Global M&A Valuation Outlook

Valuation

Transaction Consulting

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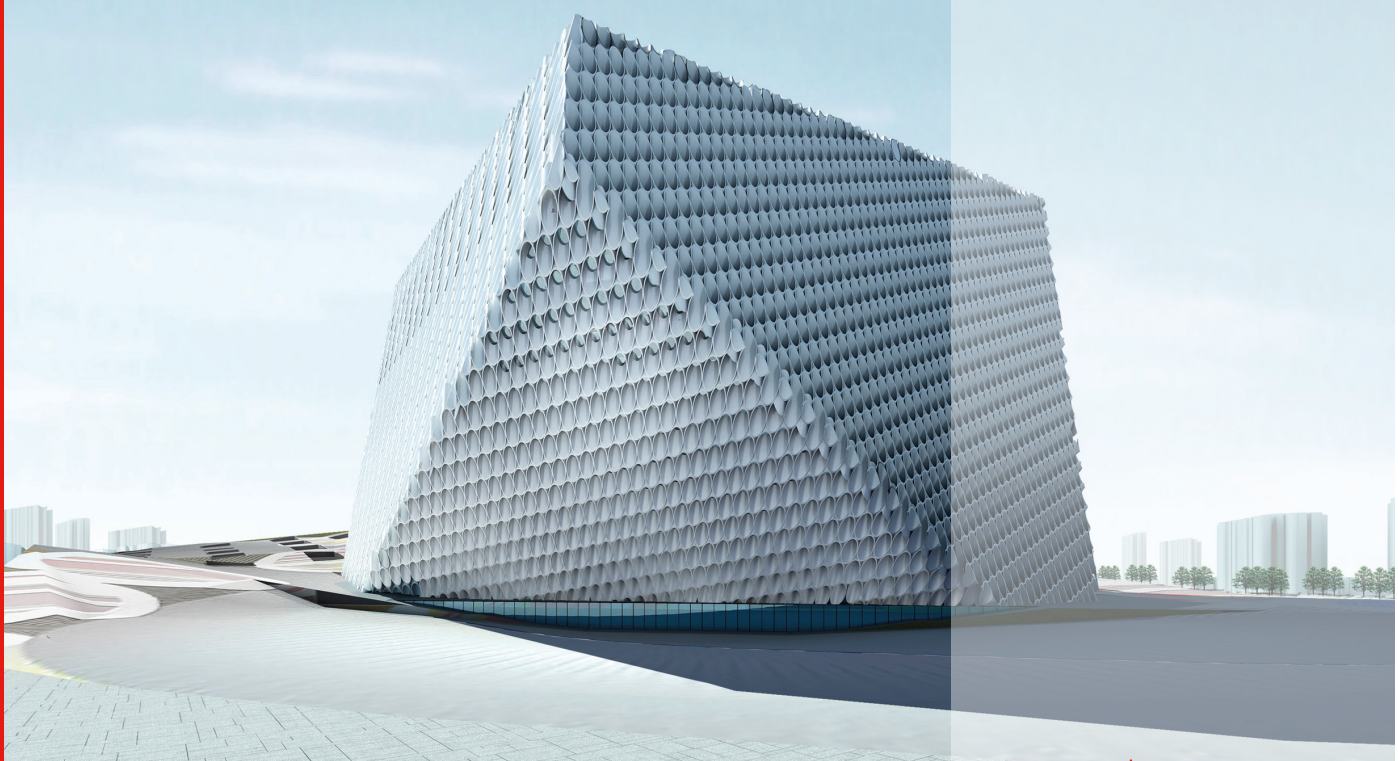

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Content

Foreword

Welcome to the first edition of American Appraisal's Global M&A Valuation Outlook, written in association with mergermarket. Our work provides us with a unique insight into the valuation assumptions inherent in a significant number of M&A transactions throughout the world. Through in-depth analysis of over 25,000 valuation data points collected by American Appraisal based on M&A data from transactions across 28 countries, we seek to unearth and evaluate the most salient trends in global M&A valuations. Drawing also on first-hand insights from our experience and discussions with clients, the report also provides a forward-looking perspective of global valuations.

This report's release comes at a time when the impact of instability in the Eurozone is jeopardizing the global economic recovery. In the absence of a lasting solution to the region's debt troubles, legislative uncertainty and financial market volatility are bringing additional stresses to the process of acquiring or selling a business. Nevertheless, as evidenced by the reduced average EBITDA multiples in the region over the past two years, the silver lining is an attractive valuation climate for Eurozone acquirers. Furthermore, successful private equity exits over the past year, such as KKR's sale of Alliance Boots to Walgreens for US$6.7bn, demonstrate that substantial returns are still achievable, even for investments undertaken at the top of the market.

Outside of the Eurozone, American Appraisal has observed generally increasing acquisition multiples with some of the highest being seen in the Technology space, where there is fierce competitive tension between buyers. Yet other industries have seen a cooling in average valuations, such as Financial Services, where larger groups continue to divest non-core assets as part of recapitalization programs.

In the Americas, the Energy, Mining & Utilities sector has seen healthy activity of late. However, heading into the second half of 2012, it seems that slipping commodity prices and worsening economic conditions have begun to take a toll, particularly in Russia and parts of Eastern Europe.

American Appraisal data and experience suggest conditions are equally challenging in the Asia-Pacific region, yet there are positive signs for the key economies. In China, monetary policy adjustment has helped to stem the decline in manufacturing output. India has its own unique set of political issues to address, yet if investor concerns over tax legislation can be overcome, reluctance to invest will quickly dissipate given the wealth of attractive targets, particularly in the Pharmaceutical, Medical & Biotechnology sector.

As we assist our clients in navigating through the challenging economic environment, the benefits of using a range of tools to help improve efficiency and mitigate risk are abundantly clear. Solutions to the challenges for deal makers range from contingent purchase price considerations which help bridge valuation gaps, to pre-empting potential post acquisition complications by harmonizing financial reporting and tax strategies.

The next 12 months will bring renewed challenges including increased investor scrutiny and continued market volatility. In addition, ongoing political turmoil across key markets will continue adding a layer of complexity and risk to deal making. Developing creative solutions to the particular regional and sector-specific challenges involved in each transaction will be key, and pursuing the right deal in the right way will become crucial.

Joseph P. Zvesper
Chairman and Chief Executive Officer
American Appraisal

Introduction

The global M&A market has been in a lull with greater reticence by dealmakers to undertake large-scale transformational deals since the midpoint of last year. Where deals are taking place, there is a preference to instead focus on safer bolt-on acquisitions and digestible plays in the middle markets. This strategy emanates in part from a desire to placate apprehensive investors. In a climate of suppressed growth and heightened uncertainty, deals are under ever more scrutiny – a trend evidenced most clearly by a number of high-profile deals rejected by shareholders last year.

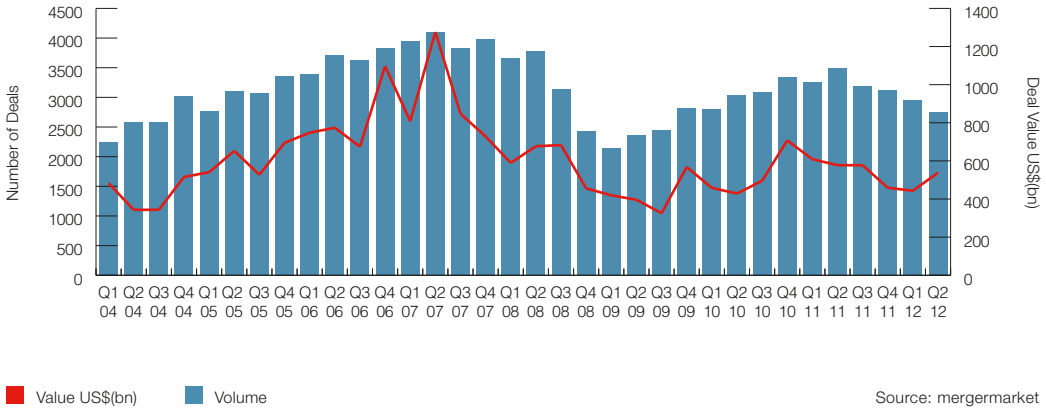
Private equity firms too must navigate the uncertain business environment and answer to their limited partner investors. The present volatile conditions confront all dealmakers – strategic and financial – with myriad challenges.

As governments respond to the shifting business climate, key factors that influence valuation trends, such as tax and interest rates, remain in flux.

In this environment, there is always a risk of miscalculated commercial decisions or a failure to pre-empt regulatory changes – both of which can be detrimental to shareholder value.

At worst, if fears materialize, they can detract from the business case underpinning a deal or

Global M&A



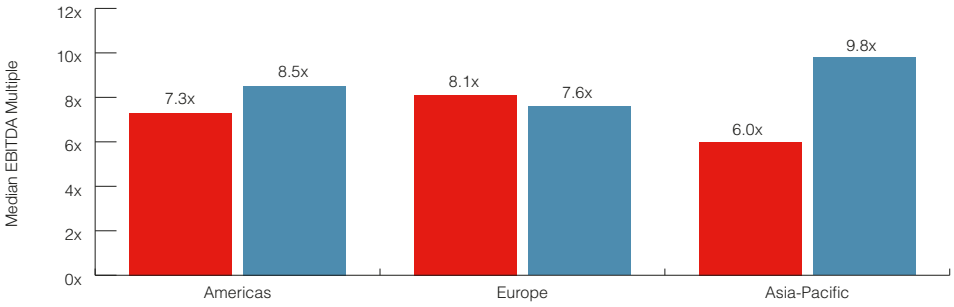
Source: mergermarket

result in costly accounting charges and perhaps overpayment for an acquisition. It is these possibilities that form the basis for investor anxiety over M&A.

Even with informed investors, the enhanced focus on mitigating risks on both sides of the negotiating table can make for a more complicated acquisition or sale process. In this regard, valuation gaps are expanding as buyers and sellers disagree more frequently over purchase price. This often extends the timeline to completion, pushes up the cost of M&A and consumes the valuable time of management teams.

Of course, volatility can also create opportunities. Better-quality targets are becoming available as companies look to divest non-core assets, often at attractive valuations. As a result, deal making will continue throughout this period of economic and political adjustment, although buyers will continue to be more aware of the downside risk.

Median EBITDA Multiple by Region



2010 2011

Source: American Appraisal

Key Sector Insights

Overview

Looking specifically at valuations, median deal multiples for earnings before interest, tax, depreciation and amortization (EBITDA) suggested the beginning of global recovery between 2010 and 2011, according to data from American Appraisal.

Private equity firms with undeployed funds and cash-rich corporates made a strong comeback in 2011 but this improvement was short-lived. The first half of 2012 saw valuations suffer as a result of persistent global economic malaise, though the valuation climate does vary considerably across different industry sectors.

Falling commodity prices not discouraging buyers in Energy, Mining & Utilities (yet)

Energy, Mining & Utilities deals have enjoyed an increase in average deal multiples despite commodities prices experiencing a general slide. This is partly driven by strategic investments into the booming Oil & Gas Extraction market in North America. This trend may lose steam as the year progresses and concerns over faltering Chinese demand filter through to impact average multiples.

According to American Appraisal data, the median internal rate of return (IRR) for Energy, Mining & Utilities deals also shrugged off commodity price volatility in 2011. A sustained median rate of approximately 14% demonstrates that buyers are still expecting attractive returns in the future. It is a positive signal that IRRs are holding steady, perhaps more so than valuations, which may have been lifted by a growing appetite for natural resources from emerging markets and the sector's solid long-term fundamentals.

Unfortunately, H1 2012 has seen M&A impacted by volatile commodity prices, such that average valuations are expected to fall in the medium-term. Particularly in Russia and the Commonwealth of Independent States, dealmakers have complained of slowing markets. Meanwhile in the Middle East, fears of supply disruptions are as acute as ever. These factors will play a significant role in determining valuations in the sector going forward.

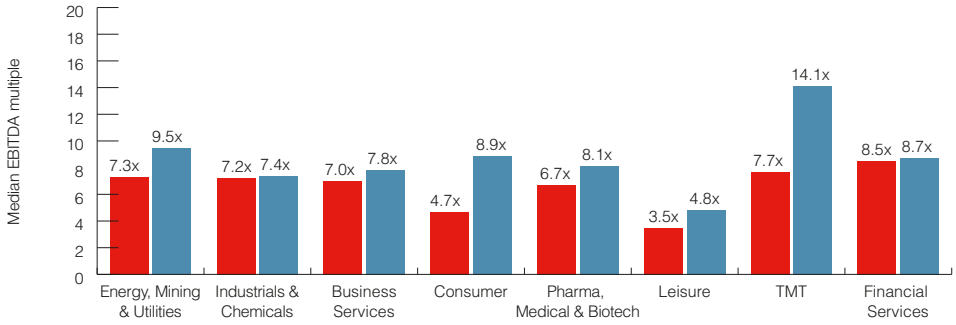
Consumer valuations strong despite uncertainty

In the consumer space, increased acquisition multiples can be traced back to macroeconomic forces. In Asia, firms are eagerly paying higher prices for companies that will benefit from the region's favorable demographics.

Growth projections in Asian economies have been a focal point for Western businesses in recent years, and strong competition for Asian assets will influence average valuations. Despite recent downward growth forecasts, businesses in the consumer space need to establish a brand and position in the market if they are to reap rewards in the long-term as new opportunities arrive.

One of the biggest challenges facing M&A

Median EBITDA Multiples by Sector



2010 2011

Source: American Appraisal

investors in the Consumer space today is the multitude of contradictory market signals. For example, after reported underperformance in Australia, an upswing in consumer spending, as well as increased mining investment, were hailed as having helped drive higher economic growth figures in the country of 4.3%. The news is, however, supported by American Appraisal's findings: some of the most attractive internal rates of return in Australia last year were found in the Consumer sector. One driver was the benefits from Australia's flourishing mining sector, which has grown through exports (particularly to China), helping to sustain employment levels and boosting consumer spending.

Looking ahead to the second half of the year, further deal making is expected across emerging markets as firms expand product lines to satisfy evolving consumer demand. This could cause companies to focus on acquiring existing brands, driving down costs and reaching more consumers through enhanced manufacturing, sales and marketing and distribution networks.

Buyers anticipate margin contraction in the Consumer, Financial Services and Technology sectors

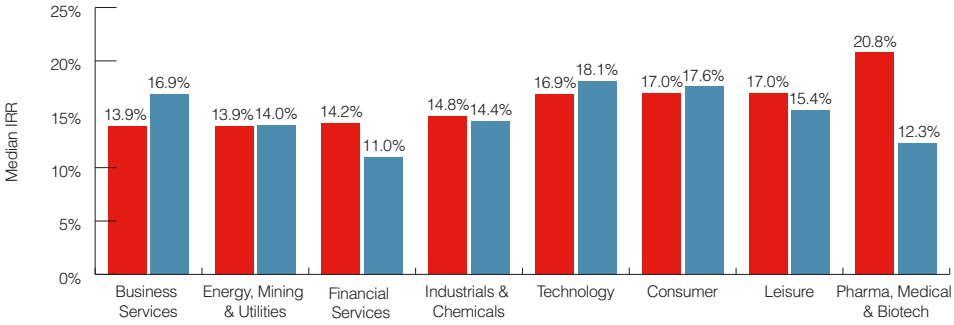
Higher average revenue CAGRs compared to average EBITDA CAGRs across the Consumer, Financial Services and Technology sectors imply that buyers in these spaces are expecting margin contraction in the years ahead. A range of factors can be seen as driving these expectations. Many areas of the Consumer and Technology industry are experiencing increasing competition, especially in the fastest growing product areas and territories. Particularly for the Technology space, the need to invest more heavily in innovation could be another key reason for anticipated margin contraction. Meanwhile in Financial Services, regulatory reform will mean substantial ongoing costs, placing significant added pressure on profit margins.

Despite the negative implications of these expectations, average Revenue CAGR figures appear healthy across all of the aforementioned sectors especially in Financial Services and

Valuation Trends and Outlook:

- Energy, Mining & Utilities sector holds up against volatile commodity prices
- Industrials & Chemicals valuations firm up but future unclear
- Median IRR drops for Pharma
- Telecom, Media and Technology (TMT) valuations steal limelight

Median Internal Rate of Return by Sector

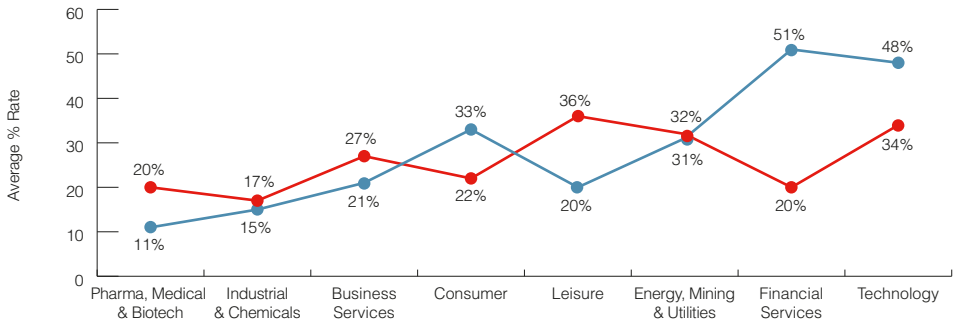


2010 2011

Source: American Appraisal

Key Sector Insights

Average of EBITDA CAGR and Revenue CAGR by sector in 2011



Average of EBITDA CAGR Yr1 to Yr 5 — Average of Revenue CAGR Yr1 to Yr 5

Source: American Appraisal

Technology. This goes some way to explain why anticipated margin contraction is not dissuading buyers from making acquisitions.

Technology, Media & Telecom remains a bright spot

Overall, TMT multiples have reflected the sector's resistance to the global M&A downturn. American Appraisal saw particular buoyancy across the space in 2011, with average acquisition multiples outshining other sectors. Ongoing technological innovation, regional demand shifts and growth in certain segments like social media are driving up valuations, as global players compete in a cut-throat market. Facebook and Skype are two examples of TMT companies whose high valuations caused a stir in the markets.

American Appraisal data shows that average technology EBITDA multiples nearly doubled in 2011 compared to 2010. This is partly driven by the particularly high revenue growth projections (average 48% in Technology) of the businesses American Appraisal worked with in 2011. It also reveals the resilience of the TMT space, where ongoing innovation and growth continue to give rise to high acquisition premiums.

In subsectors like technology and software, higher levels of risk are offset by the potentially large payoffs. Cloud technology has seen the strongest growth projections, whereas more mature areas such as telecommunications are seeing ongoing consolidation, although, following last year's antitrust blockage of the US$39bn AT&T merger with T-Mobile USA, major operators in mature markets may look to focus more on deals motivated by diversification or expansion overseas.

Ambitious growth projections are one thing, but recent months have seen high prices paid for assets yet to generate a single dollar of revenue. Instagram, for example, with zero revenues, was bought for US$1bn by Facebook. Fears of another technology bubble are widespread: buyers have learned tough lessons from the past and are applying greater scrutiny to tech purchases, though in a sector known for innovation there will always be an unavoidable layer of risk.

'The methodologies for valuing the present generation of media companies are in place; they're a lot more sophisticated than ten years ago. The question is whether the prices that buyers are paying for some recent acquisitions has reflected the value.'

Michael Weaver, Managing Director, UK & Middle East

Industrials & Chemicals valuations see mild improvement

Over the past two years, the proximity of average five-year EBITDA and revenue growth rates in the Industrials & Chemicals space suggests that benefits other than synergies are driving acquisitions. With large amounts of cash still sitting on corporate balance sheets, especially in North America, moving to new territories or product lines as well as expanding market share may have been more prominent strategic drivers.

While this suggests that attitudes are becoming less defensive, median EBITDA multiples in Industrials & Chemicals stayed approximately flat between 2010 and 2011, while most other sectors saw a significant uptick. This reflects the slowdown the sector is experiencing globally. If business confidence slips further, then cost-cutting tactics are expected to come back to the fore, and M&A will be a key part of this. With increased divestitures and non-core asset sales, average valuations could fall.

Returns dip in Pharmaceuticals, Medical & Biotech

In Pharmaceuticals, Medical & Biotech, American Appraisal observed a more than 20% increase in median EBITDA multiples over the past year; despite widespread concerns over patent-cliffs, growing cost pressures and reimbursement uncertainties.

Global pharmaceuticals firms with established sales and marketing capabilities but lacking exciting pipeline drugs are rebuilding these through M&A. This strategy is becoming more prominent given the heightened risk and reduced opportunities around early-stage R&D.

American Appraisal's data suggests that firms in this sector are achieving significant cost-synergies, with (on average) five-year EBITDA growth 9% higher than revenue growth for deals completed in 2011. While greater synergies ought to translate into higher valuations, there are complications which may prevent this trend from materializing.

Partly as a result of increased average valuations, the median IRR that American Appraisal observed across Pharmaceuticals, Medical & Biotech deals dropped from 20.8% in 2010 to 12.3% in 2011. While this provides only a clue to what is happening in the broader industry, it does also comport with widespread expectations of reduced rates of return, given that blockbuster drugs are becoming scarcer with each passing year. At the very least the decline in median IRR tells us something about the wide divergence of valuations in the sector, between, for example, high-return biotech assets and generics manufacturers with greater scale but tighter margins.

Debt is a four-letter word

One of the drivers behind the general recovery in valuations has been companies' aggressive efforts to pay down debt and build up cash reserves. This can be seen across almost all sectors where American Appraisal operates, apart from business services, where firms have maintained a relatively low level of average debt to total capital (11%). Aptly, one of the greatest changes has taken place in the Financial Services space, where average debt to total capital has come down from 17% to 11% between 2010 and 2011.

Efforts to reduce debt will likely continue to drive disposal activity. Furthermore, distress-related deals are likely to remain a prominent feature of the M&A landscape, particularly in Europe if the crisis worsens. However, when looking at healthy assets, buyers

'Revenue synergy is a key driver for pharmaceutical acquisitions. Large pharmas with substantial sales forces can push acquired launches into the market; whereas in emerging markets acquisitions result in a hub for the distribution of existing products. That said, we do not expect this to drive pharma multiples up. Instead, the achievable sale-price is influenced by a number of other factors, including the scarcity of buyers for targets with a diversified product portfolio, as well as tight credit markets.'

Ingo Schneemann, Managing Director, Central & Eastern Europe

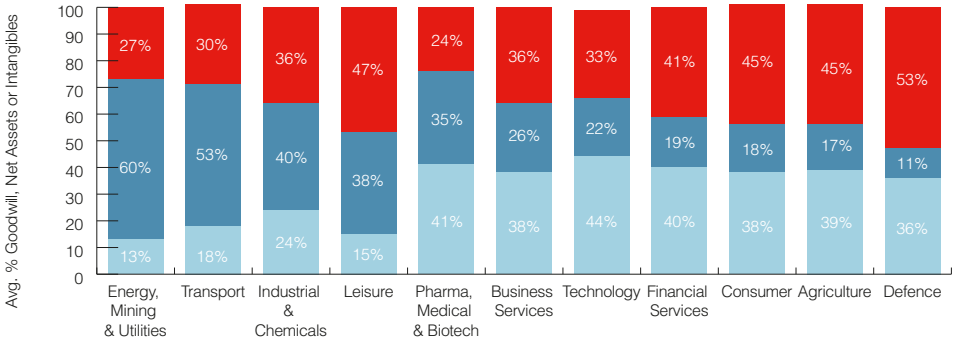
Key Sector Insights

should take care not to be dissuaded from acquisitions merely because the target has a seemingly 'high' debt to total capital ratio. An efficient capital structure includes an amount of debt, and acquiring a business with attractive revenue growth rate projections or strong synergy potential could make taking on the debt worthwhile. Be they distressed or technically healthy businesses, a number of potentially ideal targets in the market at present will have substantial debt obligations. Buyers who are comfortable assuming these liabilities will have access to the broadest range of acquisition prospects.

The return of goodwill

It is broadly believed that because of impairment testing during the economic downturn, companies wrote off much or all of their goodwill from prior acquisitions. An examination of recent transactions indicates goodwill is returning to the balance sheets of acquirers. The return of goodwill is broadly a positive development, suggesting healthier valuation levels and greater recognition of the potential upside of acquisitions. Nevertheless, ongoing uncertainty and in some regions worsening economic conditions will mean continued scrutiny from investors, just as business leaders will be wary of overpaying for deals.

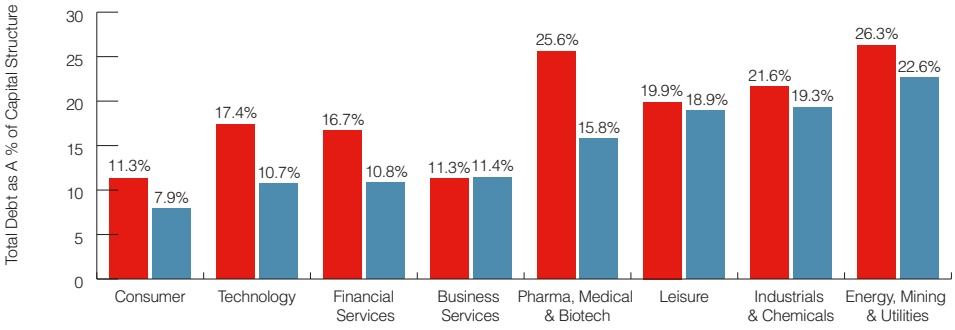
Average of Goodwill, Net Assets and Intangibles by Sector (2010 and 2011 combined)



Average of Intangibles as % of Purchase Price
Average of Net Asset as % of Purchase Price
Average of Goodwill as % of Purchase Price

Source: American Appraisal

Average of Debt to Total Capital by Sector



2010 2011

Source: American Appraisal

Americas

M&A overview

The first half of 2012 saw 2,031 deals worth a total of US$156.4bn in the Americas, marking declines of 18% and 31% in volume and value, respectively, compared to the same period last year.

Much of the decline in activity in the region is attributable to a slowdown in the US, the world's largest M&A market, where from H1 2011 to H1 2012 there was a 19% decrease in volume and a 40% decrease in value. Weakening business and consumer confidence suggest this may continue, with average valuations likely to be affected as a result.

Canada remained resilient in the first quarter, with deal flow increasing 19% year-on-year in Q1 2012, while value more than doubled. This reflects a rush of activity in natural resources, as new deposits are unearthed and companies seek to grow extraction, refining and ancillary activities. Unfortunately, the second quarter was hit by sliding commodity prices: Canadian M&A in H1 2012 finished down in volume and value by 16% and 10% compared to the same timeframe in 2011.

In contrast to North America, where M&A activity slowed between the first and second quarters, Central & South America saw deal volume and value increase in this period by 14% and 8%, with 154 deals announced in Q2 2012 worth US$41bn. The ongoing buoyancy mirrors foreign companies' appetite for growth in emerging markets.

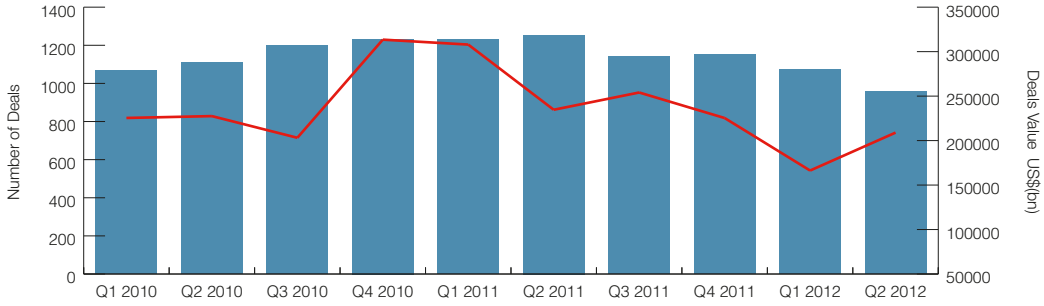
Valuation Trends and Outlook:

- Deal multiples falter after strong recovery in 2011
- Uncertainty and lack of visibility drive earnouts
- Businesses focus on growth rather than cutting costs
- More buyers pre-empt transfer pricing complexities

Anheuser-Busch InBev is one of the most high-profile examples, having cemented its position as a leading global brewer by executing the US$20bn acquisition of the remaining stake in Mexico-based Grupo Modelo that it didn't already own.

The combined company now occupies a coveted position in the beer industry, and the deal boasts an impressive US$600m in synergies. This helps to explain the 13.6x EBITDA multiple. Furthermore, Anheuser-Busch's access to relatively low-cost financing allowed it to use US$14bn of debt, helping to wring further value out of the deal.

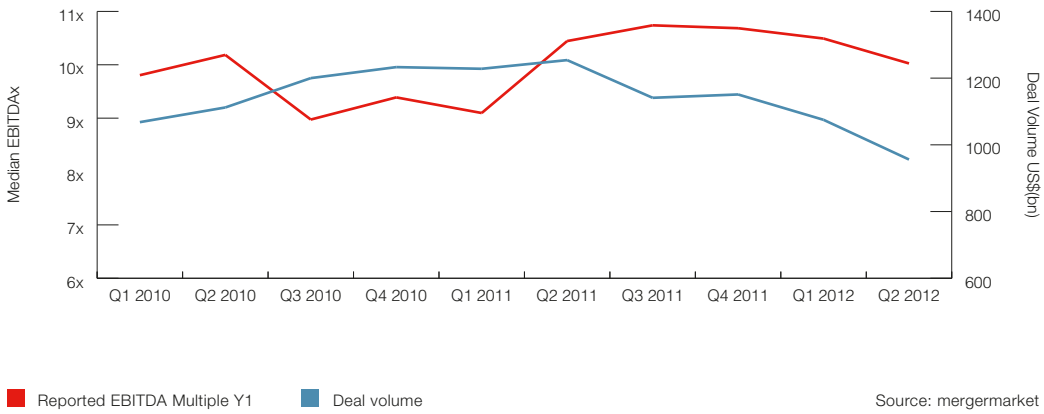
Americas M&A



Deal Value US$m Number of Deals

Source: mergermarket

Americas Deal Volume & EBITDAx Performance



Source: mergermarket

Average multiples dip in H1 2012

According to mergermarket, across the Americas median EBITDA multiples registered 9.6x in H1 2012, down from 10.7x in H1 2011. Trends over the past two years show acquisition multiples in the Americas were down substantially in 2010 with median EBITDA of 9.5x before a significant recovery in 2011 (median 10.3x). During the first six months of 2012, the challenges facing the global economy have expanded rather than dwindled, which explains the correlation between declining EBITDA multiples and declining M&A in the Americas.

Cost synergies no longer the deciding factor

Average five-year EBITDA and revenue compound annual growth rates (CAGR) inherent in transactions services performed by American Appraisal over the past two years reveal evidence that projected cost synergies for deals in the Americas have been lower than Europe in 2010 and 2011, suggesting that businesses have been more confident expanding into new areas rather than pursuing cost-savings on their core operations.

American Appraisal observed an average five-year EBITDA CAGR in the Americas of 18% in 2010 rising to 20% in 2011, with average revenue CAGR of 16% in 2010 rising to 18% in 2011. In 2012, a shift is anticipated, as more businesses look for highly synergistic opportunities in the face of continued volatility. Across all sectors, large businesses will look to acquire smaller peers, with the potential targets coming from those being restrained by the difficult financing environment.

Contingent purchase considerations on the rise in the middle market

Buyer-seller valuation gaps have been a key feature of the market over the past few years. Creative financing methods – particularly the use of vendor financing – have grown more popular as a result.

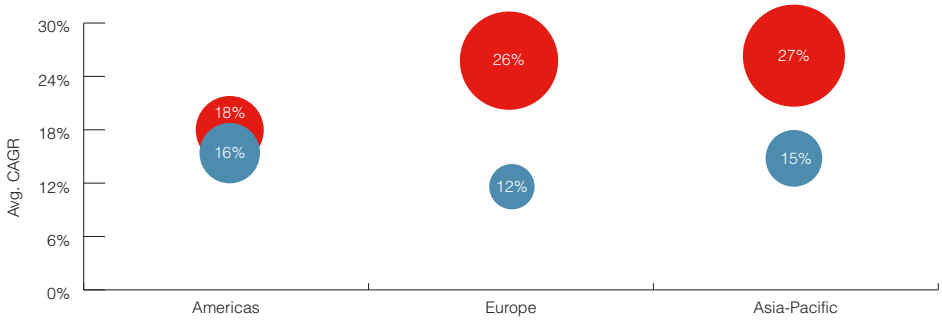
Mostly common for deals valued below US$250m, American Appraisal has observed earnouts becoming an ever more popular way to bridge valuation gaps. Especially in the US and Europe, price disagreement is becoming more common, with buyers expecting to pay distressed prices whereas sellers believe that their assets are

'Many of the deals I've worked on have included earnouts, with more and more buyers now effectively waiting to see if sellers' EBITDA projections are realized, then rewarding them accordingly when they are.'

Nancy Czaplinski, Managing Director, USA

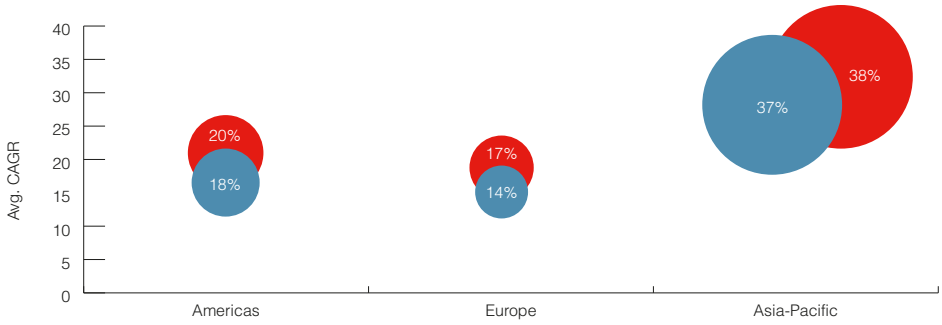
Americas

Average of EBITDA CAGR and Revenue CAGR by Region in 2010



Average of EBITDA CAGR Yr1 to Yr 5 Average of Revenue CAGR Yr1 to Yr 5 Source: American Appraisal

Average of EBITDA CAGR and Revenue CAGR by Region in 2011



Average of EBITDA CAGR Yr1 to Yr 5 Average of Revenue CAGR Yr1 to Yr 5 Source: American Appraisal

'Contingent purchase price arrangements or earnouts are still an evolving area, and utilizing them involves some additional financial reporting complexities. However, matters surrounding the way transactions are accounted for shouldn't detract from the business case behind the structuring of a deal.'

Nancy Czaplinski, Managing Director, USA

intrinsically more valuable than the market implies. By agreeing on a contingent purchase price, the seller of an asset has the opportunity to be rewarded if their business performs as they expect, whereas the buyer is protected from potentially overpaying. In an uncertain economic climate, earnouts are an ideal way for sellers to achieve a full valuation of the business. Depending on the individual case, a contingent purchase price can also be used to incentivize and retain key management. Furthermore, deferring some portion of the payment acts as a form of financing for the buyer of an asset, effectively allowing them to finance a deal with future cash flows. This is particularly useful at a time when banks are increasingly careful about lending cash for acquisitions.

With the benefits of using earnouts come challenges. They must rely upon a reliable legal framework, hence their predominant use in mature M&A markets. Also, great care must be taken to ensure full transparency between each party's accounting definitions. In order to avoid any post-completion disagreements, potential conflicts over strategy or performance metrics need to be pre-empted.

Regulatory developments have added to the accounting complications that often arise from earnouts. Whereas in the past, earnouts were recognized under US GAAP upon payment of the contingent consideration, a change in US accounting standards in 2008 means that acquirers are required to estimate the fair value of earnouts in the purchase price allocation (PPA) at the acquisition date, and to refresh this valuation at each reporting date. In spite of the complexities, contingent considerations are increasingly being included in deal terms, driven by ongoing volatility and the scarcity of debt financing.

Pre-empting complexities: Transfer Pricing

Sovereign debt crises are still playing out as certain European nations struggle to balance their books, so the tax implications of a deal are not far from every buyer's mind in today's market. In this respect, multinational businesses are increasingly aware of the potential transfer pricing implications of purchase price analyses. Assessment of transfer pricing issues has become a key feature of any thorough due diligence process, or when planning M&A further down the road.

Failing to ensure that the PPA is aligned with transfer pricing plans can lead to costly mistakes. As such, achieving synergies between a PPA and post-transaction transfer pricing issues can also integrate the target into the buyer's existing tax strategies.

'Clients are taking acquisition matters one step further now. Going beyond just the financial and tax reporting aspects of a transaction they are increasingly cognizant of the symmetry between purchase accounting and post-acquisition transfer pricing and our ability to help them.'

Richard Siladi, Managing Director, USA

Europe

M&A overview

In the first half of 2012, 2037 deals were announced in Europe worth a total of US$333.3bn, representing 21% less value and 27% fewer deals compared to the first half of 2011. This suggests remarkable resilience to the storm brewing across the region, which is the epicenter of an unprecedented liquidity crisis.

Things are worsening this year, however, as the sovereign debt crisis continues to hamper capital raising conditions, stock market volatility erodes shareholder value, and the tough business climate necessitates cautious profit forecasts for many European firms. The M&A landscape will continue to come under serious pressure as a result, with buyer uncertainty rising and many would-be sellers waiting for things to improve before beginning sale processes.

Demand for assets has already fallen enough to have a serious impact. Average valuation multiples in Europe fell between 2010 and 2011– even for the highest-quality assets. Median EBITDA multiples for deals American Appraisal advised on in Europe slid from 8.1x in 2010 to 7.6x in 2011.

Divestitures ongoing, but goodwill impairment looms

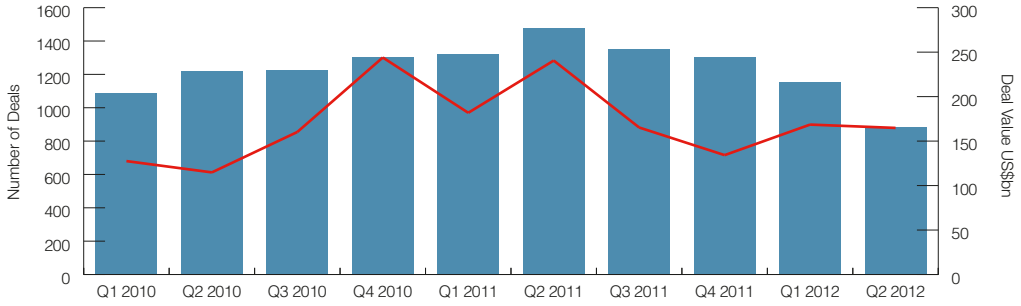
Although valuations are down and the persistent volatility of the stock market makes for a bleak exit environment, assets will still be coming to market as a result of corporate divestitures. While some European firms have been successful in recapitalizing, many firms operating in the industries hit hardest by the recession are still struggling under large amounts of debt. At the same time, multinationals continue to retreat from foreign or non-core markets – leaving behind opportunities for strategic acquirers.

Non-core disposals have already fueled some of the year's largest M&A deals in sectors like Financial Services, Pharmaceuticals and Energy & Resources, which house some of the world's largest conglomerates. A recent example is Norwegian company Statoil's US$2.8bn sale of its retail division Statoil Fuel and Retail to Canadian firm Alimentation Couche-Tard. An even larger example from the consumer space is the €9bn sale of Pfizer's infant nutrition unit to Switzerland-based Nestlé.
The current trend towards portfolio re-balancing and non-core disposals has been characterized by concerns about goodwill impairment charges.

Valuation Trends and Outlook:

- Valuations likely to remain suppressed in foreseeable future
- Impact of goodwill impairment charges
- Fiscal pressures put tax in the spotlight
- Borrowing costs creep ever higher

European M&A



Deal Value US$(bn) Number of Deals

Source: mergermarket

The risk of such charges is heightened because of depressed market conditions, which are causing management teams to reduce their expectations for future operating performance.

One of the most recent examples includes Thomas Cook, which agreed to sell its Indian business in May to the Indian subsidiary of US investment firm Fairfax for US$150m, reported a goodwill impairment charge of approximately US$500m. However, the fact that Thomas Cook is considering further disposals suggests that firms are keen to push on with M&A aspects of their recapitalization strategies despite potential accounting charges.

Privatizations to continue despite market gloom

Although many governments that had planned privatizations in 2012 have delayed them, some will be pushing ahead, depending on the severity of their debt burden. Greece is expected to announce up to four flagship privatizations in the second half of 2012, beginning with the auction of Hellenic State Lotteries; gas giant DEPA, Hellenic Horseracing and EYDAP (Athens Water) are also expected to come up for sale over the course of the next 12 months.

American Appraisal served the Netherlands and Dutch Ministry of Health and the Ministry of Finance as lead advisor in its divestiture of the production activities and facilities of the National Vaccines Production, known as NVI, and advised on developing a suitable transaction structure and sales process.

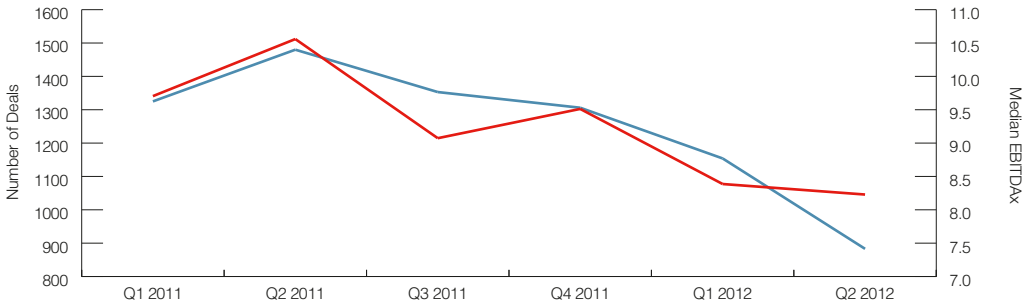
Divestitures and privatizations could present a lucrative opportunity to strategic acquirers, as well as private equity investors. Many of these deals could be completed at a discount to the target's share price, presenting attractive opportunities for foreign buyers.

2012: Year of the Strategic Acquirer

In H1 2012, private equity buyout volume and value were down 28% and 13%, respectively, compared with H1 2011, and exits fell 29% in volume and 43% in value over the same period to reach 153 worth US$38bn. This at least partly reflects the lingering gap between buy-side and sell-side price expectations, and broader concerns about economic growth in some of Europe's largest M&A markets.

Nevertheless, there are some private equity portfolio businesses that will garner attractive valuations from cash-rich corporate buyers seeking M&A-fueled growth in the next year. A case in point from the year so far is Alliance Boots, a portfolio company of KKR since 2007, which is to be acquired by Walgreens in a two-phase deal that will double KKR's initial outlay. This transaction demonstrates that successful exits are possible despite concerns over the last private equity investment cycle and that trade exits could prove to be the ideal exit route.

Europe Deal Volume & EBITDAx Performance

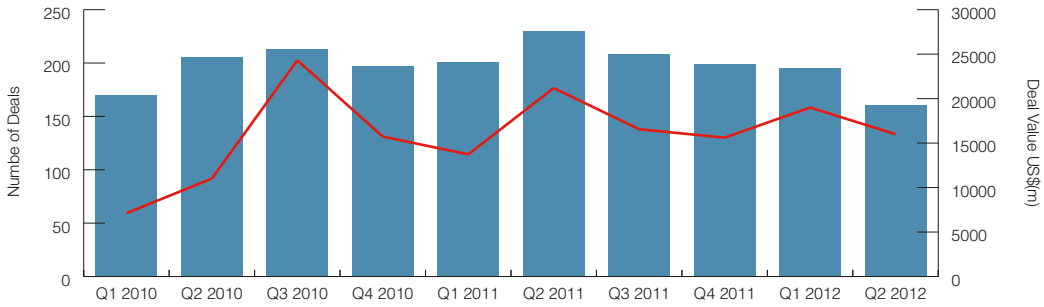


Median EBITDAx Volume

Source: mergermarket

Europe

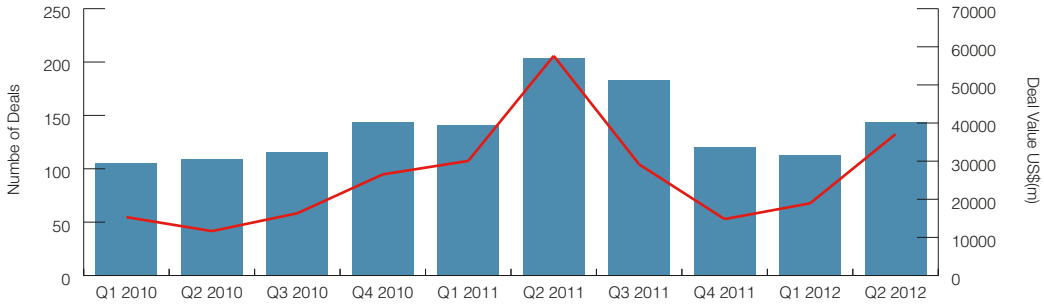
European Buyouts



Deal Value US$(bn) Number of Deals

Source: mergermarket

European Exits



Deal Value US$(bn) Number of Deals

Source: Mergermarket

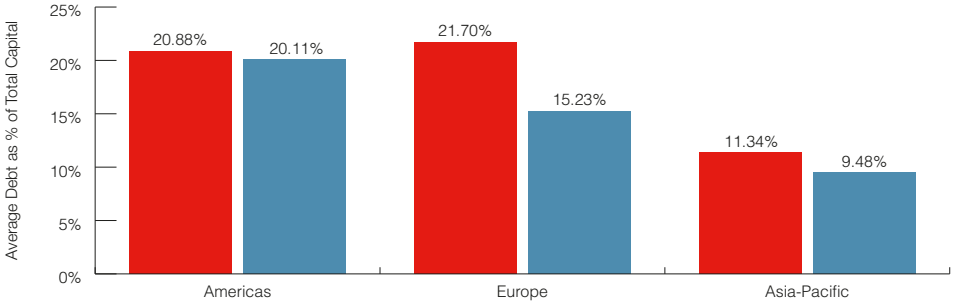
Heightened uncertainty

Buyers will always line up in force for the right asset, especially if there is an obvious strategic rationale – the Alliance Boots deal is a good example of this in Europe as it aligns with the buyer's geographic expansion strategy. But these are exceptional cases, and in the broader M&A market there is still a major undercurrent of uncertainty and long-term sovereign debt concerns. Against this backdrop, buyers have sought methods to reduce the risks associated with acquisitions in European countries. Incorporating a contingent purchase price has been a key tool in this respect. Earnouts and conditional deferred payments offer a solution to short-term volatility, and they can also benefit the seller by mitigating the effect of the risk-averse atmosphere on the sale price.

'With the long-term business outlook clouded by uncertainty, determining the terminal value has become a more challenging exercise.'

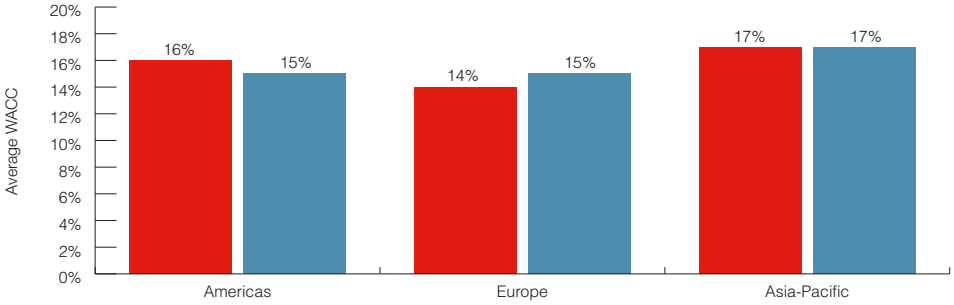
Erwin Votteler, Managing Director, Spain and South America

Average of Debt to Total Capital by Region



2010 Average of debt: Total Capital 2011 Average of debt: Total Capital Source: American Appraisal

Weighted Average Cost of Capital (WACC)



2010 2011 Source: American Appraisal

Concerns over tax exposure

Ongoing uncertainty has also raised concerns about the tax implications of M&A deals. With the tax environment fluid across many European countries, there is reduced visibility on projected tax exposure. This has magnified the attention being paid to the quantification of assets in PPAs. Accurately determining the value of intangible assets and goodwill continues to be of significant importance.

Rising cost of debt

European companies have enacted drastic debt-reducing initiatives. As revealed by American Appraisal data, the average debt to total capital in Europe fell from 22% to 15% between 2010 and 2011.

Damaged business confidence has been a key driver, with many businesses opting to pay down debts rather than invest, because they are uncertain about commercial prospects going forward.

Another key driver for reducing debts is the increased cost of borrowing. While the WACC (average weighted average cost of capital) across deals American Appraisal advised on last year remained fairly flat, the average cost of debt (after tax) rose to 4.9% from 4.4% in 2010. This comes in spite of government initiatives to improve liquidity conditions. This dynamic could make it difficult for companies to access the capital required for acquisitions, leading to a dip in demand for assets.

Asia-Pacific

Valuation Trends and Outlook:

- Businesses uphold strong growth projections despite declining confidence
- Regulatory issues cloud Indian market
- M&A a key tool in Japan's recovery
- Slowing IPO market in China could impact valuations going forward

M&A overview

After a robust performance in the first three quarters of 2011, deal making across the Asia-Pacific region has fallen in step with weaker economic growth and global market volatility. The first half of 2012 saw 1,146 deals worth US$183bn transacted, which marks declines of 32% and 14% in volume and value. However, while M&A markets have clearly been impacted by reduced demand for assets and increased volatility, broadly speaking, valuations have held firm.

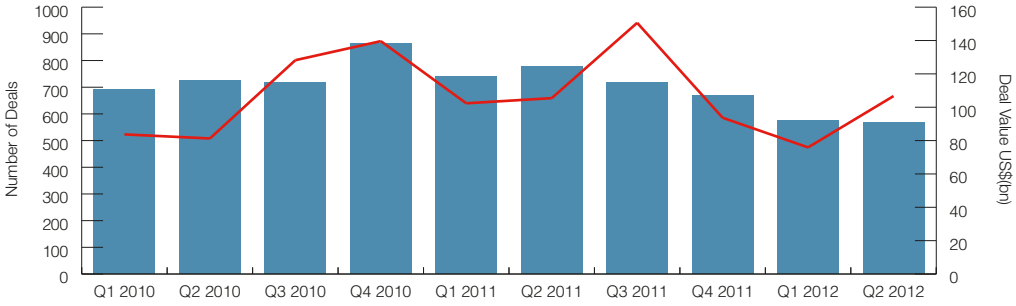
Looking at median EBITDA multiples for M&A in the Asia-Pacific region reveals that valuations increased over most of 2011, falling only in the final quarter of the year. The first half of 2012 saw a rebound in average acquisition multiples, with median EBITDA multiples rising to 9.6x, up significantly from the median of 7.9x observed in Q4 2011.

There is good evidence that buyers are still willing to pay for high-growth assets. In 2011, American Appraisal observed average EBITDA and revenue CAGRs of 38% and 37%, respectively. This also reveals that even amid widespread fear and uncertainty, there remain opportunities – or at least expectations – of achieving excellent returns.

In many Asia-Pacific countries, global economic malaise has magnified local difficulties. Japan faced the greatest trial, dealing with the damage caused by the earthquake and Fukushima crisis last March. While the increased risk level pushed up the cost of capital, deal making continued nonetheless, as a central tool used by business leaders to move forward and particularly to rebuild supply chains. As businesses in Japan invest more of their cash reserves, valuations will be positively influenced.

The picture is different in India, where valuations are coming under pressure from increased borrowing costs and ongoing regulatory obstacles. Over the past two years, American Appraisal has observed on average a WACC of 16% in India. Most believe conditions will improve in the medium-term, yet much depends on the government. Hopefully, under mounting pressure to provide positive economic leadership, they

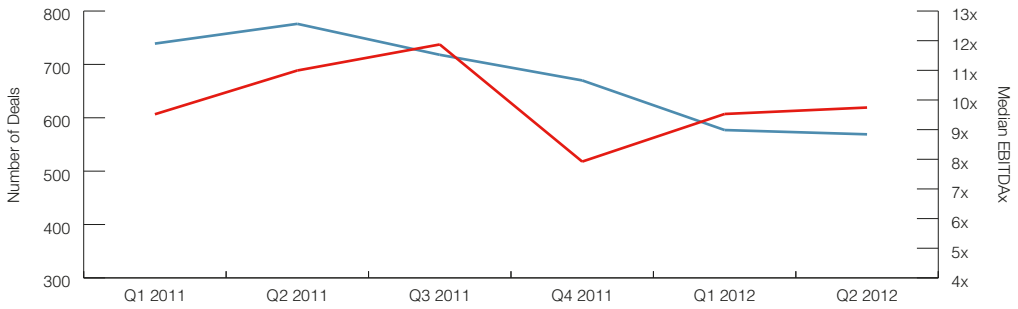
Asia-Pacific M&A



Deal Value US$(bn) Number of Deals

Source: mergermarket

Asia Deal Volume & EBITDAx Performance



Median EBITDA Multiple (across deals where reported) Number of Deals Source: mergermarket

will move decisively to address any regulatory uncertainty which may hinder deals.

In Australia, the economy is proving sensitive to global economic strain. The most positive news can be found in the mining sector, where foreign investors, particularly from China, have been keen to make acquisitions. The high IRR for Australia can partly be explained by anticipated returns from strategic mining acquisitions. Going forward, valuations in this sector could lose some of their steam, especially as Chinese buyers seek to negotiate more aggressively.

Overall, a highlight over the past 12 months has been the rise in outbound acquisitions by Asian acquirers. As Europe's crisis deepens, buyers from robust economies such as China are in strong negotiating positions, and could purchase potentially lucrative assets at attractive valuations. This activity will continue to be strong in the energy space, and is expected to grow further in the Consumer industry.

Looking ahead, valuations in Asia-Pacific are likely to continue to be impacted by lingering uncertainty and concerns over growth. Although it looks as though growth rates are reaching the bottom across the region, M&A practitioners have begun to accept heightened volatility as an ongoing challenge that is unlikely to pass quickly.

Dynamic valuation environment in China

Valuations in China have come under increasing pressure as growth slows in line with suppressed exports. However, concerns over the slowdown may be allayed in the second half of 2012 as the government aims to stimulate domestic demand in line with the twelfth five-year plan.

Q1 & Q2 2011 – Q1 & Q2 2012 Comparison

	Volume	Deal Value US$bn	Avg Deal Value US$m	Median EBITDA Multiple
Q1 11	739	102.4	179.3	9.5x
Q2 11	776	105.4	164.5	11.0x
Q1 12	577	75.9	170.6	9.5x
Q2 12	569	106.7	232.9	9.7x

Source: mergermarket

Asia-Pacific

Encouragingly, the evidence shows that Chinese M&A targets retain the positive characteristics expected of assets in emerging markets. The average internal rate of return for transactions advised upon by American Appraisal was 19% in 2010 and 18% in 2011. The average EBITDA CAGR for Chinese deals was 36% in 2010, rising to 42% in 2011, illustrating the high earnings growth that is still achievable from making acquisitions in the region. Less tangible factors are also affecting average deal multiples. In recent years valuations have been driven upwards as an indirect result of China's highly active IPO market. For private companies, the prospect of a high valuation from the market drives expectations for a more competitive purchase price. Private equity buyers have been known to make acquisitions with the knowledge that they can make a swift return simply by exiting their investment via an IPO.

Still, China is not immune to global economic forces, and in the first few months of this year IPOs have slowed in line with widespread uncertainty. In the first five months of 2012, just 3% of all IPOs in North Asia have been IPO exits, compared to 7% last year, and 11% in 2010. In addition, gaining approval for an IPO in China remains challenging. As a result, these conditions could usher in a narrowing of the valuation gap, as sellers consider accepting less cash for a secure exit route, but overall deals are expected to undergo greater levels of scrutiny as buyers and sellers approach new deals with caution.

Lessons learned from past regulatory conflicts in China

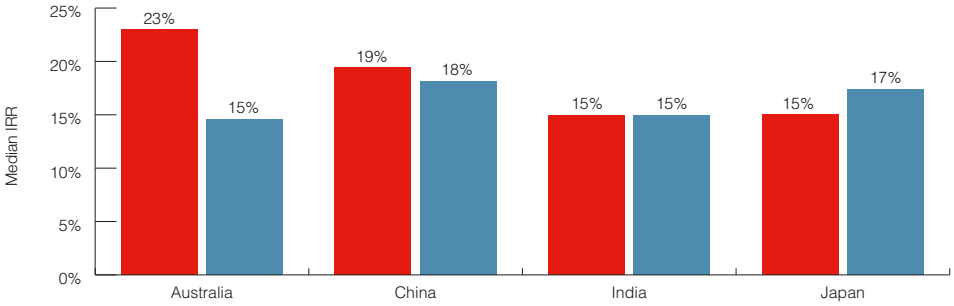
The regulatory atmosphere in China is generally conducive to M&A. But for foreign acquirers, satisfying regulators can in some instances be challenging, especially given that separate accounts must be presented to shareholders and the authorities.

Some of the greatest regulatory challenges have been faced by Chinese firms in foreign markets – particularly the US. After a notorious wave of reverse-mergers ended with scandal and investigations by the SEC, Chinese companies have been eyeing going private in order to improve their valuations. The reverse-merger trend originally began with firms seeking to improve their access to capital by listing in the US. Unfortunately, after a few firms were found non-compliant with IFRS,

'In some ways China is ahead of many other countries in Asia. Since early 2010, all listed companies have been required to comply with IFRS.'

Patrick Wu, Managing Director, China

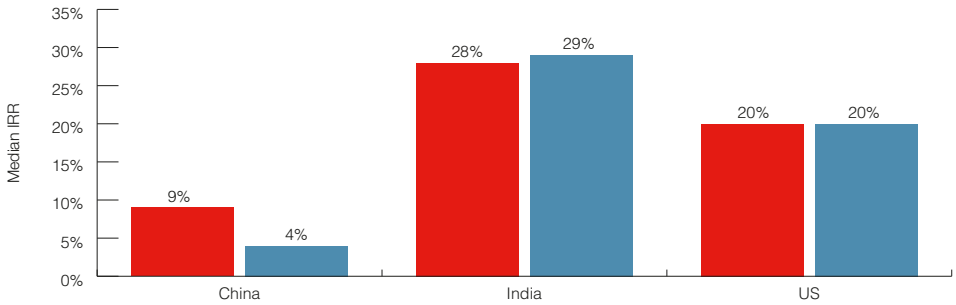
Median Internal Rate of Return



2010 2011

Source: American Appraisal

Average Debt to Total Capital



2010 2011

Source: American Appraisal

almost all foreign-listed Chinese firms were tarred with the same brush, the chief casualty being shareholder value.

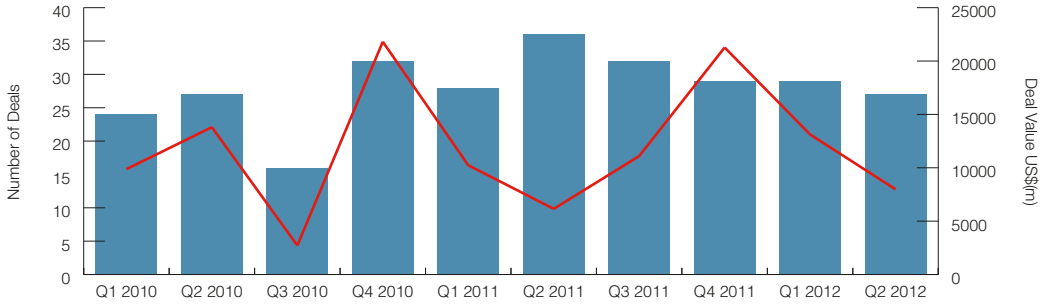
Some hope that taking the company private and listing again in China will resolve this problem. The process is an intricate one, requiring businesses to satisfy tax and shareholder obligations before completing the transaction.

Outbound M&A from China continues in full force

In the shadow of regulatory hiccups surrounding foreign listings, H1 2012 has seen continued buoyancy in outbound Chinese acquisitions, with a total of 33 deals worth US$22.bn, marking a 34% increase in value compared to H1 2011. While Chinese State Owned Enterprises (SOEs) have historically used large-scale outbound investments to access natural resources and raw materials, private companies have become far more active participants in the global M&A market. The largest outbound acquisition from China so far this year was by private company Dalian Wanda Group Corporation, a property and leisure firm, which acquired US cinema chain AMC Entertainment for US$2.6bn.

Generally speaking, private acquirers are expected to be tougher than their state-owned peers when it comes to negotiating the purchase price. Particularly when searching for distressed or

Chinese Outbound M&A



Deal Value US$(bn) Number of Deals

Source: mergermarket

discounted opportunities in Europe, Chinese buyers are likely to be driving a harder bargain. Also marking a stark contrast from the past, Chinese SOEs have reduced the premiums they are willing to pay for foreign energy assets. This mirrors the general trend: according to mergermarket data, in the year to date, median EBITDA multiples for outbound Chinese deals have been 8.3x, compared to 11.6x for the same period in 2011. All of this suggests outbound deals from China will be marked by tougher negotiation and greater levels of scrutiny in order to ascertain the fair value of targets.

In the year ahead, cash-rich entities – both private and state-backed – will continue to expand abroad. Some of this activity will encounter obstacles: for example in Mongolia, aluminum producer Chalco is facing government resistance to its acquisition of Toronto-listed, Mongolia-focused coal company SouthGobi Resources. Mongolia's natural resource wealth has been attracting the attention of global investors, yet the government is increasingly under pressure to protect national interests. However, with a scarcity of capable domestic mining firms, inbound acquisitions will be key to the country's economic flourishing. Global miners such as Rio Tinto and Tamasek will continue to seek buy-in opportunities.

Chinese companies will continue to make more acquisitions abroad, and, given the current climate, they will be looking for undervalued assets, especially in Europe. Within the country, slowing growth prospects have not yet damaged average valuations, but market volatility could bring this about. If the economy continues to slow and the markets perform less well, attention will turn to the government to provide stimulus initiatives. One area where investors hope to see improvement is the financing environment. Private businesses in China have long complained of the difficulty of accessing sufficient debt capital. This has drawn more attention from the government of late, with Beijing pressuring banks to lend more to businesses. As the market develops, it is expected that private companies' access to financing will improve – which could lead eventually to increased demand for assets.

India: hiccup in growth and political issues damage investment climate

After enjoying an economic growth rate above 7% for much of the past decade, India's economic growth rate hovered at just above 5.0% over Q4 2011 and Q1 2012. The slowdown originated from reduced output in manufacturing, and now high inflation (7.6% in May) and a large fiscal deficit have added to the country's problems. There have been concerns over the high interest rate environment – the policy repo rate currently stands at 8% – but with inflation failing to cool, the Reserve Bank of India has been unwilling to loosen monetary policy. Investor sentiment has weakened and at present the stock market is trading well below normal levels, a factor having a substantial impact on M&A valuations.

Regulatory uncertainty has been a serious issue over the past 12 months. On 16 March, the government proposed the introduction of general anti-avoidance rules (GAAR) which could lead to retrospective taxation on some cross-border transactions. The tax amendment is set to become legislation if and when the budget gains parliamentary and presidential approval. GAAR has already been cited as a reason for some investors withdrawing funds from India, particularly in the private equity field. Looking ahead, plans to adopt GAAR could result in further complications for those investing in the country, and could cause all players to examine their Indian shareholdings and investment strategies. The changes will have a substantial and immediate impact on asset value for funds with substantial Indian holdings.

India: counteracting the heightened uncertainty

For both domestic and inbound deals, uncertainty can be counteracted through individually tailored

'A lot of private equity players aren't making investments because they don't know how those investments will be taxed once they actually exit.'

Varun Gupta, Managing Director, India

consideration structures. As in the US and Europe, earnouts have been more popular recently as a way to incentivize better post-merger performance. Historically, most common in private equity acquisitions, these contingent purchase price provisions are being increasingly used by corporate acquirers who wish to retain key staff and mitigate post-acquisition risks.

India: optimism for inbound investment

Notwithstanding the challenges, dealmakers remain optimistic about future cross-border activity. India's business community has long had international perspective, with many corporations compliant with IFRS as they are either already set up/listed abroad or are looking to do so. Furthermore, efforts to encourage inbound investment in certain industries, particularly retail, are beginning to bear fruit. The recent news that IKEA is increasing its presence in India is likely to encourage others to follow suit. Going forward it is hoped that investment into ancillary or related sectors, including logistics and infrastructure, will be stimulated as a result.

Overall, a healthy amount of M&A is still taking place in India: the first quarter of 2012 saw 67 deals and aggregate disclosed value of US$16.4bn – with value buoyed by the mega-merger between Vedanta's two Indian businesses. The Pharmaceuticals sector is likely to see more transactions over the next few years as rapid industry developments attract buyers, particularly in the fast-growing Indian generics space. In the near-term, economic instability will lead to defensive deals and increased consolidation in certain industries, such as aviation, where struggling Indian carriers are looking for strategic buyers to provide investment and leadership.

The largest deal of Q1 2012 is the US$10.3bn merger of UK-based Vedanta's two metals & mining subsidiaries, Sterlite and Sesa Goa. The move reveals a focus on maximizing synergies and cutting debt (combining the two businesses is reportedly cutting Vedanta's debt by 61%). Indian companies, however, seem less focused on reducing debt. For deals which American Appraisal advised on in India in 2010, the average debt to total capital was 28%, rising to 29% for deals advised on in 2011. This contrasts with the average of 11% falling to 9% for Asia-Pacific over the same period. One reason for the contrast is the capital intensive nature of the businesses being valued; however, given recent increases in the cost of borrowing, it would be unsurprising to see Indian companies cutting debt in the near-term.

As Indian firms struggle with the rising cost of borrowing, some assistance could come from falling raw material and crude oil prices – though such variables cannot be taken for granted. Government initiatives to halt the declining rupee will be welcome, as will any connected improvement to capital inflows. While economic performance for the second half of 2012 remains difficult to predict, valuations are certainly set to become more volatile.

> *'At the corporate level there's a lot of interest in growing inorganically now, I expect to see an increase in M&A activity in the next one to three years.'*
>
> Varun Gupta, Managing Director, India

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Thinking before we act

We differ from firms that think they know the answer before the consulting process begins. Given the changes in technology and the shifts in our global economy, there are no longer absolute answers in our profession. That is why American Appraisal explores value from every angle. Lively debate is commonplace here at American Appraisal, from Shanghai to Mumbai to Milan to the U.S.

Performing with passion

We think talent helps, but it will never take you as far as passion. American Appraisal was built on the premise that if you hire talented people with the ambition to rise to the top of their profession, everyone wins.

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We believe there is a world of difference between being global and acting global. Our Consultants are native born and understand the regional market forces that can greatly influence value. Their familiarity with cultural norms ensures that relevant local factors are adequately considered.

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Broad range of complementary services

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Our clients regularly buy or sell businesses, undergo mergers, enter joint ventures, plan strategic acquisitions and defend against hostile takeovers. American Appraisal understands that successful completion of any transaction depends on overcoming obstacles that include determining the purchase consideration and terms as well as post-acquisition integration.

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