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Enhancing Shareholders' Value

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During my presentation, I will discuss:

- How to measure shareholder value and address a key challenge faced by a Jamaican firm in measuring shareholder value (estimating cost of equity)
- The need to have an integrated approach to create shareholder value
- An important tool “Value Map” to facilitate value creation.
- Some of the strategies adopted by a successful Jamaican company which has helped consistently in enhancing shareholder value.

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The general belief is that the purpose of a business is to increase shareholder value.

Let us first look at what shareholder value means. There are a number of ways to describe shareholder value, including:

- The value delivered to shareholders through management's ability to grow dividends and share price.
- The value of the company (Firm or Enterprise value) less debt.

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How do we know if we are creating shareholder value?

Goodyear Jamaica went into voluntary liquidation in December 2008. In 2007, Goodyear reported a profit of $13.6 million. Did they create shareholder value?

As at December 31, 2007, GY's reported equity was $470 million. A profit of $13.6 million amounted to a return of 2.9% to the shareholder. At this level of return it had the effect of destroying the shareholder value.

This is one of the deficiencies with our generally accepted accounting conventions, in arriving at profit, we deduct all costs including debt finance, but there is no recognition of the cost of equity capital.

At the time of announcing the liquidation, GY's share price was $3.26 per share which was substantially below book value. Since December 2008, GY Shareholders have already been paid interim distributions of $5.43 which means they have already received 67% more than the share price.

This should be looked at in the context that share prices for over 90% of the companies listed on the JSE trade below the peak May 2008 prices, and the highest reported gain between May 2008 and March 2011 was only 24% recorded by Seprod Limited.

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As at March 31, 2011, of the companies listed on the JSE, 69% traded below their book values.

Some companies may have to evaluate if the business can generate more value as a going concern.

Disposing underperforming units, mergers and acquisitions, and even liquidation can maximize shareholder value.

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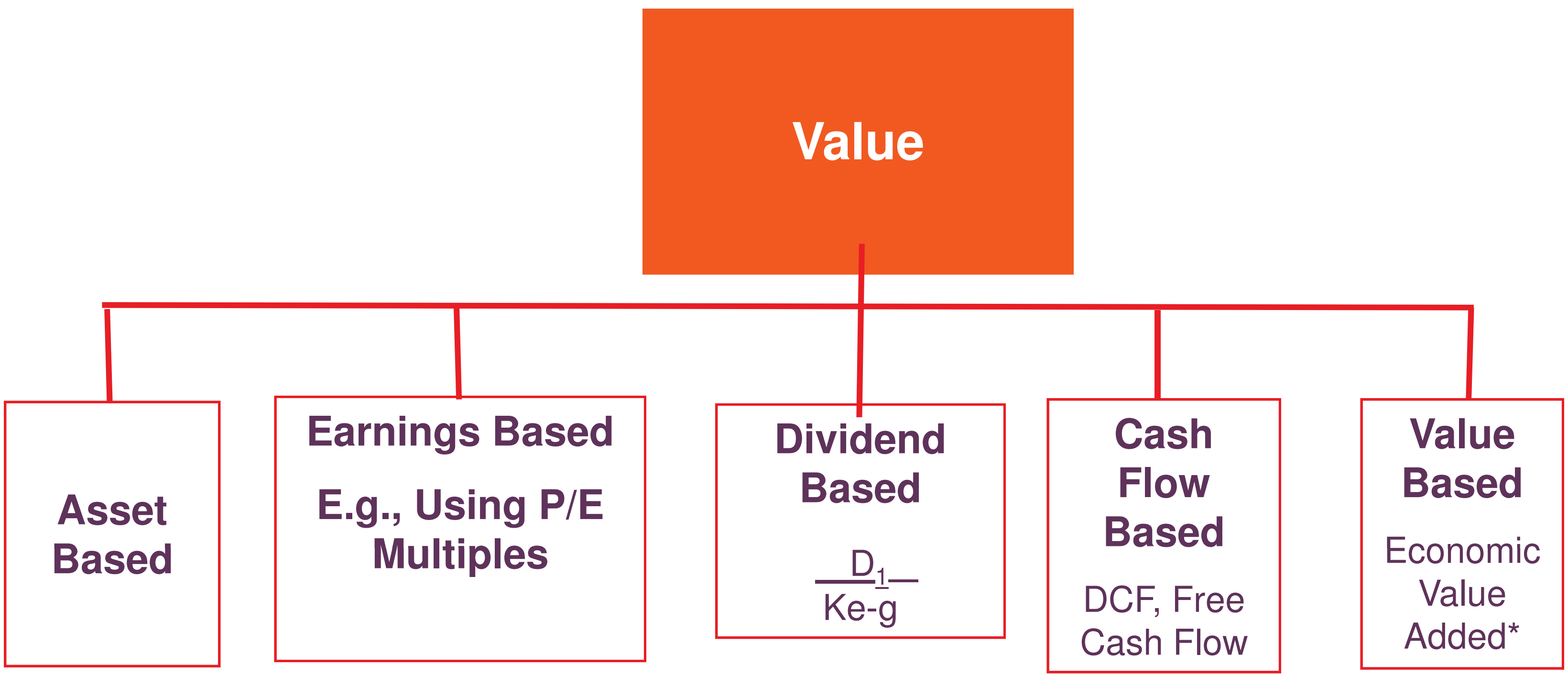
There are a number of methods used in practice to estimate value of a company.

Valuation Approaches



*Economic Value Added is a trademark of Stern Stewart & Co.

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Cash Flow Based Method is considered superior to Assets or Earnings Based methods

- If the cash flows are based on Free Cash Flows for Firm the appropriate discount rate would be the weighted average cost of capital. Estimating Weighed Average Cost of Capital requires Cost of Debt and Cost of Equity. Estimating Cost of Debt is usually fairly straightforward but estimating Cost of Equity is challenging especially for a Jamaican company as we do not have necessary published research data that is available in developed markets.

- One of the key issues for a financial manager of a Jamaican company is to determine the Cost of Equity for his or her business.

The Cost of Equity is influenced by a number of factors including:

- Riskiness of the investment
- Size of the investment
- Inflation expectations
- Capital structure/leverage

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Estimating Cost of Equity using CAPM

		%
Risk Free Rate		xx
Equity Risk Premium	xx	
Levered Equity Beta	x	
Equity Risk premium for the subject company		xx
		xx
Unsystematic Risk Factors:		
Size Premium		x
Company Specific Risk		x
Country Adjustment Factor		x
Cost of Equity		xx

- The CAMP above computation is fairly complex for a Jamaican company and heavily reliant on third party research.
- It is difficult to validate the reasonableness of the specific risk premiums derived for a subject company.
- A more practical approach to estimating Cost of Equity for a Jamaican company is the Build-up Method.

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Build-up method also starts with a base risk premium but will require plus or minus adjustments for factors such as:

- Company's industry
- Financial risk
- Diversification of company's operations
- Other operational characteristics.

Based on my experience in valuing companies for over 20 years I have found Build-up Method more useful in our environment than the Capital Asset Pricing Model.

Risk Factors

The Company's Industry

Susceptibility to economic downturns

Competition

Growth trend

Sub Total

Financial Risk

Level of gearing

Liquidity ratios

Interest cover

Receivable period

Inventory period

Earnings history

Tangible asset backing

Sub Total

The Diversification of Company's Operations

Products

Customers

Sources of supply

Geographical locations

Sub Total

Other Operational Characteristics

Management - depth and competence

Management - continuity

Marketing strengths

Labour relations

Dependence of key managers

Potential legal exposure

Contractual arrangements

Sub Total

Total

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An Integrated Approach to Shareholders' Value

Most companies in Jamaica do not have an integrated approach to create shareholder value.

I am aware of several companies that have attempted value based management with mixed results. According the Group CFO of one of the well-known privately held group of companies, main reasons for their failure in implementing VBM included:

- Failure of line managers to understand the concept as they were always busy with running day to day operations.
- Inability to translate specific activities to value creation.

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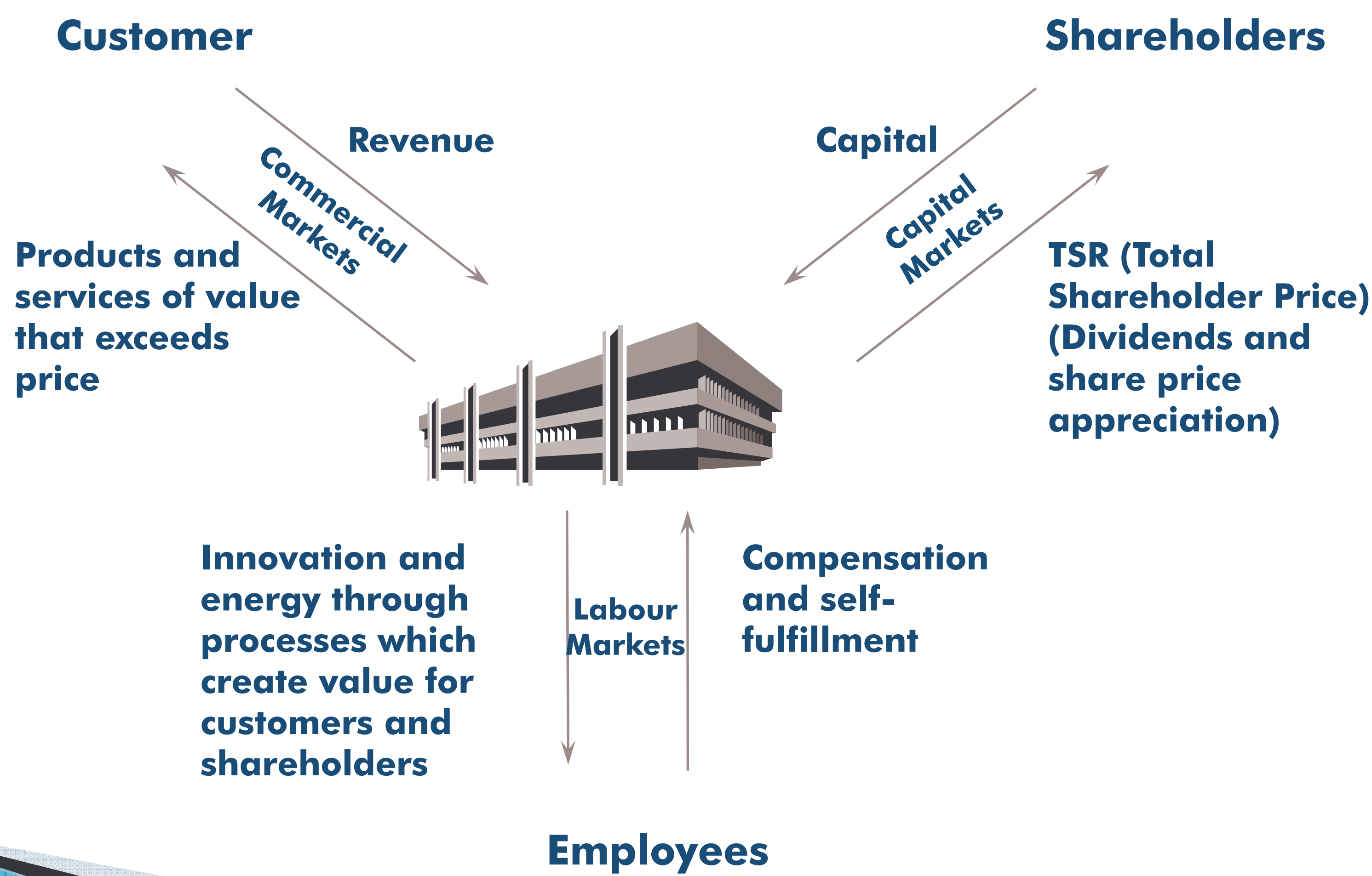
Shareholder, Customer and People Value are Inter-dependent



Value Based Management is an Integrated Management Process

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One of the key challenges faced in implementing a value based strategy is inability to translate or relate activities to value. To address this issue, Deloitte has developed Enterprise Value Map™ which is a framework that links shareholder value to various strategies and activities companies can undertake or improve on them.

The Value Map is:

- A tool to capture the relationships between the financial and operating value drivers (financial, employee and customer related) and their impacts on value creation.
- Used to test strategy options and alternatives.

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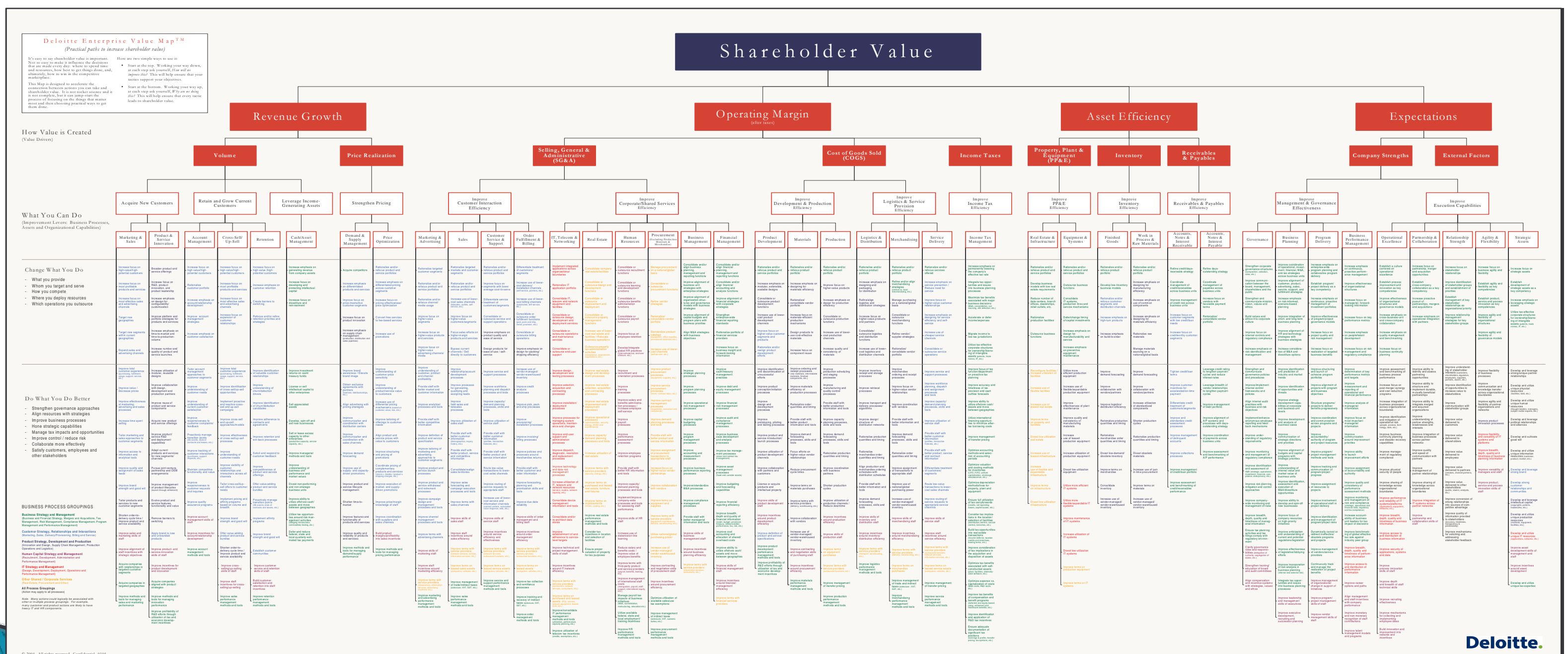
Value Map Framework

It draws practical links between:

- Strategy and tactics
- What can be done and how
- The income statement and the balance sheet
- Organizational capability and operational execution
- Current performance and future performance



The development of the map is a learning exercise in which the process of model building captures individual’s mental models of how the organization creates value.

The resulting value map allows operating managers to assess and understand the impact of operational decisions in financial terms.

This will also help focusing management action on areas that have significant leverage on value, encouraging actions and behaviours that will create value.

Deloitte has developed this Value Map based on years of experience and research on what successful companies have done to create shareholder value.

I have attempted to validate the value map to the local environment by attempting to identify value drivers of Seprod and to match them with the Value Map.

The following shows how Seprod has out-performed the JSE over the last 16 years (April 3, 2005 to April 5, 2011).

- Compound annual growth of Seprod Market Capitalization - 22.3%
- Compound annual growth in JSE index - 9.9%

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The Value Map depicts three things:

1. How Value is Created	2. What You Can Do	3. Business Process Groupings
• Revenue Growth • Operaing Margin • Asset Efficiency • Expectations	• Change What you do • Do what you do better	• Business Strategy and Management • Product Strategy, Development and Production

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- **Revenue Growth Volume**
  - Acquire manufacturing assets of Kraft Foods in 2007 with brands such as Butterkist and Ovaltine
  - Acquisition of Serge Island Dairies for ICD in 2005. Expanded range of products to generate volume
  - Continuous push for exports
  - Constantly encourage and development of new products

- **Operating Margin**
  - Rationalizing staff positions
  - Bulk purchasing for the group
  - Constantly searching for better prices by identifying alternative suppliers
  - All use the same IT platform to reduce technology and staff costs
  - Centralized payment processing, bank reconciliation, etc.

Asset Efficiency

- Bottle-making plant operates 3 shifts 7 days
- Edible oil refinery plant operate 3 shift 5 days
- Better utilization of Serge Farm assets by putting more land to pastures. It now produces about 40% of Jamaica's milk supply.
- Modernization of Serge Island
- Acquired Belvedere Estate in 2006. The estate was mainly involved in the production of mangoes and papaya but the objective of the purchase was to utilize the farm for its dairy operation while producing mangoes and papayas.
- Improved credit control have reduced bad debt expenses and improved investment income.

- **Expectations**
  - Good corporate governance: Separation of Chairman and CEO roles, active Board Committees, obtain professional advice when needed.

CONCLUSIONS

1. Making profits does not mean that you are creating shareholder value. You need to ensure that your returns exceed Cost of Capital.
2. If you are not creating shareholder value, you need to explore other options. Disposing underperforming units, mergers and acquisitions, and even liquidations can maximize shareholder value.
3. Measuring or quantifying the value creation for a Jamaican company is challenging due the difficulty in estimating Cost of Capital. If judgment is applied correctly, the Build-up Method will provide simple way of producing a fair estimate of the cost of capital.
4. Adopting an integrated approach will facilitate enhancing shareholder value. It is important for you to develop your own Value Map so that each manager will understand his or her part in the value journey.

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