange. Another important way of cooperation was to harmonize the admission requirements for new listings.[9] These requirements were not easier to comply with than the admission requirements of the traditional, established trading segments of the European stock exchanges. On the contrary, the common idea was that a separate trading segnent for innovative fast-growing companies needed stricter regulation than the established segments that targeted matured companies with proven track records. If this was true, having (some) common listing requirements across European new markets helped to prevent a race to the bottom in which companies would flee to markets with lenient listing requirements and markets start to compete with each other on the basis of their leniency.
The European new markets had also harmonized some of their disclosure requirements. All new markets required that companies produced quarterly reports of. at least, sales figures. Further, most of the new markets required that companies prepared their financial reports in accordance

with either US GAAP or International Accounting Standards. Given the opportunities for electronic cross-border trading, strict disclosure requirements could help in broadening companies' investor base as well as improve investors' opportunities for diversifying their risky investments. However, because the new markets experienced difficulties in further harmonizing their admission and listing requirements and eventually came to realize that the small cap companies **appealed** primarily to local investors, their cooperative venture was dissolved in December 2000.

One of the European new markets was the Neuer Markt. a trading segment of the 'Deutsche Boise', the German stock exchange. The Neuer Markl's target companies were innovative companies that opened up new markets, used new processes in development, production, or marketing and stiles, offered new products or services and were likely to achieve above-average growth in revenue and profit. On March 10. 1997, the initial public offering of Mobilcom AG started (he existence of the exchange. The offering of Mobil-corn's 640 thousand shares for an issue price of €31.95 was heavily oversubscribed, as 620 million additional shares could have been sold. Mobilcom's closing price at (he end of the first trading day equaled €50.10. yielding an initial return of 56.X percent. Other success stories followed. For example, on October 30. 1997. Entertainment Miinchcn. better known as EM.TV. went public on the German Neuer Markt. The Munich-based pro ducer and distributor of children's programs was able to place 600.000 of its common shares al a price sci at the upper end of the bookhuilding range, collecting approximately €5.3 million in total. There was a strong demand for (he company's shares. Al the end of the first trading day. the share price closed at €9.72. up by 9.4 *percent* At ils peak, in February 2000. EM.TV's share price had increased from to €0.35 (split-adjusted) to slightly more than €120.

Al Ihc end of February 2(MK). being close **10** ils three-year anniversary, the Neuer Markt comprised 229 companies with a total market capitalization of approximately €234 billion. However, in March 2000. the downfall began, in line w ith the plunge of the NASDAQ exchange. In .September 20(H), Gigabcll AG. was the first company to file for insolvency. The total market capitalization of the growth segment of the Deutsche Borsc declined further from €121 billion (339 firms) at the end of 2000 to €50 billion (327 firms) al the end strict compared to other segments and markets, several companies left the Neuer Markt, changing to the less regulated Geregelter Markt. During the first years of the 2000s, several Neuer Markt firms were found to have manipulated their financial statements. For example, in September 2000, EM.TV announced that it had overstated the sales and profit figures of its most recently acquired subsidiaries, the Jim Henson Company and Speed Investments, in the company's semiannual financial statements. Following this announcement, EM.TVs market capitalization declined by more than 30 percent. Other examples include computer games developer Phenomedia and Comroad, a provider of traffic information systems that was found to have falsified more than 90 percent of its 1998-2001 revenues.

On September 26, 2002, the Deutsche Borse announced that it would close its Neuer Markt trading segment in 2003. The remaining Neuer Markt companies could join the exchange's Prime Standard segment, which would adopt the Neuer Markt's strict listing requirements (i.e., quarterly reporting; IAS or US GAAP; at least one analyst conference per year; ad-hoc and ongoing disclosures in English), or its General Standard segment, with legal minimum transparency requirements. Approximately two-thirds of the remaining Neuer **Markt** firms decided to join the Prime Standard segment.

1 Do you think that exchange market segments such as the EuroNM markets can be a good alternative to venture capital? If not, what should be their function?
2 This chapter described four institutional features of accounting systems that affect the quality of financial statements. Which of these features may have been particularly important in reducing the quality of Neuer Markt companies' financial statements?

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3 The decline of the Neuer Markt could be viewed as the result of a lemons problem. Can you think of some mechanisms that might have prevented the market's collapse?

4 What could have been the Deutsche Borsc's objective of introducing two new segments and letting Neuer Markt firms choose and apply for admission to one of these segments? When is this strategy most likely to be effective?

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KASUS – 2
TEORI

1. What are the ways that a firm can create barriers to entry to deter competition in its business? What factors determine whether these barriers are likely to be enduring?

2. Explain why you agree or disagree with each of the following statements:
   a. It's better to be a differentiator than a cost leader, since you can then charge premium prices.
   b. It's more profitable to be in a high technology than a low technology industry, c The reason why industries with large investments have high barriers to entry is because it is costly to raise capital.

3. There are very few companies that are able to be both cost leaders and differentiators. Why? Can you think of a company that has been successful at both?

4. Many consultants are advising diversified companies in emerging markets such as India, Korea, Mexico, and Turkey to adopt corporate strategies proven to be of value in advanced economies like the US and Western Europe. What are the pros and cons of this advice?

PRAKTIKUM

Problem 1 The European airline industry

The Association of European Airlines (AEA) is an association of 34 established European airlines, mostly national flag carriers such as Air France. Lufthansa. Finair and SAS but also some cargo specialists such as TNT and Cargolux. The AEA continuously surveys its members and publishes reports and statistics about its members' passenger and cargo traffic and capacity, and operating performance. Although the members of the AEA do not represent the whole European airline industry, the AEA statistics are a useful source of information about the state of the industry. Following is a selection of stalistics illuslrating the developments in the industry during the years 2002-2007.
Revenue passenger kilometers (RPK) is the number of passengers transported times the average number of kilometers flown. Cargo lonne kilometers (CTK) is the amount of cargo transported (in tonne) times the number of kilometers flown. Load factors arc defined as the ratio of realized RPKs (or CTKs) and available seat kilometers (tonne kilometers). Note that the description of the European Airline Industry in this chapter covered the period 1995-2004. Use Ihc above information lo answer the following questions aboul whether and how competition in the European airline industry has changed after 2004:

1. Evaluate how the rivalry among existing firms has developed after 2004.
2. Evaluate the influence of rising fuel prices on the AEA airlines' profitability between 2003 and 2(KKS. If fuel prices had not increased after 2003. what would have been the pre-interest breakeven load factor in 2006 (assuming all other factors constant)?
3. During the period examined, some airlines started to charge fuel surcharges to (heir customers. For example, late 2(K)7 KLM charged its customers €27 on European (lights

and €80 on intercontinental (lights. Other airlines had similar surcharges. How **do** such practices affect your answer to question 2'.'

4. **Tnc opcranns murpms** of the **Al.A** airlines became positive, **on** averse in ->(KV4 and gradually .mproved (ncreaficr. W„a, do you Ihink arc Ihc most impti,:,; DCllind Ihis development?(Also consider your answers lo uuesiions 2 and I1

TABLE

		2002	*2003*	2004	2005	2006	*2007*
AEA market share ofthe...							
. . . 4 largest AEA artnes	%	58.9%	58 8%	58.5%	582%	57.6%	56.5%
. . . 8 largest AEA atrines	%	798%	793%	79.4%	79.1%	78.3%	77.1%
Revenue passenger kilometers	*mm*	589.575		656.677	699.515	741.608	781,165
RPK growth	*m*	-t M	15%	9.7%	6 5%	6.0%	5.3%
Cargo tonne kilometers	*mm*	31.499	32348	36.009	36.004	37.418	38,635
CTK growth	%	-03%	33%	106%	00%	3.9%	3.3%
Available seat kilometers	■m	*K* -	: ■: ?rE		922.077	970.717	1,015,00 4
ASK growth	%	-8-8%	1-8%	79%	48%	5.3%	4.6%
Available tonne kilometers	*mm.*	87.371	£z H:	97.869	102.398	107,568	112,477
ATK growth	%	-33%	18%	10.0%	46%	5.0%	4.6%
Passenger load factor	%	736%	733%	746%	75.9%	76.4%	77.0%
Cargo load factor	%	361%	36 6%	368%	352%	34.8%	34.3%
Overall load factor	%		63 6%	684%	689%	69.7%	
Revenue per kilometer	•L.		791	800	822	84.5	
Cost per kilometer			540	542	55.5	56.9	
Fuel cost to total cost	%		1210%	1520%		22.80%	
Pre-interest breokeven loac factor	«		683%	678%	67.5%	67.3%	
Average AEA operating margins (before interest)	%	16%	-03%	20%	2 3%	3.4%	5.2%
Average AEA operating margins (after interest)	%	-12%	-21%	05%	1.1%	2.5%	4.6%
Millions weekly seats of low-cost carriers (non-AEA members)	*mm*	■9	1 5	1 9	2 6	3.1	3 9
Low-cost earners growth	%		66.7%	26 7%	368%	192%	25.8%

Source: Association of European

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KASUS – 3
TEORI

1. *A finance student states, "I don't understand why anyone pays any attention to accounting earnings numbers, given that a "clean" number like cash from operations is readily available." Do you agree? Why or why not?*

2. *Fred argues, "The standards that I like most are the ones that eliminate all management discretion in reporting - that way I get uniform numbers across all companies and don't have to worry about doing accounting analysis." Do you agree? Why or why not?*

3. *Bill Simon says, "We should get rid of the IASB, IFRS, and EU Company Law Directives, since free market forces will make sure that companies report reliable information." Do you agree? Why or why not?*

4. *Many firms recognize revenues at the point of shipment. This provides an incentive to accelerate revenues by shipping goods at the end of the quarter. Consider two companies, one of which ships its product evenly throughout the quarter, and the second of which ships all its products in the last two weeks of the quarter. Each company's customers pay 30 days after receiving shipment. Using accounting ratios, how can you distinguish these companies?*

5. *A. If management reports truthfully, what economic events are likely to prompt the following accounting changes?*
   - *Increase in the estimated life of depreciable assets.*
   - *Decrease in the allowance for doubtful accounts as a percentage of gross trade receivables.*
   - *Recognition of revenues at the* point *of delivery rather than at the point cash is* **received.**
   - *Capitalization of a higher proportion of research expenditures costs.*

   B. What features of accounting, **if** *any, would make it costly for dishonest managers to make the same changes without any corresponding economic changes?*

6. *The conservatism (or prudence) principle arises because of concerns about management's incentives to overstate the firm's performance. Joe Banks argues, "We could get rid of conservatism and make accounting numbers more useful if we delegated financial reporting to independent auditors rather than to corporate managers." Do you agree? Why or why not?*

7. *A fund manager states, "I refuse to buy any company that makes a voluntary* **accounting** *change, since it's certainly a case* **of** *management trying to hide bad news." Can you think of any alternative interpretation?*

PRAKTIKUM

Problem - 1

One of the key accounting policies of banks and other financial institutions is how they recognize (changes in) the **fair value of** *the securities that they* **hold in** *the balance . The international* **rules on** *the recognition* **and** *measurement:*

a *Season and single ticket sales,*
b *Television, radio and media rights,*
c *Sponsorship and advertising contracts,*
d *The disposal of players' registration rights.*

Players' registration rights are recognized on the balance sheet at cost and amortized over the players' contract terms. The club leases its stadium Stadio Delle Alpi under an operating lease arrangement; however, it has started the construction of a new stadium, which is cofinanced by an outside sponsor in exchange of exclusive naming rights.

Spyker Cars N.V. *is a Netherlands-based publicly listed designer and manufacturer of exclusive sports cars. In* **2008,** *the company's revenues amounted to* **€7,852** *thousand, of which* **€5,772** *thousand was related to car sales and* **€1,752** *thousand* **was income from GT** *racing activities. In that year, Spyker produced* **30** *new* **cars** *and* **sold 37** *cars. It held* **42** *cars in stock at the end of the year. Further, the company spent close to* **€6** *million on development and* **€378,000** *on research. Spyker had been loss-making since its initial public offering in* **2004.** *At the end of* **2008,** *the car manufacturer had* **€76** *in tax-deductible* carry *forward losses.*

J Sainsbury plc *is a UK-based publicly listed retailer that operates* **502** *supermarkets and* **290** *convenience stores and has an estimated* **17** *percent market share in the UK During the period* **2004-2008,** *the company's net profit margins ranged from* **1.5** *to* **3.7** *percent. At the end of March* **2008,** *the net book value of Sainsbury's land and buildings was* **£5.9** *billion. A part of the company's supermarket properties was pledged as security for long-term borrowings. In* **2008** *Sainsbury had* **151,000** *employees* **(98,600** *full-time equivalents); many of them participated in one of the retailer's defined-benefit pension plans.*

1. *Identify the key accounting policies for each of these companies.*
2. *What are these companies' primary areas of accounting flexibility? (Focus on the key accounting policies.)*

Problem 2 Euro Disney and the first five steps of accounting analysis

Euro Disney S.C.A. is a holding company, holding **82** *percent of the shares of Euro Disney Associes S.C.A.. which operates, amongst others, the Disneyland Park, Disneyland Hotel, and Davy Crockett Ranch in Paris and holds* **99.99** *percent of the shares of EDL Hotels S.C.A. EDL Hotels operates all of the Disney Hotels in Paris (except for the Disneyland Hotel and Davy Crockett Ranch).*

Furo *Disney Associes* **leases the** *Disneyland Park (including land) under* **a** *finance lease from Euro Disneyland S.N.C.,* **which is** *owned by* **(1)** *a syndicate of banks* **and** *financial institutions* **(83** *percent participation) and* **(2/ a** *wholly-owned subsidiary of US-based The Walt Disney Company* **(17** *percent participation). EDL Hotels S.C.A. rents land to a group of six special-purpose* **financing** *companies, who. in turn, own the holds on the land and lease these hotels back to EDL Hotels. All special-purpose financing companies are fully consolidated in Euro Disney's financial statements, despite* **the** *absence of ownership in some cases. This is because, as* **the** *company reports* **in** *ils* **2008** *annual report, "the substance* **ol** *the relationship is between* **the** *group and* **these** *financing companies is* **such** *that they arc effectively controlled by* **the** *group." In* **fact, all** *special-purpose financing companies are managed by management companies* **that are** *directly or indirectly owned by The Walt Disney Company or Euro Disney Associes.*

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Kuro *Disney's* primary sources of revenue are ils two (heme parks (entrance fees mcr eHundlMi. rood and beverage, special evcn.s,. i,s seven Inlets and Disnev Villa,..- fro
Village offers themed dining, entertainment and shopping facilities. The company **has** on **average, 13,500** employees annually. **The** company **and its** subsidiaries are considered as **one French economic and** labor **unit,** regulated by **the** National Collective Bargaining Agreement signed in **2001** with six out of seven trade union represented **in the unit.** The majority of **the** company's employees (about **90** percent) have **a** permanent contract. To cope with the seasonal nature of the business. Euro Disney is able to move employees from **its** theme parks to its hotels and vice versa. Approximately **5** percent of total personnel expenses consist of training costs.

In **2005,** after a period **of poor performance.** Euro **Disney** began renegotiations with its lenders and The Wan **Disney** Company, **obtained waivers for certain** debt covenants and agreed to restructure its **financial obligations.** As part **of** the restructuring, the company would issue new share **capital, obtain the option to defer certain** payments to The Walt Disney Company, and receive **—Iwri *Mum* for a new** investment plan. Further, the company would change its organizational **Mioclte to the** one **described** above. Since the restructuring Euro Disney's debt agreements include **debt** covenants requiring the company to main-lain minimum ratios of **adjusted** operating **income (before** depreciation and amortization) to total debt service obligations- **Tmt adjusted operating income** figure is also used to determine the amount of interest on **the company's Walt Disney** Studio Park loans and the royalties and management fees payable **to Tbe Walt Disney** Company. In particular, if actual performance is less than the **conrracntafiv agreed benchmark,** the company can defer the payments of interest, royalties **and iiimi£i inrni** fees. **The debt** covenants also limit the amount of new debt capital **that** Euro **Disney can attract** to €50 million.
Euro Disney S.C.A. is **pnbfaly listed** en ore **Euronext** Pans stock exchange. By the end of ***2008. 39.8*** percent of **its** inwi were **owned by The** Walt Disney Company, ***10*** percent were owned by Prince **Afwaked and 502 percent** were in the hands of dispersed shareholders. The compam has **a Supervisory Board with** nine independent members, two of which are representatives **of** He Wall Drsoey **Company,** an audit committee and ***a*** nominations committee. **Euro Dtmet S-CA. as well as both** *t>*perating companies of Euro Disney S.*C.A.*. i.e.. Euro **Dtsnes A s m c n and** Euro Disney **Hotels,** are managed by management company Euro **Dtsney SA5 (referred to as the Gerant).** an indirect wholly-owned subsidiary of **The Wa* Dane) Company At** the end of fiscal year ***2008.*** the CEO ***of*** the **Gerant** (Euro **Disney S A_S I was Philippe** Gas, who replaced Karl Holz on September ***I, 2008.*** For the ■■njimmi semco **provided *lo*** the holding and operating companies, **the Gerant receives. ■ ■ujirmrm Sees. The** aggregate compensation lor the seven independent Supervisory Board nemfoers **was €286.421** in ***2008.*** The two representative ***of*** The ***Wall*** Disney **C.if. wuxiwul an annual** fixed salary, a bonus, restricted stocks, and slock opnranv nam He **Wan Disney** Company. Philippe ***Gas'*** employment contract promised hxnr

1. An annual salary ***of fc36X*.650.**
2. A discretionary annual boon* based[1] on mdmduai performance relative ***lo*** the objectives ***of* the** company ***and*** **Twc** Wafc DMO Company. Parks & ***Resorts*** operating segment.
3. Discretionary grams ***of*** the options, The ***Wall*** Drsue) Company***'s*** slock options, and The Wah Diinr? Company's restricted stock.
4. The Use of a company car.

In addition ***lo*** Philippe Gas. the Ksemme Committee ***of*** the **Gerant** ***consisted*** til live senior vice presidents and six vice **presidents** Euro Disney reported net losses m **2DDb** and **2007** and a small **profil (€1.7** million) in **2(XJn. *WW*** Hi e company's** ltil.il ***rocnuo increased*** by **9 *percent*** i«> **El J.*)** million in

expenses increased by 6, 2.8 and 10.3 percent, respectively. Euro Disney's operating cash flows amounted to €151.9, €191.1 and €178.2 million in 2006, 2007 and 2008, respectively. In all three years, the cash flows used in investing activities were less than the operating cash flows. In 2008 Euro Disney used part of the surplus of operating over investment cash flows to repay some of its borrowings, thereby reducing the non-current debt to equity ratio from 5.7 to 5.6. The company's trade receivables to sales ratio increased from 7.1 percent in 2007 to 7.5 percent in 2008. Liabilities for deferred revenues as a percent of sales decreased from 10.1 percent in 2007 to 9.0 percent in 2008. The allowance for uncollectible receivables increased from 1.6 percent (of gross trade receivables) in 2007 to 2.2 percent in 2008; the allowance for inventories obsolescence decreased from 8.2 percent (of gross inventories) in 2007 to 6.7 percent in 2008. During fiscal year 2008, Euro Disney did not make any voluntary change in its accounting methods and did not recognize any asset write-offs. Related patty transactions consisted primarily of the payment of royalties and management fees to the **Gerant** as well as payments to the **Gerant** to reimburse the direct and indirect costs of the technical and administrative services provided. Euro Disney's tax expense was zero in 2006, 2007 and 2008. At the end of fiscal year 2008, the company's unused tax loss carry forwards amounted to €1.3 billion and could be carried forward indefinitely. The company's 2008 financial statements received an unqualified audit opinion.
At the end of 2008. Euro Disney's share price was €3.60. The company's average share return since December 31. 2005 had been -31 percent (annually).

1 Identify the key accounting policies (step I) and primary areas of accounting flexibility (step 2) for Euro Disney.

2 What incentives may influence management's reporting strategy (step 3)?

3 What disclosures would you consider an essential part of the company's annual report, given its key success factors and key accounting policies (step 4)?

4 What potential red Hags can you identify (step 51?

KASUS – 4
TEORI

1. At the beginning of 2008. the Rolls-Royce Group reported in ils footnotes that its plant and equipment had an original cost of £2.110 million and thai accumulated depreciation was £1.146. Rolls-Royce depreciates its plant and equipment on a straight-line **basis** under the assumption that the **assets** have an average useful life of 14 years (assume a 10 percent salvage value). **Rolls**-Royce's lax rate equals 28.5%. What adjustments should be made to Rolls-Royce's (i) balance sheet at the beginning of 2008; and (ii) income statement for the year 2008. if you assume that the plant and equipment has an average useful life of 10 years (and a 10 percent salvage value)?

2. Car manufacturers Volvo and Fiat disclosed the following information in their 2008 financial statements:

	Volvo	Fiat
Property, plant and equipment (PP&E) at cost	SEK 119.089m	€ 36,239m
Accumulated depreciation on PP&E	SEK 61,819m	23,632m
Deferred tax liability for depreciation of PP&E	SEK 3,885m	679m
Statutory tax rate	28%	27 5%

Purely based on Ihe companies' deferred lax liabilities, which of the two companies appears lo be mosi conservative in its depreciation policy?

3. Dutch Food retailer Royal Ahold provides ihe following information ou its finance leases in ils financial statements for the fiscal year ended December 28. 2008:

Finance lease liabilities are principally for buildings. Terms ran^e from 10 hi 25 years and include renewal options i f it is reasonably certain, at the inception o f the leaxe. thru they *interest rate implicit in the lease, if this is practicable to determine; if not the interest rate applicable for long-term borrowings is used.*

The aggregate amounts of minimum lease liabilities to third parties, under noncan-celable

(€ millions)	Future minimum lease payments	Present value of minimum lease payments
Within one year	€ 143	€ 50
Between one and five years	537	214
After five years	1,236	811
Total	1,916	1,075
Current portion of finance lease liabilities		50
Non-current portion of finance lease liabilities		1,025

finance lease contracts for the next five years and thereafter are as follows:
What interest rate does A hold use to capitalize its finance leases?

4. On December **28, 2008,** Royal Ahold disclosed the following information about its operating lease commitments:

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(€ millions)	2007	2008
Within one year	€ 456	€ 454
Between one and five years	1,539	1,557
After five years	2,933	2,845
Total	4,928	4,856

Ahold's operating lease expense in **2008** amounted to €551 million. Assume **that** Ahold records its finance lease liabilities at an interest rate **of 8** percent. Use this rate-to capitalize Ahold's operating leases al December 31. 2007 **and 2008.**

a. Record **the** adjustment to Ahold's balance sheet at the **end** of **2007 to** reflect **the** capitalization of operating leases,
b. flow would this reporting change affect Ahold's income statement in **2008?**

7 When bringing operating lease commitments to **the** balance sheet, some analysts assume that in each year of **the** lease term depreciation on **the** operating lease assets is exactly equal lo **the** difference between (a) **the** operating lease payment **and** (b) **Ihe** estimated interest expense on **the** operating lease obligation.

a. Explain how (his simplifies the **adjustments,**

b. Do you agree thai this is a valid assumption'.'

8 Refer **to** the AstraZeneca example **on** intangibles **in** this chapter. What would be the value of AstraZeneca's R&D asset **al (he** end of fiscal years **2007 and 2008** if the average expected life **ol** AstraZeneca's R&D investments **is** only three years?

9 Refer to the Volvo example on discounted receivables in this chapter. What adjustments would be necessary if the interest rate that Volvo charges its customers equals the interest rate that the bank charges Volvo, i.e., 10 percent?

10 In early 2003 Bristol-Myers Squibb announced that it would have to restate its financial statements as a result of stuffing as much as $3.35 billion worth of products into wholesalers' warehouses from 1999 through 2001. The company's sales and cost of sales during this period **were** as follows:

(millions)	**2001**	**2000**	**1999**
Netsales	518,139	$17,695	$16,502
Cost of products sold	$ 5,454	$ 4,729	$ 4,458

The company's marginal lax rate during the three years was 35 percent. What adjustnents are required to correct Bristol-Myers Squibb's balance sheet for December 31. 2001? What assumptions underlie your adjustments? How would you expect the adjustments lo affect **Bristol**-Myers Squibb's perfonnance in the coming few years?

11 As the CFO of a company, what indicators would you look at lo assess whether your firm's non-current assets were impaired? What approaches could be used, either by management or an independent valuation firm, to assess the value of any asset impairment? As a financial analyst. what indicators would you look at to assess whether a firm's non-current assets were impaired? What questions would you raise with the firm's CKO about any charges taken for asset impairment?

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12 On Match 31. 2006. Germany's **largest** retailer Metro AG reported in its quarterly financial statements that ii held inventories for 54 days' sales. The inventories had a book value of €6.345 million.

a. How much excess inventory do you estimate Metro is holding in March 2006 if the firm's optimal Days' Inventories is 45 days?

b. Calculate ihe inventory impairment charge for Metro if 50 percent of this excess inventory is deemed worthless? Record the changes to Metro's financial statements from adjusting for this impairment.

PRAKTIKUM

Problem 1 Merger accounting

International rules for merger accounting (IFRS 3) require that firms report mergers using Ihe purchase method. Under this method the cost of the merger for the acquirer is the actual value of the consideration paid for the target firm's shares. The identifiable assets and liabilities ol the target are ihen recorded on the acquirer's **books** al their fair values. If ihe value ol the consideration paid for Ihe target exceeds the fair value of its identifiable

assets and liabilities, the excess is reported a.s goodwill on Hie acquirer's balance shed. For example, *when company* A *acquires* company B lor an *amount or*'€l hillion (paid *out* amount of €0.7 billion and recognize €0.3 billiou (1.0 - 0.7) of goodwill. The new rules require goodwill assets to be written off only if they become impaired in the future. However, as recently as 2003 some large acquisitions were reported using the pooling method. Under pooling accounting, the purchase of a target firm's shares is recorded at their historical book value rather than at their market value, so that no goodwill is recorded. For example, in the above example, company A would record.company B's net assets on its balance sheet for an amount of €0.5 billion, ignoring the net assets' fair value and the amount of goodwill on the acquisition. This is likely to be a consideration for the analyst in evaluating the performance of serial share-for-share acquirers.

In December 2000 the pharmaceutical companies SmithKline Beecham and Glaxo Wellcome merged their activities to form UK-based GlaxoSmithKline. GlaxoSmithKline reported under **UK** Generally Accepted Accounting Principles (UK GAAP) and recorded the merger transaction using the pooling method. After the merger, the former shareholders of Glaxo Wellcome held close to 59 percent of GlaxoSmithKline's ordinary shares. Because GlaxoSmithKline's shares were listed on the New York Stock Exchange, the company also had to prepare a reconciliation of its UK GAAP statements with US GAAP. The US accounting rules did not, however, consider the transaction a merger of equals but an acquisition of SmithKline Beecham by Glaxo Wellcome. These rules did not permit, therefore, the use of the pooling method to record the transaction.

The additional disclosures that GlaxoSmithKline made as part of its reconciliation to US GAAP provide the analyst with much of the information that is needed to adjust for the distortion from using pooling accounting. Under the terms of the deal, the acquisition price of SmithKline Beecham was £43.9 billion. At the time of the acquisition, the book value of SmithKline Beecham's net assets was £2.7 billion and the fair value adjustments to SmithKline Beecham's net assets amounted up to £25.0 billion. The amount of goodwill thus equaled £16.2 billion (43.9 - 2.7 - 25.0). At the end of the fiscal year 2005. GlaxoSmithKline reported in its first IFRS-based financial statements that ils goodwill on ihe acquisition of SmithKline Beecham had a remaining value of £15.9 billion, while fair value adjustments for acquired product rights were valued al £12.1 billion. The company did not. however, record these amounts on ils balance sheet. The international rules on the first-time application of IFRS allow

first-time adopters not to restate the accounting for business combinations (mergers and acquisitions) thai look place prior to the siarl of the previous year because such restatements arc complex and may require previously uncollected information. Like most first-time adopters, GlaxoSmithKline chose to apply this exemption. Pooling accounting therefore remained to affect GlaxoSmithKline's (and many other) IFRS-based financial Statements.

1 Discuss why. from an analyst's point of view, purchase accounting is preferable over pooling accounting.
2 What adjustments should an analyst make to GlaxoSmithKline's 2006 beginning balance sheet to correct for the distortions from using pooling accounting? (Assume that GlaxoSmithKline's marginal lax rale is 30 percent. Note thai the international accounting rules for income taxes prohibit the recognition of deferred taxes on nondeductible goodwill.)
3 What adjustments should an analyst make to GlaxoSmithKline's 2006 income statement?

Problem 2 - Impairment of non-current assets

Consider the acquisitions by Germany-based media company EM.TV & Merchandising Ati of the Jim Henson Company, creator of The Muppel Show, ami Speed Investments I. id., co-owner of the commercial rij:liis to formula One motor racing. Al the end of the popular sporting events. After its initial public offering on the Neuer Markt segment of the German Stock Exchange in October 1997, EM.TV's share price soared from €0.35 (split-adjusted) to a high of just above €120 in February 2000. Its high share price helped EM TV to finance several acquisitions through a secondary stock offering and the issuance of convertible debt. In March and May 2000, respectively, the company made its two largest acquisitions with the intention of expanding its international reputation. The company acquired the Jim Henson Company for €699 million and Speed Investment for €1.55 billion. At ihe time of the acquisition, Speed Investment's book value of equity was negative and the amount of goodwill that EM.TV recognized on the investment was €2.07 billion. The rationale of capitalizing this amount of goodwill on EM.TV's balance sheet is that it could truly represent the future economic benefits that EM.TV expects to receive from its investment but that are not directly attributable to the investment's recorded assets and liabilities. However, the analyst should consider the possibility that EM.TV has overpaid for its new investments, especially in times where its managers are flush with free cash flow.

At the end of the fiscal year, when EM.TV's share price had already declined to €5.49, the company was forced to admit that it had overpaid for its latest acquisitions. Goodwill impairment charges for the year ending in December 2000 amounted to €340 million for the Jim Henson Company and €600 million for Speed Investment. In its annual report, EM.TV commented that "the salient factor for the write-offs was that, at tbe time of the acquisitions, the expert valuation was determined by the positive expectations of the capital markets. This was particularly expressed through the use of corresponding multiples." Despite the large write-offs, a considerable amount of goodwill, related to the acquisition of Speed Investment, remained part of EM.TV's assets. This amount of €1.41 billion was equal lo 170 percent of EM.TV's book value of equity. Given the questionable financial health of Speed Investment, did the initial €2.07 billion of goodwill ever represent a true economic asset? Was it reasonable to expect to receive €2.07 billion in future economic benefits from a firm thai had not been able to earn profits in the past? If not. was the €600 million write-down adequate?

1. What balance sheet adjustments should an analyst make if she decided lo record an additional write-down of €1.41 billion in the December 2000 Financials?

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2. What effect would this additional write-down have on EM.TV's depreciation expense in 2001? (Assume that the adjustments to EM.TV's balance sheet are in conformity with current IFRSs.)

Problem 3 - H&M and Burberry's non-current assets

Hennes & Maurit/ AB (H&M) and Burberry Group pic (Burberry) are publicly listed apparel retailers. The following information is laken from their financial statements for the fiscal years ending on November 30. 2007 and March 31 . 2(X)8. respectively (hereafter referred lo as fiscal 2007):

	H&M fiscal 2007	Burberry fiscal
Land and buildings book value at the beginning of the year	SEK 420m	£58.2m
Book value of land, buildings, and equipment leased under finance leases at the beginning of the year	SEK 222m	£0.0m
Equipment at cost at the beginning of the year	SEK 13.605m	£192.8m
Equipment book value at the beginning of the year	SEK 7,134m	£99.2m (Continued)

	H&M fiscal 2007	Burberry fiscal 2007
Cost of equipment acquired during the year	SEK 3.466m	£38.3m
Buildings depreciation expense	SEK 14m	£1.9m
Equipment depreciation expense	SEK 1,750m	£27.0m
Sales	SEK 78,346m	£995.4m

Both retailers had non-cancellable operating leases related to land, buildings and equipment. Under the operating lease agreements, the companies were committed to paying the following amounts:

	H&M		Burberry	
Due in	fiscal 2007	fiscal 2006	fiscal 2007	fiscal 2006
Year 1 Years 2-5	SEK 6,801m	SEK 6,169m	£39.1m	£86.0m
After year 5	SEK 19,732m	SEK 17,689m	£112.9m	£103.8m
	SEK 12,478m	SEK 11.593m	£167.5m	
			£31.5m	
Actual lease payment made during the year	SEK 7,810m	SEK 7.030m	£43.0m	£31 0m

The incremental borrowing rate of H&M in fiscal years 2006 and 2007 was 4.4 percent: the incremental borrowing rate of Burberry in fiscal years 2006 and 2007 was 5.4 percent. The statutory tax rates of H&M and Burberry were 28 and 30 percent, respectively.

Assume that all land, buildings and equipment have zero residual values. Further assume that both retailers **recognize** half a year of depreciation on assets acquired during the year.

1. *Two measures of the efficiency of a firm's investment policy are (a) the ratio of land, buildings and equipment to sales and (h) the ratio of depreciation to sales. Calculate both ratios for H&M and Burberry based on the reported information. Which of the two companies appears to be relatively more efficient in its investment policy'.*
2. Calculate the depreciation rates that H&M and Burberry use for their equipment.

3. What adjustments to (a) the beginning book value **of** H&M's **equipment** and (b) the equipment depreciation expense would be required **if** you would assume that **H&M** uses the Burberry's depreciation rate?
4. What adjustments to (a) Ihe beginning book value of H&M's and Burberry's land, buildings and equipment and (h) H&M's and Burberry's depreciation expense would be required if you would capitalize the retailers' operating leases?
5. Recalculate Ihe investment efficiency measures using the adjusted **data.** Do ihe adjust merits affect your assessment **of the** retailers' **investment** efficiency?

KASUS – 5

TEORI

1 Which of the following types of firms do you expect to have particularly high or low asset turnover? Explain why.

- A supermarket.
- A pharmaceutical company.
- A jewelry retailer.
- A steel company.

2 Which of the following types of firms do you expect to have high or low sales margins? Why?

- A supermarket.
- A pharmaceutical company.
- A jewelry retailer.
- A software company.

3 Sven Broker, an analyst with an established brokerage firm, comments: "The critical number I look at for any company is operating cash (low. If cash flows are less than earnings. I consider a company to be a poor performer and a poor investment prospect." Do you agree with this assessment? Why or why not?

4 In 2005 France-based food retailer Groupe Carrcfour had a return on equity of 19 percent, whereas France-based Groupe Casino's return was only b percent. Use the decomposed ROLL framework to provide possible reasons for this difference.

5 Joe Investor asserts. "A company cannot grow faster than ils sustainable growth rate." True or false? Explain why.

6 What are the reasons for a firm having lower cash from operations than working capital from operations? What arc the possible interpretations of these reasons?

7 ABC Company recognizes revenue al the point of shipment. Management decides lo increase sales for the current ***quarter*** by filling all customer orders. Explain what impact this decision will have on:

- Davs' receivable for the current ***Quarter.***
- Sales growth for the current quarter.
- Sales growth for the next quarter.
- Return on sales for the current quarter.
- Return on sales for the next quarter.

8. What ratios would you use to evaluate operating leverage for a firm?

9. What are the potential benchmarks that you could use to compare a company's financial ratios? What are the pros and cons of these alternatives?

10. In a period of rising prices, how would the following ratios be affected by the accounting decision to select LIFO, rather than FIFO, for inventory valuation?

- Gross margin.

- Current ratio.
- Asset turnover.
- Debt-to-equity ratio.
- Average tax rate.

PRAKTIKUM

Problem 1 ROE decomposition

Inditex S.A. is the Spain-based parent company of a large number of clothing design, manufacturing and retail subsidiaries. The company's brands include Zara, Pull & Bear, and Massimo Dutti. At the end of the fiscal year ending on ***January*** 31, 2009 (fiscal year 2008). the subsidiaries of Inditex operated 4.359 stores across 73 ***countries***, making Inditex one of the three largest clothing retailers in the world.
The following tables show (he standardized and adjusted income statements and balance-sheets for Inditex. for the years ended January 31. 2007 and 2008. Operating lease obligations have been capitalized and the operating lease expense has been replaced with depreciation and interest expense, following the procedure described in Chapter 4:

Standardized and adjusted income statement millions)	2008	2007
Sales	**10,407**	**9,435**
Cost of materials	(4,493)	(4,086)
Personnel expense	(1.703)	(1,473)
Depreciation and amortization	(910)	(803)
Other operating income, net of other operating expense	(1,168)	(1,039)
Operating profit	**2,133**	**2,033**
Investment income	0	(9)
Net interest expense	(84)	(72)
Profit before taxes	**2,050**	**1,953**
Tax expense	(.JS5)	(474)
Profit after taxes	**1,595**	**1,479**
Minority interest	(8)	(7)
Net profit	**1,587**	**1,471**

Standardized and adjusted balance sheet (€ millions)	2008	2007
Non-Current Tangible Assets	6,325	6,000
Non-Current Intangible Assets	148	139
Deferred Tax Asset	203	133
Other Non-Current Assets	188	165
Total non-current assets	6,863	6,437
Trade Receivables	585	464
Inventories	1,055	1,007
Other Current Assets	158	45
Cash and Marketable Securities	1,466	1,466
Total current assets	3,264	2,982
TOTAL ASSETS	10,127	9,418
Shareholders' equity	5,055	4,414
Minority Interest	27	24
Non-Current Debt	2,003	2,095
Deferred Tax Liability	343	197
Other Non-Current Liabilities (non interest	308	229

bearing)		
Total non-current liabilities	2,655	2,522
Current Debt	234	371
Trade Payables	2,073	1,975
Other Current Liabilities	84	112
Total current liabilities	2,391	2,458
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	10,127	9,418

1. Calculate Inditex's net operating profit after taxes, operating working capital, nel non-current assets, net debt and nel assets in 2007 and 2008. (Use the effective tax rate |lax *expense*/profit before taxes| lo calculate NOPAT.).
2. Decompose Inditex's return on equity in 2(X)7 and 2008 using the traditional approach.
3. Decompose Inditex's return on *equity* in 2007 and 2008 using the alternative approach. What explains the difference between Inditex's return on assets anil ils operating return on assets?
4. Analyze the underlying drivers of the change in Inditex's return on equity. What explains the decrease in return on equity'.' How strongly appears Inditex to be affected by the economic crisis of 2008? (In your answer, make sure lo address issues of store productivity, cost control, pricing and leverage.)

PROBLEM 2 RATIO ANALYSIS AND ACQUISITIONS

TomTom is a Netherlands-based designer and manufacturer of portable GPS car navigation systems thai it sells across the world. The company's initial public offering in 2005 helped boost the company's revenues from €102 million in 2004 lo £1.364 million in 2006. In the fourth quarter of 2007. TomTom acquired 29.9 pcrcenl of lhe shares of Tele Alias, a provider of digital maps. The company completed the acquisition in 2008. The following tables show the components of return on equity and balance sheet items as a percent ol sales lor TomTom N.V. lor 2006. 2007 and 2008. The ratios have been calculated alter removing lhe nuirgm effect i»t a imc-time impairtvtcivt ctu\rg.tf. m 2,OOt*.

Ratio	2008	2007	2006
Net operating profit margin	12.6%	17.5%	15.9%
x Net operating asset turnover	1.03	1.87	11.11
= Operating ROA	12.9%	32.6%	176.7%
Spread	9.7%	29.2%	175.4%
x Net financial leverage	2.21	-0.31	-0.78
= Financial leverage gain	21.5%	-9.1%	-136.4%
ROE = Operating ROA + Financial leverage gain	34.5%	23.5%	40.3%

Ratio	2008	2007	2006
Operating working capital/Sales	5.9%	8.2%	10.6%
Net non-current assets/Sales	91.5%	45.4%	-1.6%
Non-current intangible assets/Sales	111.5%	3.2%	2.9%
... of which Goodwill/Sales	51.1%	0.0%	0.0%
Non-current financial assets/Sales	0.3%	47.0%	0.0%
PP&E/Sales	3.2%	1.0%	0.6%
Days' accounts receivable	62.4	83.5	70.2
Days' inventory	58.6	48.4	56.4
Days' accounts payable	61.3	56.2	30.6

1. Summarize the main factors behind the decrease in TomTom\s ROE in 2007 and the increase in the company's ROE in 2008.

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2. What effect did the acquisition of a 29.9 stake in Tele Atlas have on the components of TomTom's ROE in 2007?
3. What effect did the acquisition of a majority stake in Tele Atlas have on the components of TomTom's ROE in 2008"

PROBLEM 3 RATIOS OF VOLKSWAGEN AND PORSCHE

Germany-based Volkswagen AG is a leading car manufacturer, offering a wide variety of car brands, such as Audi, Bcntley, Bugatti. Lamborghini, SEAT, Skoda and Volkswagen. Germany-based Or. Ing. h.c.F. Porsche AG is one of its industry peers, focusing on the manufacturing of exclusive sports cars and multipurpose SUVs, such as the Porsche 911, the Porsche Boxster, and the Porsche Cayenne. In 2004 Volkswagen's earnings performance suffered from (he slow economic growth in Germany as well as in the other eurozone countries. At the same lime the strong euro harmed the company's exports to its primary markets outside the eurozone, such as the US and Asia. Price competition, stimulated by car manufacturers' overcapacity, forced Volkswagen to lower the price premium it had traditionally asked for its products and to launch a cost savings program, called ForMotion, in March 2004. The program focused on cutting product costs, one-time investments and development outlays, and overhead costs.
Porsche's sales were also negatively affected by the slowdown in economic growth in the eurozone, the strong euro, and rising petroleum prices. However, because of the company's focus on the top segment of the passenger car market, it was able to maintain its price premium and slay out of the price wars that were hanning Volkswagen's sales. In September 2(X)5 Porsche acquired an 18.5 percent interest in Volkswagen AG, financed hv cash, with ihe intention of becomiug Volkswagen's larucsl sini'le shareholder

The following tables show the components of return on equity, common-size income statements, asset turnover ratios, and leverage ratios for Volkswagen and Porsche:

ROE Decomposition	Volkswagen 2005	Volkswagen 2004	Porsche 2005
Net operating profit margin	1.9%	1.3%	11.7%
x Net operating asset turnover	1.08	1 07	1.69
= Operating ROA	2.1%	1.4%	19.7%
Spread	1.0%	0.6%	20.5%
x Net financial leverage	2.70	2.51	0.34
— Financial leverage gain	2.6%	1.5%	-6.9%
ROE = Operating ROA + Financial leverage gain	4.7%	2.8%	26.6%

Income statement line items as a percent of sales	Volkswagen 2005	Volkswagen 2004	Porsche 2005
Sales	100.0%	100.0%	100.0%
Cost of materials	(65.7%)	(66.5%)	(43.7%)
Personnel expense	(15.4%)	(15.8%)	(14.7%)
Depreciation and amortization	(9.1%)	(9.6%)	(7.8%)
Other operating expense	(6.9%)	(6.2%)	(15.3%)
Net interest expense/income	(1 2%)	(0.8%)	0.2%
Tax expense	(0.6%)	(0.4%)	(7.0%)
Net profit	1.2%	0.8%	11.8%
Cost of sales	(86.5%)	(88.2%)	N.A
Selling, general, and admin expense	(11.8%)	(11.8%)	N.A.
Other operating income/expense	1.3%	1.8%	N.A.

Asset turnover ratios	Volkswagen 2005	Volkswagen 2004	Porsche 2005
Operating working capital/Sales	23.6%	23.6%	11.4%
Net non-current assets/Sales	69.1%	70.2%	47.9%

PP&E/Sales	33.9%	36.3%	30.9%
Operating working capital turnover	4.2	4.2	8.8
Net non-current asset turnover	1.4	14	2.1
PP&E turnover	3.0	2.8	3.2
Trade receivables turnover	36	3.7	8.3
Days' receivables	100.0	97 2	43.3
Inventories turnover	5.5	5.1	4.6
Days' inventories	65.8	71.0	78.3
Trade payables turnover	8.4	7.6	7.6
Days' payables	42.7	47.6	47.2

Ratio	Volkswagen 2005	Volkswagen 2004	Porsche 2005
Liabilities-to-*equity*	4.32	3 97	2.05
DebHo-*equity*	3.25	2 96	1 39
Mnldohl to rmntu	*D70*	*251*	*07&*

Ratio	Volkswagen 2005	Volkswagen 2004	Porsche 2005
Debt-to-capital	0.76	0.75	0.58
Net debt-to-net capital	0.65	0.61	0.06
Interest coverage (earnings based)	2.53	2.41	not relevant
Interest coverage (cash flow based)	10.95	16.32	not relevant

1. Analyze the effect of the cost savings program on Volkswagen's ROE using all available information about ROE's components.
2. Compare the ratios of Volkswagen and Porsche. In particular:
   a. Discuss how differences in the two companies' product strategies can explain some of differences in their ratios,
   b. Analyze the efficiency of the car manufacturers' working capital management. Are the manufacturers equally efficient?
   c. Although Volkswagen and Porsche's PP&E turnover ratios are fairly similar in 2005, their net non-current assets turnover ratios are substantially different. What may explain this difference?
   d. Discuss how Volkswagen's and Porsche's financial strategies differ. What effect do these strategic differences have on return on equity? (Also explain why Porsche's financial spread exceeds its operating return on assets.)

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KASUS – 6

TEORI

1. GlaxoSmithKline is one of the largest pharmaceutical firms in the world, and over an extended period of time in the recent past it consistently earned higher ROEs than the pharmaceutical industry as a whole. As a pharmaceutical analyst, what factors would you consider to be important in making projections of future ROEs for GlaxoSmithKline? In particular, what factors would lead you to expect GlaxoSmithKline to continue to be a superior performer in its industry, and what factors would lead you to expect GlaxoSmithKline's future performance to revert to that of the industry as a whole?
2. An analyst claims. "It is not worth my time to develop detailed forecasts of sales growth, profit margins, etcetera, to make earnings projections. I can be almost as accurate, at virtually no cost, using the random walk model to forecast earnings." What is the random walk model' Do you agree or disagree with the analyst's forecast strategy? Why or why not?
3. Which of" the following types of businesses do you expect to show a high degree of seasonality in quarterly earnings? Explain why.
   - A supermarket.
   - A pharmaceutical company.
   - A software company
   - An auto manufacturer.
   - A clothing retailer.
4. What factors are likely lo drive a linn's outlays lor new capital (such as plant, property, and equipment) and for working capital (such as receivables and inventory)? What ratios would vou use to help generate forecasts >' these outlays?
5. How would the following events (reported this year) affect your forecasts of a firm's future net profit?
   - An asset write-down.
   - A merger or acquisition.
   - The sale of a major division.
   - The initiation of dividend payments.
6. An investment banker slates. "It is not worth my while to worry about detailed long-term forecasts. Instead. I use the following approach when forecasting cash flows beyond three years. 1 assume that sales grow at the rate of inflation, capital expenditures are equal lo depreciation, and that nel profit margins and working capital to sales ratios slay constant." What pattern of return on equity is implied by these assumptions? Is this reasonable?

PRAKTIKUM

Problem 1 Predicting Tesco's 2009/2010 earnings

On April 21. 2009. UK-based retailer Tesco pic presented ils preliminary financial statements for the fiscal year ending on March 31. 2009. Ihe following tables show a selection of Tesco's financial figures for the fiscal years 2007/2008 and 2008/2009 (i.e., the fiscal years ending on March 31. 2008 and 2009. respectively):

Balance sheet (£ millions)	2008/2009	2007/2008
Net working capital	(4,912)	(3,885)
Non-current tangible assets	*23,152*	*19,787*
Non-current intangible assets	*4,027*	*2,336*
Other Non-current assets	*3,469*	*1,725*
Non-interest bearing liabilities	*(888)*	*(954)*
Net non-current assets	29,760	22,894
Net debt	*11,910*	*7,194*
Equity	*12,938*	*11,815*
Net assets = net capital	24,848	19,009

Other information (£ millions)	2008/2009	2007/2008
Depreciation of non-current tangible assets	*1,036*	*876*
Amortization of non-current intangible assets	*153*	*116*
Non-current tangible assets at cost	*29,844*	*25,550*
Non-current intangible assets at cost	*4,790*	*2,944*
Dividends paid	*883*	*792*

In ADDITION TO *disclosing the* FINANCIAL *statements. Tesco's management also provided* GUID*ance about future* INVESTMENT *plans, financing strategies, and performance expectations.* IN *particular, the following information became available to investors and analysts* ON *the publication date:*

- *In 2008/2009. Tesco opened 9 million square feel of new store space. The retailer plans to open 8 million square feet of new store space* IN *2009/2010.*
- *Revenues in 2008/2009* WERE *the revenues of 53 weeks. The fiscal year 2009/2010 will include 52 weeks.*
- *Group capital* expenditure *during 2008/2009 was GBP 4.7 billion, a little more than planned (GBP 4.5b) due to currency movements. Tesco*'s *management indicates that capital expenditures in 2009/2010* will be around *GBP 3.5 billion. One reason for why capital* expenditures *can be reduced is* that *in the current economic downturn, Tesco can buy more new store space lor less.*
- *Tesco's effective tax rate in 2008/2009 was 26.7 percent versus 24.0 percent* IN *2007/ ^008 The increase in lax rate was primarily the result of one-time lax benefits* IN *2007/ 2008. Management expects the* EFFECTIVE *tax rate for 2009/2010 to be around 27 percent.*
- *In 2008/2009.* Tesco *was* able *to realize* cost saving iff close to *GBP 550 million* through its Step-Change program. Management expects *these cost* savings *to persist.*
- In *2008/2009. Tesco*'s net finance cost, *including the company*'s *return on pension* assels. was *GBP 284* million. The *underlying* interest charge was *GBP 309 million, up* from *GBP 159 million in 2007/2008. The weighted* average *coupon rate of Tesco's debt was 5.6 percent.*
- *Tesco*'s *net debt rose substantially during 2008/2009* as a *result* of:
  1. *increased capital expenditures.*
  2. An increased pension deficit (GBP *0.65 billion increase).*
  3. *The significant depreciation in the sterling-dollai/eiiro exchange rates (with a debt* impart of approximately GBP 1 billion).

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REALIZED AND PLANNED STORE OPENINGS:

(£ millions)	UK	Rest of Europe	Asia	US
2008/2009 (Realized):				
Revenues	*38,191*	*8,862*	*7,068*	*206*
Operating profit	*2,540*	*479*	*343*	*(156)*
Square feet store space (x 1,000):				
Beginning-of-year	*29,549*	*22,517*	*23,363*	*530*
Openings, extensions, adjustments	*1,773*	*3,502*	*3,006*	*620*
Acquisitions	*239*	*3,015*	*0*	*0*
Closures/disposals	*(276)*	*(196)*	*(190)*	*0*
End-of-year	*31,285*	*28,838*	*26,179*	*1.150*
2009/2010 (Expected):				
Square feet store space (x 1,000):				
Beginning-of-year	*31,285*	*28,838*	*26,179*	*1,150*
Openings, extensions, adjustments	*1.897*	*2,697*	*2,733*	*600*
Acquisitions	*98*	*0*	*0*	*0*
Closures/disposals	*(225)*	*0*	*(63)*	*0*
End-of-year	*33,055*	*31,535*	*28,849*	*1,750*

1 Predict ***Tesco***'s ***2009/2010*** sales using the ***information*** about the company***'s*** store space ***and revenues*** (per geographical segment).

2 Predict the 2009/2010 book values of Tesco*s non-current assets and working capital using the information about the company's investment plans. Make simplifying assumptions where necessary.

3 During fiscal year 2008/2009, at least two factors influenced Tesco*s operating expenses: (a) the increase in depreciation and (b) the cost savings of approximately GBP 550 million. Assume that all other changes in the company's operating profit margin were caused by the economic downturn.

   A. What was the net effect of the downturn on Tesco*s operating margins?
   B. Estimate losco's 2009/2010 operating expense under the assumption that the effect of the economic downturn fully persists in 2009/2010. (Estimate the company's depreciation and amortization expense separately from the other operating expenses.)

4 Estimate Tesco's 2009/2010 interest expense and net debt-to-equity ratio under the assumption that the company reduces its net debt in 2009/2010, as planned.

5 What do the above estimates (and your estimate of Tesco's 2009/2010 tax expense) imply for the company's free cash How to equity holders in 2009/201t)? How likely is it thai Tesco will be able to reduce its nel debt in 2009/20107

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KASUS – 7

TEORI

1 Jonas Borg. an analyst at EMH Securities, states: "I don't know why anyone would ever try lo value earnings. Obviously, the market knows that earnings can be manipulated and only values cash Hows." Discuss.

2 Explain why terminal values in accounting-based valuation are significantly less than those for DCF valuation.

3 Manufactured Earnings is a "darling" of European analysts. Its current market price is €15 per share, and ils book value is €5 per share. Analysts forecast that the firm's book value will grow by 10 percent pet year indefinitely, and the cost of equity is 15 percent. Given these facts, what is the market's expectation of the firm's long-term average ROE?

4 Given the information in question 3. what will be Manufactured Earnings' share price if the market revises its expectations of long-term average ROE to 20 percent?

5 Analysts reassess Manufactured Earnings' future performance as follows: growth in book value increases lo 12 percent per year, but the ROE of the incremental book value is only 15 percent. What is the impact on the market-lo-book ratio?

6 How can a company with a high ROE have a low PE ratio?

7 What types of companies have:

a A high PE and a low market-to-book ratio?
b A high PE ratio and a high market-to-book ratio?
c A low PE and a high market-to-book ratio?
d A low PE and a low market-to-book ratio?

8 Free cash flows (FCF) used in DCF valuations discussed in the chapter are defined as follows:

FCF to debt and equity = Earnings before interest and taxes X (1 - tax rate) + Depreciation and deferred taxes - Capital expenditures - / + Increase/decrease in working capital FCF to equity = Net profit + Depreciation and deferred taxes — Capital expenditures - / + Increase/decrease in working capital + / - Increase/decrease in debt

Which *of* the following items affect free cash flows to debt and equity holders? Which *affect free* cash flows to equity alone? Explain why and how.

- An increase in trade receivables.
- A decrease in gross margins.
- An increase in propem. plant, and equipment.
- An increase in inventories.
- Interest expense.
- An increase in prepaid expenses.
- An increase in notes payable to the bank.

9 Starite Company is valued at *€20* per share. Analysts expect that it will generate free cash flows to equity of €4 per share for the foreseeable future. What is the firm's implied cost of equity capital?

10 Janet Stringer argues that "the DCF valuation method has increased managers' focus on short-term rather than long-term performance, since the discounting process places much heaver weight on short-lerm cash f)OWS than long-term ones." Comment.

PRAKTIKUM

Problem 1 Estimating Hugo Boss's equity value

Hugo *Boss* AG is *a* German designer, manufacturer and distributer of men's and women's in *the* higher end of *the* clothing retail industry. *During the* period *2001-2008, the company* consistently earned returns on equity in excess of *18* percent, *grew lis* book *value of equity* (before special dividends) *by 5.5* percent *per* year, on *average, and* paid *out 65-70* percent of *its* net profit as dividends. In *2008. the* company paid out I *special* dividend of *€345.1* million. Consequently, the company's book value of equh} decreased *from €546.8* million in *2007* to *€199.0* million in *2008.*

On April I. *2009. one month before the* publication of the first-quarter results, when *Hugo Boss's 70.4 million common shares trade at about* €1 1 per share, an analyst proforma:

Income statement (€ millions)		2009E	2010E	2011E
Sales		1548.1	1493.9	1561.2
Gross profit		897.9	875.1	923.7
EBIT		179.6	176.9	196.2
Net interest expense		(45)	(40)	(35)
EBT		134.6	136.9	161.2
Tax *expense*		(36.3)	(37)	(43.5)
Net profit		98.3	99.9	117.7
Balance sheet (€ millions)	**2008R**	**2009E**	**2010E**	**2011E**
Total non-current assets	459.2	480.8	499.1	512
Inventories	381.4	325.1	304.3	305.3
Trade receivables	201	175.4	160.8	156.1
Cash & cash equivalents	24.6	33.5	32.5	47.2
Other current assets	95.4	136.5	172.5	203.2
Total current assets	702.4	670.5	670.1	711.8
Shareholders' equity	199	200.2	221.6	259
Non-current provisions	27.9	25.6	24.7	25.8
Non-current debt	588.5	576.7	565.2	553.9
Other non-current liabilities (non-interest bearing)	26.7	24.5	23.6	24.8
Deferred tax liabilities	17.9	18.3	18.7	19
Total non-current liabilities	661	645.1	632.2	623.5
Current provisions	59.3	59.3	59.3	59.3
Current debt	40.2	40.2	40.2	40.2
Other current liabilities	202.1	206.5	2159	241.8
Total current liabilities	301.6	306	315.4	341.3
TOTAL EQUITY AND LIABILITIES	1161.6	1151.3	1169.2	1223.8

Assume that Hugo Boss's cost of equity equals 12 percent.

1. Calculate free cash Hows to equity, abnormal earnings, and abnormal earnings growth for the years 2009-2011.

2. Assume that in 2012 Hugo Boss AG liquidates all its assets at their book values, uses the proceeds to pay off debt and pays out the remainder to its equity holders. What docs this assumption imply about the company's:
   a Free cash How to equity holders in 2012 and beyond?
   b Abnonnal earnings in 2012 and beyond?
   c Abnormal earnings growth in 2012 and beyond?
3. Estimate the value of Hugo Boss's equity on April I, 2009 using the above forecasts and assumptions. Check that the discounted cash How model, the abnormal earnings model and the abnormal earnings growth model yield the same outcome. T
4. The analyst estimates a target price of €20 per share. What is the expected value of Hugo Boss's equity at the end of 2011 that is implicit in the analysts' forecasts and target price? (5.5 percent) continue in the future, what would be your estimate of Hugo Boss's equity value-to-book ratio before the company paid out its special dividend! How does the special dividend payment change your estimate of the equity value-to-book ratio?

Problem 2 Estimating Adidas's equity value

Germany-based Adidas is one of the world's largest producers of sportswear. During 2008, Adidas showed strong operational performance but saw its equity value decrease by 47 percent to €5,252 million as a result of the overall decline of international stock markets. On April 1, 2009, one month before the publication of the first-quarter results, an analyst produces the following forecasts of Adidas's 2009-2011 performance and financial position.

Income statement (€ millions)	2009E	2010E	2011E
Sales	10428.0	10617.0	11143.0
Gross profit	4771.8	5005.3	5277.3
EBIT	771.0	903.3	970.9
Net interest expense	-141.0	-115.6	-113.9
Profit before tax	630.0	787.7	857.0
Tax expense	-181.2	-226.5	-246.5
Group profit	448.8	561.2	610.5
Minority interest	-2.5	-3.3	-3.5
Net profit	446.3	557.9	607.0

Balance sheet (€ millions)	2008R	2009E	2010E	2011E
Fixed assets	4630.0	4737.8	4850.4	4958.1
Non-cash current assets	4518.0	4332.1	4400.0	4596.0
Cash	385.0	338.2	312.0	547.6
Total assets	9533.0	9408.1	9562.4	10101.7
Shareholders' equity	3386.0	3735.5	4181.2	4666.3
Minority interest	14.0	7.0	3.5	1.3
Non-current provisions	1526.0	1480.6	1509.7	1576.7
Non-current and current debt	2625.0	2300.0	2000.0	1900.0
Other non-current liabilities	764.0	738.1	721.0	757.0
Current liabilities	1218.0	1147.0	1147.0	1203.0
Total equity and liabilities	9533.0	9408.1	9562.4	10101.7
Other estimates	**2008R**	**2009E**	**2010E**	**2011E**
Dividends		96.8	112.2	121.9

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Assume that Adidas's cost ol equity equals 12 percent.

1. Check whether all changes *in* the book value of equity that the analyst *predicts* can *be* fully explained through earnings and dividends. Why is this an important property of the analyst's equity estimates?
2. When using Ihesc forecasts to estimate the value ol equity, the analyst can deal with mimuilN inleic^*li* in die followine unvv --
   a (1) Classify minority interests on the balance sheet as a non-interest-bearing liability (and hence as a negative operating asset) and (2) exclude income from minority interests from earnings (i.e., focus on net profit).
   b (1) Classify minority interests on the balance sheet as (group) equity, (2) include income from minority interests in earnings (i.e., focus on group profit), and (3) subtract the book value of minority interests from the estimated value of group equity to arrive at the value of shareholders' equity. These approaches may yield different values. Discuss potential drawbacks of both approaches.
3. Based on a market value of €4,849 million on March 31, 2009 and the analyst's estimates, Adidas's leading market value-to-earnings ratio is 10.9. What does this ratio suggest about the analyst's expectations about future abnormal earnings growth?
4. Calculate abnormal earnings for the years 2009-2011.
5. Assume mat abnormal earnings in 2012 and beyond are zero. Estimate the value of Adidas's group equity (group equity is the sum of shareholders' equity and minority interests). What might explain the difference between your equity value estimate and Adidas's actual market value (of €4,849 million)?

KASUS – 8

TEORI

1 A spreadsheet containing Loewe's actual and forecasted financial statements as well as the valuation described in this chapter is available on the companion website of this book. How will the forecasts in Table 8.3 for Loewe change if the assumed growth rate in sales from 2009 to 2018 remains at 5 percent (and all the other assumptions are kept unchanged)?

2 Recalculate the forecasts in Table 8.3 assuming that the NOPAT profit margin declines by 0.1 percentage points per year between fiscal 2009 and 2018 (keeping all the other assumptions unchanged).

3 Recalculate the forecasts in Table 8.4 assuming that the ratio of net operating working capital to sales is 10 percent, and the ratio of net non-current assets to sales is 25 percent for all the years from fiscal 2009 to fiscal 2018. Keep all the other assumptions unchanged.

4 Calculate Loewe's cash payouts to its shareholders in the years 2009-2018 that are implicitly assumed in the projections in Table 8.3.

5 How will the abnormal earnings calculations in Table 8.4 change if the cost of equity assumption is changed to 10 percent?

6 How will the terminal values in Table 8.6 change if the sales growth in years 2019 and beyond is 5 percent, and the company keeps forever its abnormal returns at the same level as in fiscal 2018 (keeping all the other assumptions in the table unchanged)?

7 Calculate the proportion ol terminal values to total estimated values of equity under the abnormal earnings method, the abnormal earnings growth method, and the discounted cash How method. Why arc these proportions different?

8 Under the competitive equilibrium assumption the terminal value in the discounted cash How model is the present value of the end-of-year book value of equity in the terminal year. Explain.

9 Under the competitive equilibrium assumption the terminal value in the discounted abnormal earnings growth model is the present value of abnormal earnings in the terminal year times minus one, capitalized at the cost of equity. Explain.

10 What will be Loewe's cost of equity if the equity market risk premium is <S percent?

11 Assume that Loewe changes its capital structure so that its market value weight of debt to capital increases to 45 percent, and its after-tax interest rate on debt at this new leverage level is 4 percent. Assume that the equity market risk premium is 7 percent. What will be the cost of equity at the new debt level? What will be the weighted average cost of capital?

12 Nancy Smith says making the assumption that Loewe's dividend payout will vary from year to year. If she makes a constant dividend payout assumption, what changes does she have lo make in her other valuation assumptions to make them internally consisiem »_h each other?

PRAKTIKUM

Problem 1 Hugo Boss _ and Adidas's terminal values

Refer to Problem 1 in Chapter 7 (see p. 339).

1 The analyst following Huz a target price of €20 per share. Under the assumption that the asset turnover, and capital structure remain constant after 2011. what is ihe terminal growth rate that is implicit in the analysts' forecasts and target pnce ?

2 Using the analyst's forecasts, estimate , Boss's equity value under the following three scenarios:

a. Hugo Boss enters into a ctmrnptud»e equilibrium in 2012.

b. After 201 1. Hugo Boss's cnmpetkive advantage can only be maintained on the nominal sales level achieved ın 3011.

c. After 2011. Hugo Boss's compeutrte advantage can be maintained on a sales base that remains constant in ;

3 Using the analysts forecasts, estimate Hugo Boss's equity value under the assumption that the company's profitability graduallK reverts to its required level (i.e.. AE, ~ 0.75 x AE, i) after the terminal year-Refer io Problem 2 in Chapter.

4 Using the analyst's forecasts, estimate Adidas's terminal values in the discounted cash How and the abnormal earning, under the assumption that the company enters into a competitive.

Problem 2 Anheuser-Busch InBev S.A.

In November 2008. the Belgian InBo SA. completed the acquisition of US-based Anheuser-Busch. The brewer acquired Aimemcr-Busch for close to €40 billion, of which 1 classified approximately €25 billion as pood* ,11 At the end of ihe fiscal vear ending on December 31. 200K. Anheuser-Busch mBcC (AB InBev) net assets" amouuted to €61.357 million, consisting of €64 1X3 mln in non-current assets and €2.826 million in working capital. The company's book value of equity amounted lo €16.126 million. Early 2009, when AB Inbev's million common shares trade at about €24 per share, an analyst produces the following forecast for the company and issues an everv l recommendation.

Forecasts (€ millions)	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Sales NOPAT	28,475	26,688	27,909	29,047	30,086	31,011	31,810	32,470	32,311	32,658
Depreciation and	6,169	6,294	6,729	7,003	7,254	7,476	7,669	7,828	7,790	7,874
amortization	2,297	2,158	2,228	2,318	2,402	2,475	2,539	2,592	2,579	2,607
Investment in non-current assets	-1,526	-1,441	-1,549	-1,743	-1,805	-1,860	-1.909	-1,948	-1,939	-1,959
Investment in working capital	485	580	669	435	451	465	477	487	485	490
Free cash flow to debt and equity	7,425	7,590	8,077	8,014	8,301	8,556	8,777	8,958	8,915	9,011

1 *The analyst estimates that AB InBev's weighted average cost of capital is 9 percent and assumes that the free cash flow to debt and equity grows indefinitely at a rate of 1 percent after 2018. Show that under these assumptions, the equity value per share estimate exceeds AB InBev's share price.*

2 *Calculate AB InBev's expected abnormal NOPATs between 2009 and 2018 based on the above information. How does the implied trend in abnormal NOPAT compare with* the general trends in the economy?

3 *Estimate AB InBev's equity value using the abnormal NOPAT model (under the assumption that the WACC is 9 percent and the terminal growth rate is 1 percent). Why do the discounted cash flow model and the abnormal NOPAT model yield different outcomes?*

4 *What adjustments to the forecasts are needed to make the two valuation models* consistent?

KASUS – 9

TEORI

1. *Despite many years of research, the evidence on market efficiency described in this chapter appears to be inconclusive. Some argue that this is because researchers have been unable to link company fundamentals to share prices precisely. Comment.*
2. *Geoffrey Henley, a professor of finance, states: "The capital market is efficient. I don't know why anyone would bother devoting their time to following individual shares and doing fundamental analysis. The best approach is to buy and hold a* well-*diversified portfolio of shares." Do you agree? Why or why not?*
3. *What* is *the* difference between fundamental and technical analysis? Can *you think of any trading strategies that use technical* tl *What* are *the underlying assumptions made by these strategies?*
4. *Investment funds follow many different types of investment strategies. Income funds focus on shares with high dividend yields, growth funds invest in shares that are expected to have high capital appreciation, value funds follow shares that are considered to be undervalued, and short funds bet against shares they consider to be overvalued. What types of investors are likely to be attracted to each'of these types of funds' Why?*
5. *Jntergalactic Software Pic went public three months ago. You are a sophisticated investor who devotes time to fundamental analysis as a way of identifying mispriced shares. Which of ihe following characteristics would you focus on in deciding whether to follow this share?*
   - *The market capitalization.*
   - *The average number of shares traded per day.*
   - *The bid-ask spread for the share.*
   - *Whether the* underwriter *that took the firm public is a Top* Five *investment banking* linn.
   - *Whether its audit company is a Big Four firm*
   - *Whether there are analysts from major brokerage* fiims *following the* company.
   Whether the share is held mostly h\ retail or institutional investors
6. *There are two major types of financial analysts: buy-side and sell-side. Buy-side analysts work for investment firms and make recommendations that are available only* to *the management of funds within that firm. Sell-side analysis work for brokerage firms and make recommendations that are used to sell shares to the brokerage firms* clients, which include individual investors and managers of* investment *funds. What would be the differences in tasks and motivations of these two types of analysts?*
7. *Many market* participants *believe that sell-side analysts are too optimistic in their recommendations lo buy shares and too slow to recommend sells. What factors might explain this bias?*
8. *Joe Klein is an analyst for an investment banking firm that offers both underwriting and brokerage services. Joe sends you a* highly *favorable report on a share that his firm recently helped go public and for which it currently makes the market. What arc the polenlial advantages and disadvantages in relying on Joe's report in deciding whether lo buy the share?*

9. *Intergalactic Softwares shares have a market price of f. 20 per share and a* book \ *alue of €I2* per *share. If its cost of equity capital is \ > percent and its book value is expected to prow at 5 percent per year* indefinitely, *what* is *the markets* assessment *of* Return?

PRAKTIKUM

VALUATION AT NOVARTIS

In early 2007, Novartis announced record annual earnings of $7.2 billion for the year ended December 31, 2006, representing a 179c increase over the prior year. The company's return on beginning book equity of 21.7% far exceeded the company's estimate of its cost of equity (8.5%). Further, since 2003. the company had grown earnings by an average of 17% per year, and its return on beginning book equity had increased steadily from 16.8%. Despite this superior performance, the company's stock performance had lagged that of the S&P500 and Swiss Market indexes, growing by an average of 10% per year (see *Exhibit* 1). In addition, its price-to-earnings multiple had declined steadily from 22.9 2003 to 19.4 in 2006 (see *Exhibit 9).*
Several explanations for the gap between the company's earnings and stock performance [1] ere plausible. First, given the sustained strong performance of the pharmaceutical industry and the company's past success, market expectations were likely to be high. Merely meeting those heady expectations would generate only normal stock pnce appreciation. A second explanation was that the market questioned whether Novartis could sustain such strong performance, perhaps because of heightened regulator)' oversight and proposed changes in the U.S. medical system, or as a result of concerns about the viability of the company's unique strategy of investing in both branded pharmaceuticals and generics. Finally, it was possible that investors had under-estimated *Novartis* and the stock was undervalued. For Novartis's management, understanding which of these best explained the company's situation was a necessary first step before deciding on an appropriate course of action.

The pharmaceutical industry

The pharmaceutical industry had an impressive track record of generating strong growth and returns for shareholders over an extended period. From 2003 to 2006. the industry reported revenue and earnings growth of 11% per year, and had an average return on book equity of 17.5%.' Two forces had combined to help create this sustained high performance. First, the industry had been remarkably successful in creating new innovative drugs to address patient needs. This was a costly process. Only one in 5.000 to 10,0000 compounds tested in the laboratory reached the market, and of these only 30% were a commercial success.[2] As a result of extensive testing and regulatory approval to ensure drug efficacy and safety, total drug development time lasted around fourteen years and cost more than $800 million per drug. On average, in 2006 pharmaceutical companies spent $55.*2* billion (17.5% *of* sales) *on* research and development.[3] However, patent protection *of new* compounds prevented competitors from copying successful new innovations *and* enabled innovators to recover the heavy costs of drug discovery and development. The average effective patent life for branded drugs was 11.5 years.[4]
A second factor behind the industry's performance was its strong sales and marketing capability. *On* average, pharmaceutical companies spent around *30%* of sales *on* sales and marketing costs. In many markets, drug companies employed an army of sales reps who visited doctors *to* convince them to prescribe their firms' drugs. However, given the time constraints faced by physicians, sales rep visits were typically short, enabling the reps *to* drop *off* promotional materials and free sample drugs. Drug companies therefore frequently organized educational conferences, dinners and other events to enable sales reps *to* spend time with doctors. Firms also

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appealed directly to patients by consumer advertizing. By 2005, direct-to-consumer advertising was $4.2 billion.[5]

In early 2007, the pharmaceutical industry faced a number of challenges. Public concern over the cost of medical care and drugs had escalated, particularly in the U.S., the most expensive (and also most profitable) health care market in the world. For the first time *in* fifteen years politicians had seriously begun debating whether the health care system *in* the U.S. needed to be changed. Candidates for the 2008 presidential elections from both political parties were in the process of developing new health care initiatives to solve dual problems of a large uninsured population and the increased cost of health care. While increased access to health care could potentially benefit the pharmaceutical industry, there was also a significant risk that changes would increase the power of health care providers (including federal and state governments) which would use their leverage to obtain price cuts of as much as 40%, reducing the industry's profitability and the financial resources available for developing new dings.

A second challenge had emerged following publication of research showing adverse cardiac risks for patients using Merck's blockbuster Vioxx painkiller. Merck had voluntarily withdrawn Vioxx from the market in September 2004 following the publication. However, research findings from a 2001 study presented to the company also showed cardiac risks, leading critics to allege that the company had over-promoted the drug and underplayed its risks. By early 2007. roughly 22,000 lawsuits in U.S. state and federal courts had been filed against Merck. Analysts estimated that company's legal liabilities could range from $4 billion to more than $25 billion. Merck opted to defend each suit separately on its merits. Of the 17 cases tried as of March 28. 2007, Merck won ten, lost five, and two had ended in mistrials.[6] Merck planned to or had appealed the cases it had lost. However, the problems had increased pressure on the Food and Drug Administration, which regulated drug approvals in the U.S.. to be more cautious in approving new drugs and to respond more promptly to drug safety questions.

In addition, it appeared that the industry was becoming less productive in discovering and commercializing new drugs lo replace those going off patent. Drug development costs had increased from $54 million per new drug in 1976 to $2.31 million in *1987* and to *$802* million in 2001.[7] A study by Bain & Co. discovered that by 2003. only one in thirteen drugs that reached animal testing actually reached the market, down from one in eight in the late 1990s. Opinions were divided on the causes of this decline. Some argued that it was becoming more difficult to discover breakthrough drugs. Others pointed to increased regulatory oversight to improve drug safely. Despite questions about research productivity, spending on R&D continued lo grow, both in dollar terms and as a percent of sales. In 2006, industry R&D totaled $55.2 billion, a 7.8% increase over the poor >ear. As a per centage of sales, R&D increased from 12.9% in 1985 to 17.5% in 2006.

Finally, the industry faced increased pricing pressure from generics companies that produced and marketed drugs for which patent protection had expired. Genencs drugs sold at 30% to 90% discounts relative to prices of brand-name drugs prior to patent expiration. Analysts estimated that in the first year after patent expiration, a brand-name drug could lose more than 80% of its volume to generics. The generics share of the U.S. prescription drug market had grown from 19% in 1994 to 47% in 2000 and 54% in 2005.[9] This growth was driven by managed care providers, which substituted generics drugs for the brand names to reduce costs. Generics companies followed a very different business model than traditional pharma companies. They spent much less on research and development, and on marketing and sales. Their focus was on aggressively challenging existing brand name drugs about to Jose patent protection since the first to market was granted six-month period of market exclusivity. Once this six month period ended, however, other generics firms were free to enter the market, leading to intense competition.

Novartis

Novartis was founded in J 996 through the merger of Ciba-Geigy and Sandoz. Under the leadership of Daniel VaselJa. who was appointed CEO in 1999, Novartis grew through a combination of successful new drug discoveries and selected acquisitions. From 1999 to 2006, revenues increased from $20.4 billion to $36 billion, and operating earnings grew[1] from $4.6 to $8.1 billion (see Exhibit *2* for Novartis "s income statement and balance sheet data for the period 1999 to 2006).[10] During this period Novartis was among the industry leaders in introducing new dings, including Femura (for breast cancer), Excelon (for AJzheimers). Dio-van/Co-Diovan (for hypertension). Visudyne (for age-related macular degeneration). Gfee-vac/GiJvec (for chronic myeloid leukemia), and Zometa (for cancer complications)." It also successfully refocused by divesting its agribusiness and made several key acquisitions, including contact lens maker Wesley Jessen for $845 million in 2000. generics companies Lek ($959 million in 2002). Eon and Hexal ($8.4 billion in 2005). and Chiron, a biopharma-ceutical, vaccine and diagnostics *firm* for $6.3 billion in 2006.[12]

By early 2007. Novartis comprised four divisions: Pharmaceuticals, Sandoz (its *generics* business). Consumer Health, and Vaccines and Diagnostics. The company's strategy was to provide customers with a full complement of the health *care* products the/needed, including branded drugs, generic drugs, vaccines, and over-the-counter medicines.

Pharmaceuticals, the largest division with sales of $26.6 billion, boasted highly successful dings in the cardiovascular, oncology and neuroscience areas (see *Exhibit 3* for data on the company's top twenty drug sales and *Exhibit 4* for sales by drug maturity). Sales growth al Pharma exceeded 12% for 2006 with profit margins of 28.7%. The unit's drong performance was expected to continue in 2007 and 2008 with approvals pending in he U.S. and Europe for a number of new drugs, including Ex forge and Tekturna (hypcr-ension), Galvus (type 2 diabetes), and Lucentis (for blindness). A total of 138 new pro-ects were in progress at the end of 2006. 36% classified as new molecular entities, and he remainder as life cycle management projects. Fifteen projects had been submitted to egulatory authorities, thirteen were in phase I11 (large clinical trials), and another 76 were n phase Il clinical trials.[1]* The company's major competitors in this sector included

GlaxoSmithKline, Johnson & Johnson, Merck, and Pfizer (see *Exhibit 5* for data on the performance of these firms).

Sandoz, with sales of *$5.6* billion in *2006,* was the world's second-largest generics business. In *2003,* Novartis consolidated its different generics businesses using the Sandoz brand. It subsequently invested in building the generics business with acquisitions of Lek, Hexal and Eon. Novartis was the only major pharma company with a generics drug business. In commenting on the strategy, CEO Vasella explained that the company viewed "generic medicines as a critical complement to innovative medicines. Large purchasers like Wal-Mart, and private and state-run health care providers want to buy a range of generic and patented products."[14] Also, generic drugs were projected to increase their market share as patents for many large drug companies were scheduled to expire *in* the U.S. market. However, some analysts expressed doubts about the move, pointing out that "competition is high in the (generics) sector, fueled by the entry of low-cost producers from emerging markets like India which (has) hurt (generic drug) margins and profitability."[15] In *2006,* Sandoz sales grew by *27%* and operating profit margins increased to *12%* as a result of the completion of the Hexal and Eon acquisitions, and rapid growth in the U.S. and Eastern European markets. Key competitors in this sector included Teva Pharma-ceutical Industries, Watson Pharmaceuticals, and a range of smaller companies (see *Exhibit 6* for data on the performance of key competitors in the industry).

The Consumer Health division included several businesses. Over-the Counter (OTC), Animal Health, CIBA Vision, and Gerber. In *2006,* the group*s Medical Nutrition unit was sold to Nestle for *$2.5* billion. Consumer Health sales from continuing operations grew by *8%* to *$6.5*

billion. This was led by strong performance in OTC, which jumped from sixth largest in sales to the fourth largest in the world, and in Animal Health which jumped three positions to number five. The group*s other major business units included eye lens firm CIBA Vision and Gerber. the leading baby nutrition company in the U.S. Key competitors in this sector included Johnson & Johnson. Schering-Plough, Reckitt and Benkiser. and Pfizer (see *Exhibit 7* for data on the performance of key competitors).

The Vaccines and Diagnostics unit arose from the acquisition of Chiron. *2006* sales for the post-acquisition eight months were *$956* million, up *42%* over the comparable period for *2005*. This increase was driven by a sharp increase in influenza vaccines in the U.S. market. Novartis reported that given novel new products and innovations in manufacturing technologies it anticipated double digit growth in this segment during the following decade. Key competitors in this sector included Johnson & Johnson. Sanoll-Aventis, Merck, and Abbott Laboratories (see *Exhibit 8* for data on the performance of competitors).

Valuation

The healthcare industry had experienced declining stock multiples from *2003* to *2006*. Price-lo-earnings multiples during the period had dropped steadily from *47.8* to *33.0*. despite strong earnings growth in *2006*. Price-to-book multiples had declined from *6.0* to *4.0* during the same period despite sustained strong returns on book equity (see *Exhibit 9)*.

In early *2007*, Novartis's price to earnings multiple was higher than that of three of its five leading competitors (GlaxoSmithKline, Pfizer and Johnson & Johnson). Yet its price to book multiple was lower than that all but Pfizer (see *Exhibit* 10). Despite continued strong earnings performance, its record of new drug introductions, and ils strong pipeline of future new drugs, management was puzzled by the stock"s three-year record of merely tracking the S&P index. What assumptions was the market making about Novartis's *future* performance? How were questions about the future of the industry, and the company's unique strategy affecting its valuation? And what actions if any should the company's management team take to respond to *market's* assessments?

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KASUS – 10

TEORI

1 What are the critical performance dimensions for (a) a retailer and (b) a financial services company that should be considered in credit analysis? What ratios would you suggest looking at for each of these dimensions?

2 Why would a company pay to have its public debt rated by a major rating agency (such as Fitch, Moody's or Standard & Poor's)? Why might a firm decide not to have its debt rated?

3 Some have argued that the market for original-issue junk bonds developed in the US in the late 1970s as a result of a failure in the rating process. Proponents of this argument suggest that rating agencies rated companies too harshly at the low end of the rating scale, denying investment-grade status to some deserving companies. What are proponents of this argument effectively assuming were the incentives of rating agencies? What economic forces could give rise to this incentive?

4 Many debt agreements require borrowers to obtain the permission of the lender before undertaking a major acquisition or asset sale. Why would the lender want to include this type of restriction?

5 Betty Li, the Finance Director of a company applying for a new loan, states. "I will never agree to a debt covenant that restricts my ability to pay dividends to my shareholders because it reduces shareholder wealth." Do you agree with this argument?

6 A bank extends three loans to the following companies: an Italy-based biotech firm; a France-based car manufacturer: and a UK-based fcxxi retailer. How may these three loans differ from each other in terms of loan maturity, required collateral, and loan amount?
Cambridge Construction Pic follows the percentage-of-completion method for reporting long-term contract revenues. The percentage of completion is based on the cost of materials shipped to the project site as a percentage of total expected material costs. Cambridge's major debt agreement includes restrictions on net worth, interest coverage, and minimum working capital requirements. A leading analyst claims that "the company is buying its way out of these covenants by spending cash and buying materials, even when they are not needed." Explain how this may be possible.

7 Can Cambridge improve its Z score by behaving as the analyst claims in Question 7? Is this change consistent with economic reality ?

8 A banker asserts. "I avoid lending to companies with negative cash from operations because they are too risky." Is this a sensible lending policy?

9 A leading retailer finds itself in a financial hind. It doesn't have sufficient cash flow from operations to finance its growth, and it is close to violating the maximum debt-Io-assets ratio allowed by its covenants. The Marketing Director suggests. "We can raise cash for our growth by selling the existing stores and leasing them back. This source of financing is cheap since il avoids violating either the dcbt-io-asseis or interest coveniiM? ratios in our covenants." Do you agree with his analysis? Why or why

KASUS – 11

1 Since the year 2000. there was a noticeable increase in mergers and acquisitions between firms in different countries (termed cross-border acquisitions). What factors could explain this increase? What special issues can arise in executing a cross-border acquisition and in ultimately meeting your objectives for a successful combination?

2 Private equity firms have become an important player in the acquisition market. These private investment groups offer to buy a target firm, often with the cooperation of management, and then lake the firm private. Private equity buyers tend to finance a significant portion of the acquisition with debt.

a What types of firms would make ideal candidates for a private equity buyout? Why?

b How might the acquirer add sufficient value to the target to justify a high buyout premium?

3 Kim Silverman. Fm;::ve Director of the First Public Bank, notes: "We are fortunate to have a cost ol capital of only 10 percent. We want to leverage this advantage by acquiring other banks that have a higher cost of funds. I believe that we can add sig-nilicant value to these banks by using our lower cost financing." Do you agree with Silverman's analysis? \Vh\ or whv not'.'

4 The Munich Beer Company plans lo acquire Liverpool Beer Co. for *£60* per share, a 50 percent premium over the current market price. Jan Hoppe. the Financial Director of Munich Beer, argues that this valuation can easily be justified, using a price-earnings analysis. "Munich Beer has a price-earnings ratio of 15. and we expect that we will be able to generate long-term earnings for Liverpool Beer of £5 per share. This implies thai Liverpool Beer is worth 175 to us. well above our £60 offer price." Do you agree with this analysis? What are Hoppe\s key assumptions?

5 You have been hired In CiS Investment Bank lo work in the merger department. The analysis required for all potential acquisitions includes an examination of the target for any off-balance sheet assets or liabilities thai have to be factored into the valuation. Prepare a checklist for your examination.

6 A target company is currently valued at £50 in the market. A potential acquirer believes that it can add value in two ways: £15 of value can be added through better working capital management, and an additional *(.10* of value can be generated by making available a unique technology to expand the target's new product offerings. In a competitive bidding contest, how much of this additional value will the acquirer

PRAKTIKUM

THE AIR FRANCE-KLM MERGER

We have always been convinced of the necessity of consolidation in the airline industry. Today, we announce a combination with KLM that will create the first European airline group, which is a milestone in our industry. This will bring significant benefits to customers, shareholders and employees. Capitalizing on the two brands and on the complementary strengths of both companies, we should, within SkyTeam, be able to capture enhanced growth opportunities.

—Jean-Cyril Spinetta, Chairman and CEO of Air France

KLM has been pointing out the need for consolidation in light of the challenges facing our industry, and we have not made it a secret we were looking for a strong European partner. Through this innovative partnership with Air France and our subsequent expected participation in the SkyTeam alliance, we are confident that we have secured a sustainable future for our company. Our valuable Schiphol hub will be an integral part of the dual hub strategy of the new airline group, allowing us to build on what KLM and its staff have achieved over nearly 85 years.

—Leo van Wijk, President and CEO of KLM

On September 30, 2003. Air France and KLM Royal Dutch Airlines - two European airlines that provided international passenger and cargo airline services - issued a press release that announced their planned merger. The merger envisaged the creation of the leading European airline Air France-LM. In 2003. both airlines were the primary national ("flag carrying") airlines in their home countries. France and the Netherlands. However, poor industry conditions put pressure on the airlines' growth and operating margins. In the fiscal year ending on March 31, 2(K)3, Air France, the larger of the two airlines, reported an increase in total sales of slightly more than one percent to €12,687 million and a net profit of €120 million (€0.55 per share). KLM performed worse than Air France. In the same fiscal year, KLM reported a decrease in total sales of slightly less than one percent to €6,485 million and a loss (before extraordinary items) of €186 million (€3.97 per share).

For a number of years, KLM had been searching for a strategic partner, which seemed to be of essential importance given the deteriorating industry conditions. Initially, KLM attempted to form an alliance with the Italian flag carrier, Alitalia. However, this alliance soon appeared to be unsuccessful because of the poor functioning of Milan Malpensa Airport, an unexpected delay in the privatization of Alitalia, and cultural incompatibilities between the Italians and the Dutch.[1] Alter breaking with Alitalia. KLM kept on searching for another partner. In early 2000, talks about joining forces with British Airways remained unfruitful, as KLM and its main shareholder, the Dutch stale, were unwilling to hand over control to the British flag carrier.[2] In the second half of 2003, Air Prance came to the rescue.

KLM Royal Dutch Airlines*

KLM Royal Dutch Airlines was founded in 1919, which, at the time of the merger made it the oldest continuously operating airline in the world. Landmarks in the company's history were its very first scheduled flight to London in 1920, its first intercontinental flight to Jakarta (formerly Batavia) in 1924, and its operating scheduled flights to New York from 1946.

Over the years, the core activities of KLM remained very much the same. The airline provided worldwide passenger and cargo transport, engineering and maintenance, and, in a later stage, charter and low-cost scheduled flights. KLM operated its charter and low-cost flights primarily through its subsidiaries Buzz and Transavia. In 1994, KLM served 153 cities in 81 countries on six continents and ranked eighth among the largest international airlines based upon ton-kilometer traffic on international flights. Nine years later, KLM served 350 cities in 73 countries on six continents and ranked fifth among the largest international airlines.

In its prospectus from 1994, which accompanied the issuance of 18.5 million additional ordinary shares, the airline summarized its most important operating risks. First, the airline operated in an industry that was cyclical and highly competitive. The cyclical nature could have a strong adverse effect on KLM's profitability because, as every other airline, it had a high degree of operating leverage (high fixed-to-variable cost ratio). Second, the airline's profitability depended strongly on exchange rate fluctuations as well as on fluctuations in aircraft fuel prices. Third,

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because in many parts of the world airlines and international air traffic were highly regulated. KLM's operations could be affected by foreign governments" actions of protectionism.
Within this uncertain economic environment. KLM's corporate objective was ". . . to position itself as an airline operating worldwide from a European base that provides quality service for passengers and cargo shippers at competitive cost levels." The strategy that KLM used to attain this objective was to:

■ *Increase customer preference.* KLM focused on aehie\ ing a high level of customer satisfaction, for example, by closely monitoring customer demand and by expanding ils "Flying Dutchman" frequent flyer program.
■ *Strengthen its market presence around the world.* KLM strengthened ils market prcs-" ence in the world's major air transportation markets by expanding its hub-and-spoke operations at Schiphol Airport and by creating alliances with other European. American, and Asian airlines. For example, in 19X9. KI.M had acquired a 20 percent stake in Northwest Airlines, a North American airline having its operations hubs in Boston Detroit, and Minneapolis. This acquisition helped KLM to gain belter access to American desl.nat.ons. The alliance between KLM and Northwest implied thai both airlines operated as a joint venture on transatlantic flights, while KLM did all their marketing in Europe and Northwest in Ihe US.
■ *Reduce ils costs to at least an internationally annpetiiive level.* During the early 1990s. KLM launched a restructuring program thai aimed to reduce ils costs and increase its productivity.
The program included spinning oil noncore business units, network optimization eliminatinu the first class section on inlerconlinental flights, redesigning business processes, and acquiring more efficient aircraft. KLM launched a second restructuring program. Hocus 2000. in 1996. and a third one. Baseline, in 2000.

In 2003. KLM's shares were lisled on the Amsterdam Uuroncxl Exchange and on the New York Stock Exchange. Since early in KLM's history, ihe Dutch slale had been KLM's primary shareholder. The slate's ownership interest in KLM gradually decreased over the years, from 38 percent of the votes in 1994 to 14 percent in 2003. Nonetheless, the state remained able to effectively influence the airline's major (non-operating) decisions through various mechanisms. First, up to the date of the merger, the state had the option to obtain a 50.1 percent voting interest to prevent any undesirable accumulation of share ownership in the hands of others. This option was especially important to prevent a country imposing restrictions on KLM exercising international traffic rights. Because such traffic rights were the result of bilateral treaties between governments and tied to domestically owned airlines, countries could deny these rights to KLM if in their view the airline was no longer in Dutch hands. Second, the articles of association offered the state the right to appoint a majority of the Supervisory Board. Third, the state held the majority of KLM's priority shares, through which it had a veto over important decisions such as the issuance of shares, payments of stock dividends, and changes in the articles of association.

The merger agreement[4]

During 2002, while renewed negotiations between British Airways and KLM reached deadlock, KLM representatives also started to meet with Air France representatives to talk about the possibilities of cooperation. Parallel to these meetings, Air France's North American alliance partners. Continental Airlines and Delta Airlines, discussed possible cooperation with KLM's North American alliance partner. Northwest Airlines. In August 2002, the three North American airlines signed a ten-year agreement to improve schedule connections between the airlines and to share codes, frequent flyer programs, and airport lounges. After *the* signing of the agreement, the three airlines encouraged Air France and KLM to start similar cooperation in Europe. *However,* because the French state was planning to privatize Air France (i.e.. reduce its

shareholdings to a level below 20 percent). Air France and KLM envisaged a closer form ol cooperation. Initially, both parties discussed the option of creating a dual listed company structure. Air France and KLM would keep their separate listings but cross-hold 50 percent of the shares of each other's operating subsidiaries. Because Air France had a substantial!) greater market value than KLM. Air France would also become the direct owner of 52 percent of KLM's shares and certain of its assets would be excluded from the transaction. However, *the* idea of creating a dual listed company *structure* appeared tot) complex and both airlines soon opted for a simpler alternative, which they presented to their shareholders on September 30. 2003.

The alternative proposal implied that the former shareholders of KLM and Air France became shareholders of the public!) listed holding company Air Francc-KLM. which would hold 100 percent of the shares ol two private operating companies. Air France and KLM. Former Air France shareholders would receive one Air France-KLM share for every Air France share thai they held. In exchange for 10 KLM shares, former KLM shareholders would receive I I Air France-KLM shares plus 10 Aii France KLM warrants. The warrants had a strike price of €20.00, were exercisable after IS months and had an exercise period of 3.5 years. Three *Warrants* gave the *warrant* holder the right to purchase two Air France-KLM shares.

Based on Air France's closing price on September 29. 2003. the estimated value of one warrant was equal to €1.68 (according to the Air France-KLM merger announcement). This warrant value was based on the following assumptions:

- The September 29 AIR France! KLM) share price *was* €13,69
- The risk-free rale equaled 2.89 percent.
- The estimated future volatility of the AIR France! KLM) share price was 40 percent.
- Estimated dividends per share were €0.096. €0.144. and €0.188 during the exercise period (based on 1/B/E/S estimates).

Based on the AIR France (-KLM) share price of €13.69 and a warrant value of €1.68, the total value of the offer for KLM shareholders equaled €16.74 per share (11/10 x €13.69 + €1.68), which implied a premium of 40 percent over KLM's closing share price on September 29, 2003. After the share exchange, former KLM shareholders would own 19 percent of the ordinary shares (and voting rights) of Air France-KLM. The share exchange offer would commence only after approval from the *EU* and *US competition* authorities, and if no third party announced a public offer for either KLM's *or Air* France's shares.

The transaction between Air France and KLM was not a full-blown merger. The two private operating companies, Air France and KLM, remained separate entities, in particular because it was important to preserve the two established brand names Further the Dutch state retained the option to acquire a 50.1 percent voting interest in KLM (the operating company) if necessary to preserve KLM's landing rights.

Motivation for the merger

Airline industry analysts tend to distinguish two phases of evolution in a deregulated airline industry - i.e., the expansion phase and the consolidation phase. To illustrate, in the 1970s, the US government deregulated the US airline industry, which led to a serious expansion of supply from 1978 to 1990. In this expansion phase, US airlines responded cutting their costs, but their operating margins experienced a secular decline. In the stages of consolidation, from 1986 onwards, mergers resulted in the elimination of several brands, but did not restrict or reallocate capacity. Since the mergers initially raised margins remained under pressure. In the later stages of the consolidation phase. US airlines reallocated their capacity from unprofitable (geographical) areas to profitable (geographical) areas. This significantly improved US airlines' profit margins. In the mid-1990s, the European airline industry was in a different

stage of development than the US airline industry. At that time. European airlines had just entered into the earlier stages of consolidation by creating alliances. However, alliances made it difficult to reallocate capacity and improve profitability. Furthermore, government interference hindered efficient allocation of capacity.

During the late 1990s and the early 2000s. the profit potential of the European airline industry changed substantially. Al the end of the 1990s. Europe had an increasing number of large and small airlines, many airports close together, and most governments supporting loss-making national airlines. Government support resulted in very few unprofitable companies leaving the market. At the same time, many airlines started downgrading their product by offering low levels of service on short-haul flights to compete on costs. *All* major airports had capacity constraints, which (in combination with their slot trading system that favored current slot-owners) made access lo established airports difficult for new entrants. However, new entrants, such as Ryanair and easyJet were moving to si nailer,'local airports to avoid the capacity constraints of the major airports. These new entrants further intensified the competition (on costs) in the European airline industry. Finally, the use of web booking systems made the market more transparent. *Customers* were able to easily compare prices, which substantially reduced switching costs.

After 2000. the profit *potential* of the European airline industry improved slightly. The European Commission had allowed governments to cover insurance risks and costs laced by airlines alter the September 11. 2001 *terrorist* attacks: however, other forms ol government support were no longer allowed. Further, after September 2001. many airlines Significantly reduced (fixed) capacity, which reduced competition. Finally, more and more countries sinned bilateral "open skies" agreements with the US. implying that European airlines could fly to any place in the US, at any fare, at any time (but only from their home countries). In early 2004, a European agreement with the US was being negotiated, implying that, for example, the German national airline Lufthansa would be allowed to fly from Milan to New York. Nonetheless, KLM's return on equity during the fiscal years ending in 2001, 2002, and 2003 was 3.7, -7.8, and -24.1 percent respectively.

Exhibit 1 reports KLM's and Air France's motivation for entering into the merger agreement, as it was set out at the merger presentation on September 30, 2003.

Response of the Dutch Investor Association

In early 2004, the Dutch Investor Association (VEB; Vereniging voor Effectenbezitters) began to oppose the merger proposal. The VEB was of the opinion that during the months following the merger, KLM's value had increased substantially due to changed circumstances, which would justify a higher takeover price. KLM shareholders had to decide before May 5, 2004 (just before KLM's publication of its 2003/2004 financial statements) whether or not they wished to offer their shares to Air France. The VEB claimed that KLM shareholders should be able to take these latest financial results into account when making their decision. Air France and KLM refused this, supported by a Dutch court decision on April 29, 2004. Exhibit 2 sets out the VEB's objections in detail.

On May 6, 2004, KLM announced that net profit, operating profit, and revenues for the fiscal year 2003/2004 were €24 million, €120 million, and €5,870 million, respectively.

Questions

1 Evaluate the motivating factors behind the Air France-KLM merger. Does the merger effectively address the strategic challenges faced by KLM and Air France?

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2 Calculate the present value of the synergies. To what extent is the actual market response to the merger announcement consistent with the estimated value of the expected performance improvements?

3 To what extent can the premium be justified by the expected performance improvements (as presented in Exhibit 1)?

4 Critically analyze each of the VEB's (Dutch Investor Association) objections to the proposed takeover price (as presented in Exhibit 2). Do you have any evidence that Air France shareholders agree with the VEB?

5 If you were a shareholder of KLM. would you support this merger proposal?

KASUS – 12

TEORI

1 In December 2(M)4, Denmark-based Danske Bank experienced a share price decline of 6 percent upon its announcement that it planned lo acquire the Irish bank National Europe Holdings. The Danish banks Finance Director explained that "the market perception of us changed from being a high-yield equity story, because we'd been paying a huge amount of dividends and doing massive share buy backs, to being a growth-oriented, cross-border story." What actions could the Finance Director lake to restore investor confidence?

2 A. What arc likely lo be Ihe long-term critical success factors for the following types of firms?

- A high technology company, such as semiconductor equipment maker ASM Lithography.

How useful is financial accounting data for evaluating how well these two companies are managing their critical success factors? What other types of information would be useful in your evaluation? What are the costs and benefits to these companies from disclosing this type of information to investors?

3 The International Financial Reporting Standards permit management to revalue fixed assets that have increased in value. Revaluations are typically based on estimates of realizable value made by management or independent valuers. Do you expect that these accounting standards will make earnings and book values more or less usefil to investors? Explain why or why not. How can management make these types of disclosures more credible?

4 Under a management buyout, the top management of a firm offers to buy the company from its shareholders, usually at a premium over its current share price. The management team puts up its own capital to finance the acquisition, with additional financing typically coming from a private buyout firm and private debt. If management is interested in making such an offer for its firm in the near future, what are its financial reporting incentives? How do these differ from the incentives of management that are not interested in a buyout? How would you respond to a proposed management buyout if you were the firm's auditor? What about if you were a member of the audit committee?

5 You are approached by the management of a small start-up company that is planning to go public. The founders are unsure about how aggressive they should be in their accounting decisions as they come to the market. The Managing Director, asserts, "We might as well take full advantage of any discretion offered by accounting rules, since the market will.be expecting us to do so." What arc the pros and cons of this strategy? As the partner of a major audit firm, what type of analysis would you perform before deciding to take on a new start-up that is planning to go public?

6 Two years after a successful public offering, the Managing Director of a biotechnology company is concerned about equity market uncertainty surrounding the potential of new drugs in the development pipeline. In his discussion with you, the Managing Director notes that even though they have recently made significant progress in their internal R&D efforts, the shares have performed poorly. What options does he have to help convince investors of the value of the new products? Which of these options are likely to be feasible?

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7 Why might the Managing Director of the biotechnology firm discussed in Question 6 be concerned about the firm being undervalued? Would the Managing Director be equally concerned if the shares were overvalued? Do you believe that the Managing Director would attempt to correct the market's perception in this overvaluation case? How would you react to company concern about market undervaluation or overvaluation if you were the firm's auditor? Or if you were a member of the audit committee?

8 When companies decide to shift from private to public financing by making an initial public offering for their shares, they are likely to face increased costs of investor communications. Given this additional cost, why would firms opt to go public?

9 In some Continental European countries firms are traditionally financed by banks, which have representatives on the companies' Boards. How would communication challenges differ for these firms relative to UK firms, which rely more on public financing?

PRAKTIKUM

Investor relations at Total

Jerome Schmitt knew not to surprise. As head of Investor Relations (IR) at Total, the world's fourth-largest publicly traded oil and gas company and France's flagship enterprise, he had seen first-hand how fast the financial markets and the company's many other stakeholders could change their views of Total based on unexpected news. It was the fundamental task of the IR-group, though, to maintain long-term relationships with investors and avoid short-term sensibilities.

As an integrated oil and gas company. Total was involved both in exploration and production as well as in refining, shipping, and marketing. Present in over 130 countries, the company produced oil and gas in 27 countries.[1] ran 28 refineries worldwide,[2] and managed over 16.000 gas stations—and the nature and mere size of its operations made Total a natural focal point for many interested parties. Providing pertinent information to such a diverse group—consisting of employees, investors (both institutional and individual), customers, partners, environmentalists, governments, and the general public, especially in the company's home market France—complicated Total's communication approach, especially as the groups all called for different types of information. Still, the communication had to be consistent. "It is the same story we have to tell everyone." said Schmitt.

Total believed it had a successful communication policy based on being consistent and on never over-promising. In September 2005. however, the system was being put to the test. While Total wanted to save money and create buffers against future bad times— against increasing oil prices and to ensure that the French corporate beacon did not become a takeover target—it also showed a €5.8 billion profit for the first half year 2005.' Telling the public both about strong earnings and about the need to save made for a complex communication situation—especially within the sociopolitical context in France, where Total employed half of its 110.000 employees. Total received further media attention when Frances finance minister announced on

September 9 that he would hit the oil majors with extra taxation unless they increased refining capabilities and cut petrol prices in France. The executive management. Schmitt. and his IR team had some communication challenges ahead of them.

Total: The company, its history and its communication

Total was founded in 1924 as Compagnie Francaise des Petroles (CFP) on initiative from the French president and in order for France to develop an oil industry. With no domestic oil reserves, CFP immediately ventured abroad, using a stake that the French state had in a Turkish petroleum company. CFP also proceeded to open new oil production fields, starting in 1927 in Iraq, and grew both in scope (adding refining, transporting and marketing) and geographical size (prospecting in places such as Venezuela, Algeria, Indonesia, and the North Sea). The word "Total," which originally was a brand introduced in 1954, became part of the company name in 1985 and the sole moniker in 1991. That year, Total listed ADRs (American Depository Receipts) on the New York Stock Exchange. Said CFO Robert Castaigne:

*7997 in a way marks the beginning of our financial communication. We were still unknown in the U.S. and U.K. We were a relatively small company, which had to set large targets and sell these to the market. Luckily, we were able to meet our targets and establish a "capital of **trust**" with the financial community.*

Listed on the French stock exchange since 1929, CFP's main shareholder for many years was the French state. However, the government sold off large parts of its holdings in the mid-1990s to hold less than 1% (and later divested this remaining interest in 1998). Also in the mid-1990s. Total was reorganized by then CEO Serge Tchuruk, who wanted to turn a bureaucratic-ally run company into a world oil major. Said Castaigne, "Tchuruk woke up the company and brought new impetus." Tchuruk was in turn succeeded in 1995 by Thierry Desmarest. who continued Total's revitalization. Described as preferring to let action speak louder than words. Desmarest made a few "loud" decisions early on. For instance, he braved U.S. sanctions and developed two large oil fields in Iran, a country that U.S.-based Conoco Oil had just abandoned for political reasons.[4] The investment in Iran followed Total's involvement in the region for over 70 years. Total under Desmarest was also not shy about investing in other politically charged locations, such as Libya and Myanmar (the former Burma).[5]

In the late 1990s. Totals portfolio of exploration and production operations gave the oil and gas company a decidedly "upstream" look, as industry observers put it. Selling the North American subsidiary had streamlined the company even further by divesting downstream activities such as refineries and gas stations. Total emphasized that it would concentrate on the upstream segment while rationalizing downstream operations in mature markets. Exploration **and** production were the more profitable parts of the oil business and where Total would continue to focus.

The acquisitions in 1999 and 2000

Investors and industry observers were therefore taken aback when on December 1. 1998, Total announced it would acquire Belgian group Petrofina. a downstream-heavy company with refineries, chemical plants, and gas stations/' The sudden downstream move surprised analysts, who cringed at the 37% premium[7] over the Petrofina share price that Total would pay. Total's stock price dropped 11% the day after the announcement;[8] several analysts abruptly downgraded Total; and others claimed the merger's benefits added up to only half the premium Total had paid.[9] In the following week, Total shares dropped a total of 22%.[10] Desmarest and his team found themselves having to fly to the financial centers of the world to make their case directly to investors.[11] Said Castaigne, "It was necessary. Our message until then had always been 'Total is upstream, only upstream.' We decided to visit the financial community and investors to explain

the strategy. They were very upset." Total could understand the market's reaction, commented Ian Howat, senior vice president of Strategy:

> *We massacred the implicit contract we had with the investors and the analysts. They thought we were one type of animal and now all of a sudden we were another. But sometimes you have to do things you know the markets will not like. There wasn 7 an alternative. We had about 4% market share in a mature R&M [refining and marketing] market in most European countries. There is no way to grow out of that situation unless you make some acquisitions.*

The message that Desmarest and his team now kept repeating was that Total had to make external acquisitions to grow in a maturing—and also consolidating—market in order to avoid becoming a takeover target or a niche player. The industry was already seeing similar examples: Exxon and Mobil had announced plans to merge, and BP and Amoco Corp. had already joined in the summer.[12] Acquiring Petrofina gave Total downstream assets such as oil refining and marketing in northwest Europe and parts of the U.S.[13] Investors argued that the company did not need the downstream market: they also pointed out that Petrofma's chemical operations almost fully overlapped with Total's.1" Upstream, however, analysis agreed that the two companies were complementary: Total was strong in the Middle East. Latin America, and Southeast Asia, and Petrofina in the North Sea and North America.[15] Ten days after the announcement. Total's share price was still 17% below its November level.[16] (See Exhibit 1 for Total's share price between October 1998 and December 1999.) More calculations were presented, showing even larger cost savings due to synergies, but it would be time-consuming to help the financial markets overcome their surprise. Said Castaigne:

> *This is a good example of how you learn as a company to* **be** *consistent in your message. I When you present to the financial community,] you are in front of people who take notes of everything you say—and next time, they will of course try to see what is different between what you said before and what you sax now. So it is important to be consistent. Tor us, this surprise change of strategy meant we had to slowly rebuild the trust with the financial markets* **by** *visits, visits, and more visits, and also by listening more to our investors.* **We were** *helped somewhat in this phase by one financial institution who quickly understood our strategy. They invested when others were selling off their shares in Total.*

It took Total seven months to complete the acquisition process and on July 1, 1999, the new company, named TotalFina, was officially formed. "And the following Monday," said Castaigne, "we moved on Elf Aquitaine."

Interestingly, thought Castaigne, the financial markets appreciated this second acquisition more than the first. Going after rival Elf was seen as a sign that Total stood firm by its new aggressive growth strategy. TotalFina was the world's sixth-largest oil company with a market capitalization of $40 billion,[17] but it was still too small to be a "major." Merging Total with Elf made sense to analysts, if Total wanted to end up on equal footing with industry giants. The match also looked good geographically: TotalFina was a west-east company and Elf s focus was north-south.

The move, however, came as a complete surprise to previously state-run Elf Aquitaine (it was privatized in 1995). The hostile takeover bid of €42 billion[18] (15% over Elf s share price)[19] was turned down by an infuriated Elf management. The French government, which held a "golden share" in Elf with veto rights against any takeover,[20] could have blocked the deal. It announced, however, that it would not oppose a merger—which made Elf. led by CEO Philippe Jaffre. make a counteroffer to buy TotalFina for €49 billion.[21] As a response. TotalFina upped its offer by almost 10%. arguably both to appease Elf shareholders and also to serve as a warning to other potential suitors such as Italy's ENI." By September 1999. Desmarest and Jaffre agreed to merge and create the world's fourth-largest oil company after Exxon Mobil. Shell, and BP/Amoco. Desmarest was to lead the new group with Jaffre leaving the group. The new entity, named

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TotalFinaElf. became the largest company in the Eurozone and on the French slock market, w ith a market capitalization of €95.47 billion, ahead of telecom group France Telecom and the food retailer Carrcfotirr

The disasters in 2000 and 2001

The two high-profile acquisitions raised awareness of the Total group both in the industry and for the general public. Said Yves-Marie Dalibard. VP of Corporate Communication. "Unfortunately, though, the Tola! story with the public and the media since 1999 is more about two serious accidents than these two acquisitions."

The first accident happened as the Elf merger was concluding. On December 12. 1999. Ihe oil tanker Erika. a vessel that Total had chartered to carry heavy fuel oil. broke into two off the coast of Brittany after heavy storms. No lives were lost, but the sinking ship leaked about 15.000 tons of oil. At first, officials predicted that the rough weather would break up the oil slick before reaching land. However, by Christmas Day oil hit the French Biscay coastline. Eventually over 10,000 tons came ashore, killing over 120,000 seabirds.[24] Total was made the media's focal point and journalists hung to the company's first comment that the tanker did not actually belong to Total.[25] Said Dalibard:

Top management had been working seven days a week far 18 months with our mergers. So when the wreckage happened, it did not receive our full dedication, especially when the maritime department told us that the oil spill would not be that severe. People left for Christmas. Then, two to three days later, we have 10,000 tons on the shores. So yes, our reaction was late. Also, the words we used did not show appropriate compassion. Legally speaking we were not responsible but the public-needed someone that could be assigned responsibility. So the public opinion, fueled by our lack of timely response, decided we were the responsible ones.

Eventually, Total agreed to finance all oil removal operations from the wreck. It also helped to clean the coastline, pump out the remaining cargo from the sunken tanker, and process over 230.000 tons of waste.[26] By 2005. the French courts were still a year away from assigning legal responsibility and Total and five employees were still under investigation. Legal repercussions aside, however. Total knew that the oil spill heavily influenced the company in its home market. Said Dalibard:

When we conduct brand surveys, 44^c/c say that "Erika" or *"oil spills" are important parts of the Total story. Surprisingly, they also think that the Total story consists of the Prestige wreckage, when a tanker chartered by a Russian oil company sank off the Spanish coast in 2002. Total was not a party in any shape or form to that oil spill.*

While Total handled the Erika-effccts and continued to integrate Petrofina and Elf. another disaster occurred: On September 21. 2001. a plant belonging to the group blew up in Toulouse. France. The AZF factory was part of the group's chemical division Grande Paroisse and specialized in nitrogen chemistry, especially for fertilizers. An accident in a stockpile of ammonium nitrate pellets caused an explosion which killed 30 people and injured over 2.500. As the plant was located Within the eitv boundaries, a portion of the city was also significantly damaged.[2'] Said Dalibard:

// was very sad and very dramatic. This is *ten days after* **V// /.** so *terrorism* **is of** *course on our mind, hut it may also have been a pure incident, this lime, the company reacted completely different compared to Erika.* **One** *hour after the blast, our chairman* **flew to** *Toulouse, and two hours after he* **was** *on site. He expressed all* **his** *sorrow and support* **to** *the community and directly* **look fall** *responsibility* **on** *behalf* **of** *Total.*

Going silent until 2003

Total's quick response positively affected the company image. "In our branding surveys now. there is no sign of people remembering AZF as a disaster for Total." said Dalibard. "Very strange, because lor us it was a horrendous event." In lad. the two accidents combined made Total's management take a drastic decision, they stopped all corporate communication to the general public. The "blackout" lasted until 2003, and did not include financial communication. Dalibard explained:

> *The executive committee concluded that we had no right to speak. We had to solve the problems of the people suffering from the wreckage and the explosion. Advertising or sponsoring would be completely unsuitable. "We have to be attentive to the people of the area," is what we said—and then be silent for the rest, keep a low profile, just hold our breath.*

The decision was not limited to France but was applied worldwide, even in countries where the public opinion hardly knew of Total. Dalibard explained: "I think it reflects the state of mind of the executive committee. It is not totally rational to do this across the board, but it is linked to what happened to these people personally. It was a trauma." The company did continue with standard press relations and financial communication. Limited so-called "commercial communication" was also allowed. Explained Dalibard:

> *We separated between a person's relationship to the institution and to the commerce. The commercial relationship was somewhat kept, through for instance our 'You know where to turn" campaign for our filling stations. But institutional messages were forbidden. So although the company was successful, we did not tell the public of our growth.*

(**Exhibit 2** shows Total's stock price development between 1991 and 2005; **Exhibit 3** compares Total's stock during the first nine months of 2005 with the other oil majors.)

Commented Schmitt. "of course, the IR activities continued: we did tell our shareholders and the financial community about *our* strategy and objectives." In 2003. Total decided it was time to lift the ban on corporate communication. At the same time, the group was renamed from TotalFinaElf back to just Total and a new visual identity was introduced. The group also launched an advertising campaign to re-establish a relationship with the public. The campaign ran on the motto "Our energy is your energy" (or in French. "Pour vous. notre energic est inepuisable." literally translated as "For you. our energy is inexhaustible**: see **Exhibit 4** for an ad sample). Said Dalibard:

> *The campaign explains the job of an oil group: refine existing resources, find new resources, do this in good conditions while preserving the environment, and all to the benefit of the customer. We run customized campaigns in different regions, but they are all based on the same concept and all try to restore the image and understanding for what an oil group does.*

Total in 2005

Total could by 2005 present itself as the world's fourth-largest publicly traded oil and gas integrated company. It operated in more than 130 countries, covering the entire oil and gas chain from exploration to distribution, and also held large operations in chemicals manufacturing. 2004 sales reached €123 billion, up from €104 billion the year before. **Ninety-five** percent of Total's profit came from outside of France. (**Exhibit 5** shows Total's 2004 linancials.) In 2004. Total had over I 10.000 employees worldwide with 44% working in Prance. Employees held 47; of the shares. (See **Exhibit 6** for Total's shareholder and employee base in 2004.)

Total divided its activities into three segments. The first segment. *Upstream,* encompassed exploration and production (F.&P) of oil and natural gas. along with some other gas and power

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activities. Total had B&P activities in 44 countries and produced oil and gas in 27 countries. Europe stood for 32% of the group's production, Africa 31%, North America 2%, South America 9%, Asia-Pacific 9%, and the Middle East 16%. As a country, Norway was the largest contributor with 406 thousand barrels of oil equivalent (kboe) per day in 2004. (**Exhibit** 7 shows production by region.) New exploration opportunities were evaluated based on geological, technical, political, and economic factors as well as on.projected oil and gas prices.

The second segment, *Downstream*, covered trading and shipping, refining, and the marketing of Total and Elf brand petroleum products, automotive and other fuels, and specialties such as LPG (liquefied petroleum gases), aviation fuel, and lubricants, through both the retail network and other outlets worldwide. In 2004 Total had refinery capacity of 2.7 million barrels per day (b/d) and nearly 17,000 service stations, 2,700 of them in France under the Total and Elf brands.

The third segment, *Chemicals*, included petrochemicals, fertilizers and specialty chemicals. It also housed Arkema, a new legal entity which Total intended to spin off in spring 2006 and which included vinyl products, industrial chemicals, and performance products.[29]

The three operational segments were each built around an organizational pole (**Exhibit 8** shows the organizational chart.) The segments were then supported by functions such as finance, strategy, legal affairs. HR, and corporate communications. An Executive Committee (COMEX) managed the company and answered to its board of directors. COMEX worked with an extended Management Committee (CODIR), which included all COMEX members plus 22 senior managers. (**Exhibit 9** shows all committee members.) The extended board consisted of French and Belgian nationals, with the exception of Howat who was Scottish. He described the company: "Total is basically a bunch of engineers with a few hard-nosed finance people at the top—who by the way also happen to be engineers. Their job is to make sure the ingenuity of the engineers is set to create shareholder value."

In 2001. Total formed an Ethics Committee to coordinate Total's ethics practices, described in the company's 26-page Code of Conduct. The committee organized educational and auditing resources and also handled the procedure for answering employee concerns. This included accepting so-called "whistle blowers" or employees who anonymously reported perceived conduct violations. Richard Lanaud. head of the Ethics Committee, reported directly to the CEO Desmarest. He said:

> *The code of conduct guides our business principles and individual behavior as they link to the environment, to people, to sustainable development.* It *is a top-driven initiative that the CEO decided to implement. It is also not targeted to one stakeholder group over another. External pressures may play a role in developing an ethics policy, but more important are the rewards it brings for the internal organization: creating a common language* of *shared values, satisfaction among employees, and* **growth for the company by** *protecting* **its** *name.*

Lanaud believed that the code of conduct had only a limited impact on persuading investors lo invest in Total stock. Personally, he spent 80</r of his lime on internal activities over external ones.

Organizational units could also use a self-assessment procedure to **determine** themselves how well they complied with the code.[30] Total **further** worked with **U.K.**-based accreditation company GoodCorporation to conduct ethical assessments of subsidiaries. GoodC orporation had turned Total's code into 84 points of control which they used as a checklist when assessing subsidiaries. Lanaud explained:

> *We don't ask GoodCorporation to give our subsidiaries an accreditation although they handle the assessment. You couldn't give an accreditation to Total on a group level and it doesn't make sense on a subsidiary level. Also, we didn't want to create a race between our subsidiaries. We just wanted to find our weaknesses and also our good practices. To use an external party for this was fundamentally easier than doing it ourselves; they had an existing methodology and*

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could also meet our stakeholders to get an outsider's more impartial view. Their job is important: you cannot set an efficient ethics policy without checking.

Financial communication

Financial communication at Total consisted of several formal processes, such as issuing the annual report, preparing the quarterly result publications, managing the conference calls that went with these, organizing investor "road shows," and managing the shareholders' annual general meeting. In addition, financial communication also included the daily activities of keeping the company's stakeholders up-to-date with the strategy, the results, and activities of the company.

The annual report

The most technical piece of communication that Total delivered was its annual report. It was also the document that was the most code-driven since it had to abide by financial rules and regulations. Thierry Reveau de Cyrieres. general legal counsel to the board of directors, said. "Our accounts must give an image of the company's financial situation which is true. As a lawyer, I check that nothing significant has been omitted—to the extent I am aware of it. of course." The actual process of drafting the annual report involved some 50 people. Among those, three participants stood out. explained Reveau de Cyrieres: "There are three key players: IR. legal function, and the communications group. Of course |wej also involve people in accounting and treasury. Naturally, the people in the divisions make a very significant contribution as well, since they are the major part of the report."

Once the annual report had been put together it went through a detailed release process. It started with the disclosure committee made up of the group's main functional executives, which checked that there were no outstanding issues. It then went to the audit committee, consisting of three independent directors with more time lo examine risks more broadly, who made a final report to the board of directors. The board then received the report, which was not made public until the board approved it. With Total's financial year following the calendar year, the annual report was published in early spring. It then fonned the discussion basis for the annual shareholders' meeting, thought of as "a true discussion between shareholders and the CEO."

Road shows

Twice a year (once in September and once in February); Total went on "road shows" where a group of senior executives visited around 35 cities[M] and met with institutional investors and analysts. Four teams (raveled the world, led by CEO Desmarest. CEO

Castaigne, Head of Strategy and Risk Assessment Bruno Weymuller and Ian Howat, senior vice president of Strategy. Overall, Total had in 2004 organized about 400 investor and analyst meetings.[32] The message that the teams presented during those presentations was crafted throughout the year by the Investor Relations group together with Desmarest and Castaigne, as well as the strategy and planning group and the operational business team. Said Schmitt, "Management has to be deeply involved in crafting the message because they will have to deliver it." The end result was a slide show of some 30-35 slides. Schmitt expanded:

> *In an ideal world, IR should not exist. Thierry Desmarest could talk once or twice a year and tell the company's strategy. But it doesn't work that way. We are dealing with an audience that is also tracking a lot of other companies, which means they have time and attention constraints. So we on our end have to be both clear and simple in our message—which we then have to repeat over and over again.*

Dalibard emphasized that consistency was key to making sure Total's message was received and taken at face value. He said:

The most important (issue] here is to use the same criteria and targets between each presentation and between road shows. Otherwise the analysts won't trust you. For four to five years now, we have had the same strategy and criteria to measure our success. We have changed the targets once or twice, based on changes in the external environment, but we have continued to use the same strategy and criteria, which make our presentations very coherent over time.

Schmitt explained further:

Total doesn't change the broad message that everyone is getting. What might change is how deep you get into certain issues. More and more investors walk in the room and they already know the broad message and want answers to some very spatjic questions. Obviously Total must be prepared to answer them in a detailed way. But generally speaking, consistency and transparency of the broad message k crucial, because if there were message differences investors would find out quicklx as they are bound to talk with each other—and that would hurt the company's credibility.

During the road shows, however, the company did not provide valuation multiples or other calculations of firm value. Said Casiaignc: "It is not our job lo calculate these numbers. They are for the financial community to create. We give them the information they need, bin we let them value the company. In ihe end. Ihe market sets the share price."

Day-to-day communication

Although Total's main message was formulated once or twice a year, the company issued press releases year-round. Press releases were issued for one of three reasons: material events where ihe company by law or regulation was obliged to inforn: events thai were related to the main IR crafted story; or happenings that were in Total's interest to report on bill were coincidental to the main message, such as opening a new facility or sponsoring a sports event. All press releases, regardless ol their purpose, were reviewed by the investor relations team to make sure they were consistent with the overall message that Total wanted lo spread. As a matter ol standard, every press release also referred systematically lo the geographic location and gave ihe environmental dimension of the event.
In Schmitt's view, in addition to spreading the corporate message, the IR group also had a function of being receptive to and understanding the expectations of the market participants. He explained:

IR must be able to understand a trend even before it becomes apparent. For example, how would the investors react to Total's dividends policy or share buyback strategy? Or about mergers and acquisitions in 2005? Before putting out the story, we need to have an idea of whether it will be valid for our shareholders—and for all stakeholders in general.

Investors' sentiments toward Total, or their general assessment of a situation, could often be gauged through their ratings of a company or by simply picking up the phone and talking with them. However, the general public's views were harder to assess. To help with this, Total ran frequent market surveys, measuring both the public's awareness of Total as a company and the public's sentiments toward it. Said Dalibard:

The surveys show us how quickly views can change. In January [2005], surveys showed overall positive results for Total. Then came February with three different incidents. First, our financial results were very good—which is actually not that accepted by the French public. It is a vety specific aspect of this country. Second, we had a small legal problem connected to Erika, which gave our opponents a new chance to emphasize Total's involvement in the story. Finally, we also

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had a social situation in a subsidiary in the south of France. So from a 68% positive rating in January, we dropped to 48°/c in February. Only to rebound two months later, back to 63°/c—which I think shows that the public in France is very sensitive to any event concerning Total.

Interestingly, the surveys seemed to indicate the French public made a distinction between Total, the company, and Total, the gas stations. The gas stations consistently received higher ratings than the company of the same name: Total interpreted this as the public having a "warmer" relationship with the gas stations and a "colder" relation with the company itself.
Given the impact that any information about the company—financial, corporate or otherwise—seemed to have *on* the general sentiment towards Total. IR worked closely with the company's internal media group to make sure they all conveyed the same story. Said Dalibard,

Press relations link completely with financial communication, since journalists of course will look at how we talk to investors. We have to maintain a strong internal relationship between our media and financial people to "keep the same tempo." Actually, every new press officer we hire has to be trained on the rules of financial communication. For media relations, we have processes and rules—but in terms of financial communication wc as a company have legal commitments lo be transparent, fair. ... Our media people have to take all these rules into consideration. Journalists and analysts cross-check what we tell them to get the full presentation. So even if we may differ in the emphasis on pieces between the two audiences, the overall message has to be the same.

However, working with two types of audiences presented its own problems. Dalibard continued:

Most journalists work like analysts: they are their papers' specialists in the oil and gas business. If we have problems, if is not with them but with the general journalists that do not understand our business. But they are just as powerful I in shaping public opinion/, probably more so. since few in the general public read the specialist section of the newspaper and instead read the front page or main section articles where these generalists write.

Investor relations: Communicating with stakeholders

In 2005 the Financial Communication team at Total consisted in 2005 of about 10 people in Paris, with an additional team in New York of three people. The group's job, as described by its head Schmitt, could be divided into three main areas: communicating with retail investors, with institutional analysts and shareholders, and with ethical or environmental analysts and investors. The last area was newly established in order to match the growing number of specialized analysts on the investor side who looked specifically into the corporate social responsibility (CSR) aspects of a company. (See **Exhibit 10** for the formal mission statement of the Financial Communication group.)
Members of the IR-group attended some executive committee meetings, long-term planning meetings, budget meetings, etc., and also met regularly with the CEO. In order to understand the business issues, the IR team members all had operational backgrounds within Total. The IR group under Jerome Schmitt reported to the CFO Castaigne. (See **Exhibit 11** for the organization of the IR and Financial Communication group.) Commented Castaigne, "In the financial reports of any company, there are strategic messages that are very important. So the financial communication office is placed at the highest level internally."

Communicating with institutional investors

During the two 2004 road shows, members of the company's management met, as they did every year, with portfolio managers and financial analysts in the leading financial centers of the world. In addition, institutional investors could download material on the Total corporate website, and the CFO conducted three telephone conferences during the year. (**Exhibit 12** shows the 2005 IR

calendar.)[33] To Schmitt. the bulk of the IR work was to deal with institutional investors and convey the company's strategy. Howat further commented on the role of IR vis-a-vis institutional investors:

Contrary to the popular belief that the financial markets are always short-sighted, we are fortunately in an industry which investors like for its long-term perspectives and development potential. Most of our presentations and most of the market's interest are on the company's long-term plans. Specifically for our E&P f exploration and production} activities we give a five-year indication of production targets. We should not disappoint the market, so our five-year numbers come out of our own planning, hut with prudence built into them.

Not disappointing the market was a recurring theme in internal discussions, said Howat:

This was really drummed into us by our previous CEO. financial communication is an exercise in honesty. Like the old saying, "You can fool some people all of the time, you can fool all of the people some of the time, hut you can't fool all the people all the time. " You can't fudge. Everything you choose to say should be the truth, the whole truth, and nothing hut.

Communicating with retail investors

As Ell Aquitaine had had many more individuals as shareholders than Total, the merger meant that Total now had to cater to a large number of retail investors, a number that continued to grow. **By 2005. total had 520.000** retail investors, ot 97< ol the shareholder base.

About 40% ot these had fewer than 30 shares; about 40% *between* 30 and 99- 10% between 100 and 200 *shares;* and the remaining 10% had more than 200 shares About 90% of all retail investors were *French;* about 60% of the shareholders had held their Total shares for more than 10 years and 25% between 5 and 10 years. Valerie Laugier had been head *of Retail* Investor Service for four years and was responsible for all *communication that* went to *this group.* She said:

After the merger, my unit was attached directly to the financial communication group as it had been at Elf. It is not attached to the corporate communication, sustainable development, or general secretary. Instead, since we belong to the financial communication group, we are linked directly to the CFO, which makes it easier for us to all communicate the same message. Even if the message I bring to my retail investors may have been simplified or made more pedagogical—since my audience is not made up of "petrol pros " like the oil analysts—it is the same exact message as the "pros" get. Although I may spend my days thinking about retail needs, I sit next to people that "swim " daily (so to speak) in the main message.

While the basic message and information conveyed were the same as with institutional investors. Laugier pointed out that the approach used to communicate with Total's retail investor was based on very different strategies:

We base our retail investor communication on technic/ues that come from consumer communication. I was nine years with Total's gas station network, working with consumer seniles, and it felt natural to use the same approach when talking with our retail investors. These are individuals with whom we have a relationship, just like with our gas station clients. I installed, for instance, a CRM f customer relationship management! system to keep a history of all communication with each shareholder. Before we did not know if someone who wrote or called us had ever been in contact with us—but now the CRM system can tell us that and also provide information about the person, such as how many Total shares they own, etc. Each

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individual shareholder has a file in our CRM system, to which we link all communication with that person. It allows us to not only trace previous communication but also to personalize it.

Another change Laugier brought was to *hmui* the number of publications created for retail investors, while at the same time increasing the distribution of the remaining printed material. She said. "My argument was that nobody will hear us unless we turn up the volume, regardless of how many times we change the CD. 1 wanted to reach more *retail* investors more often." Thus, by 2005. Total communicated with its retail investors in carefully selected diffusion channels. One was the shareholders journal. *Journal cles Actionnaires.* which 300.000 shareholders (the ones holding a minimum of 10 shares) received four times a year. Once a year, at the lime of the annual report, all 520.000 individual shareholders received the journal.[3-4] Other channels were the company's website and the loll-free number through which shareholders *couk* obtain information about the company. The toll-free number received X0.000 calls annually and was run by an interactive voice server. The callers who did not *\"inc* their answer in the preset menu were *con*-neeled with a staff member (who reported to Laugier). who since early 2004 had been dedicated to answering shareholder questions, whether by telephone, e-mail. fax. or regular letters.

As another channel. Total invited shareholders with more than 30 bearer shares or one registered share to join the "Shareholders' Circle." which organized events such as visits to industrial or cultural sites. For this group. Total also ran one-day training P^r0^s o" "Understanding Total Financial Statements." which since its inception in May 2003 had attracted about 700 participants. About 100 shareholders had also attended a new program called "Moving to IFRS Norm Accounting." The training programs had so far been held in Paris (twice), Nice, and Clermont-Ferrand.

Another channel for communication was a schedule of about four annual information sessions for individual shareholders, which were held in Paris and in other regions. CEO Desmarest led the session in Paris; the others were chaired by Schmitt. These sessions were open to all individual shareholders. In addition, Total participated at the annual Actionaria Trade Show held in Paris. In 2004, Desmarest had participated in a question-and-answer session with two journalists in front of 1,200 individual shareholders/"

The year's largest retail investor event, however, was the shareholders' meeting or annual general meeting (AGM). The 3.5-hour meeting was prepared by several Total teams: IR. corporate communication, legal, security and logistics. In 2004. the AGM was held on May 15 at the Paris Convention Center at Porte Maillot in central Paris. Personal invitations were sent to all shareholders holding 100 shares or more, about 100.000 people. Said Laugier:

> *A few years ago. we only sent out invitations to people with more than J(1000 shares. This basically meant that nearly no invitations were sent at all. We then changed that to a minimum of 100 shares—and for the next year we will set the limit even lower, at 50 shares.*

In 2002. the AGM had seen 1.900 attendants; by 2005 this number had grown to 2.300 shareholders, with many more attending from outside of the Paris region. Commented Laugier:

> *The shareholders' meeting is one of the most important things we do. But when i discuss this with any Anglo-Saxon colleague, they don't understand the need. In their cultures, especially the American, it is so much more common for individuals to invest in shares. But for us. the French, it is still not established and the people who do invest need the attention.*

Since many retail shareholders were both investors and French citizens, mans of the issues with the general public were also of concern for retail shareholders. For example. Laugier commented about the Erika and AZF disaster in Total's pasl. and about the decision to freeze corporate communication for a while:

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At the time, people were ashamed to hold Total shares. They told us lime after time that we needed to stand up and defend ourselves—but what they were really asking for was for us to defend them *and their choice to hold Total shares. They want to he shareholders—hut they also want to have a good conscience and even build their personal image by owning Total shares. We also see this reflected in the increasing number of questions on how we behave socially, ethically, and environmentally.*

In order to better understand how retail investors perceived Total both as a company and as an investment opportunity. Total had a 12-pcrson strong .Shareholders Advisory Committee (in French. *Connie (onsulla/if)*. The committee was appointed lor a specific time and the incoming committee members were chosen by Total in cooperation with an external recruitment agency. Said Laugier:

harlwr we could end up with on unrepresentative committee, consisting of loo many retirees, too many Parisians, and (in fact) also people who sal on similar hoards almost for a living. So we hired this recruitment agency to help us make a more representative selection—and also find committee members more likely to argue with us on issues they don't agree with.

The committee met four times a year in meetings that Schmitt and Laugier chaired. After a short presentation of the latest financial results by Schmitt, the meetings would quickly turn into a workshop where the members would criticize the latest financial publication or other official communication piece, and would also work with benchmark exercises to come up with suggestions for Total to improve its communication.

Communicating with employee investors

A special category of retail investors were the company's own employees, who owned *4%* of Total. Said Dalibard:

Since our staff follows media we have to be attentive to the message coming from the outside. Every press release we issue for investors and media is put on the intranet, with comments added for specific business areas. We need to manage the rhythm of communication to the financial community, to media, and internally. They have to be done at the same time. When the rhythm breaks, you have problems. So internal communication is linked to financial communication, absolutely. Take, for instance, the issue of share buy-back. The shareholders like it since it is a way of increasing the value of each share. However, it means that this money is not distributed to staff or invested back into the company, so employees will argue that "if Total is successful enough to buy back shares, why can't we take part in that success?"

Some employees would try to use the annual shareholders' meeting as a platform for their views, whether they were shareholders or not. For instance, at the 2004 meeting, employees upset with the company's decision to spin off part of its chemical business into a separate company attempted—unsuccessfully—to march onto the meeting stage.

Communicating with ethical investors

As the financial markets had more analysis dedicated lo ethical issues, as well as certain funds investing only in "ethical companies.'" Total had adapted its IR organization. Eve Gautier was now responsible for Corporate Social Responsibility information. Previously in the corporate communication and internal audit departments at Total, she had for the last six months been in charge of Total's relationship with CSR analysts. Schmitt commented on her role within the IR group:

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Previously, I'd say that mainstream analysis often ignored these concerns, but (he concerns didn't going away. The business of analysis is to pick the slock that will appreciate in the shortest amount of lime; their bonus is calculated on that capital gain; so if any corporate social responsibility issues appear, they want them to go away as fast as possible. That is when they contact us directly.

One specific example involved a large Scandinavian investor. Said Gautier:

We got a contact from a Scandinavian investment fund. They said they were considering dropping our stock because of our presence in Myanmar. So for the analyst in that fund to be able to justify keeping our slock, we need to explain to him why we are in Myanmar and why this is in accordance with our ethical charier.

Retail shareholders also took a direct interest in Total's ethical policies, explained Gautier: *For retail shareholders, CSR is important, as is respecting the environment. The fact that we invest in bio diesel and solar energy renewables, for instance, is significant for retail investors. Retail shareholders want to be able to go to a dinner and say that they are proud to have invested in a socially responsible company.*

Overall, Total saw how the importance of ethical and social responsibility continued to grow. A recent example came from the kick-off meeting on the 2005 fall road show: The first question from the first analyst did *not* deal with the company financials, as normally was the case, but targeted the company's sustainable development activities.

Presenting a balanced message

Although the IR group at Total could point to a successful track record (they were, for instance, given four awards by IR Magazine in 2004, including the Grand Prize for Best Financial Communication), its coiporate communication efforts were growing increasingly complicated. The task of staying with "only one message" was more challenging than ever, especially given the large variety of stakeholders. Commented Schmitt:

How we communicate our financial results is a key issue. We want to be confident with analysts and the financial community and say, "Look how well we have done..." but at the same time, we have to be modest and show both them and others that although we did a good job we have to prepare for the future. It is all about semantics: how blunt do you *want to be? Everything has to be in the message but the fine liming happens* in the *subtleties. It is obvious that with an institutional investor we will spend more time dwelling on dividend policy. In other situations, with "g other audiences,* we *don't speak much about the dividend, only a short sentence, and £ instead* we go *deeper* on *different issues.*

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For our upcoming September road show, we know people will ask "What do you do with all your money?" We *have prepared descriptions of our investments and projects* to make *both investors and* the *public understand how difficult, expensive, and time-consuming* it is to *prepare the future of the company. Also, a number we like to emphasize is that* we *only represent 14'/(of the world's oil production, while our share* of *the oil industry investments is approximately 237r. And bv "we" I don't mean Total alone, but all the five biggest oil majors. Most production activity actually lies with national oil companies. Many I people I don't know this.*

The topic of share buybacks was also expected to come up at the road-show. In 2004. Total bought back 22.44 million of its own shares at a cost of €3.6 billion. The buybacks involved of the company's capital. For 2005. Total had announced that share buybacks would continue, adjusted for the financial environment and asset sales." [6] Commented Schmitt:

There is a real tension here: investment analysts want us to talk about dividend policy, share buvhacks, restructuring: but employees and unions prefer to hear that fatal is investing more for the future, hiring more people, etc. This is why we spend cpute a lot of time detailing our cash allocation policy, which consists first of carefully selected investments projects, then dividends and shore buvhacks, all of this with a gearing comprised between 2ffl and MY7<.

The volatile nature of oil and gas prices complicated both setting the strategy and then **communicating it. CFO Castaigne summarized the approach:**

There are really three imporiant factors when it comes to financial communication The first is that it is a long-term process. You build your reputation over time. Second, be consistent. Third, don't sell your results, sell your performance. Since we are in a business where external conditions affect us heavily, we must distinguish between the impact of the environment and our own performance. If the environment changes drastically and we cannot meet our targets, we have to be clear in our communication about the link between the target and the change. We have to sell to the market that which is under our control—for instance, costs, projects to increase production, the efficiency of our explorations, or the advantage of our technologies. But it is hard for us to guess on, say, oil taxes that countries may or may not introduce.

Castaigne then added:

You have to remember that in the life of a company, you have good times and bad times. So when reporting in good times, you have to keep in mind that tomorrow might be bad. You have to caution for things that may go wrong—because you know your own weaknesses. So over time, we have managed to self the evolution of Total compared to our targets. That builds a good capital of trust with the investors, which allows them to plan long-term, and for us this also translates into an increased share price.

Total's emphasis on a message that was consistent over time seemed to be appreciated by the financial analyst community. Wrote one analyst after Totals road show in September 2005: 'Total's mid-year review contained no major surprises and represented a continuation and extension of its successful strategy and equity story, in our view." Given that consistency, minor modifications to the overall strategy then appeared to be acceptable, as evidenced by another analyst report: "Small changes in strategic outlook we consider to be the hallmark of a high-quality major running the business for the long-term." (See Exhibit 13 for a summary of analyst reports after the September 2005 road show.)
The balance in communication between rejoicing in good results while still emphasizing the need to save for future downturns was not an easy one to strike. Desmarest said in a press interview that French critics might "have difficulty understanding the size of the company. They wonder, perhaps it is too big."[37] Expanded Howat:

In a Trench political context, vis-d-vis the trade unions and the politicians, this type of message is a hit controversial, first, in France, nobodv has ever seen a company that makes a net profit of €/ billion a month-so that immediately gets people s attention. And when they look at our level of dividend and the fad that we have typically been buying back J</<-4<7< of the company every year and in the context of France's culture and politics . . . it is not thai simple.

A surprise windfall tax?

Universitas Esa Unggul

As if to prove Howafs point, the apparent contradiction of Total's message became the focus of a debate that erupted in late 2005. On September 8. French finance minister Thierry Breton told reporters that France might adopt a windfall tax on the "exceptional profits" of the oil companies.** The government was worried that high oil prices would deter consumer spending, so Breton called on "all the actors of the oil sector" to "behave as citizen businesses and make proposals, such as one could imagine them lowering prices at the petrol pump." If not, the French state would put in place new taxation on the oil companies, in addition to the taxes that already accounted for two-thirds of French petrol prices and more than half of diesel prices.[39]

In a meeting with Breton the following week, CEO Desmarest reiterated what he had already announced at Totals "First Half 2005 Financial Results" presentation in early September: that Total would boost investments in French refineries and renewable energy research. Total would also wait about three weeks every time oil prices rose before raising consumer prices, while it would, on the other hand, immediately lower petrol prices if oil prices dropped. Although apparently satisfied with the outcome, Desmarest did tell reporters that some Total shareholders had asked the company to move its tax domicile abroad to avoid similar threats in the future. A spokesperson for the finance ministry emphasized emphatically that oil groups "should not just consider their shareholders but all stakeholders."[40]

Schmitt and the IR group at Total knew this all too well.