

Second Quarter 2013

# Valuation Insights

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### About Duff & Phelps



In this edition of Valuation Insights we discuss the Alternative Investments Outlook 2013: Limited Partner Survey that Duff & Phelps recently published in collaboration with Mergermarket. The report, which included interviews with 100 limited partners operating across North America and Western Europe, indicated their intent to increase allocations to private equity investments in 2013.

In our Technical Notes section we discuss the 2013 Duff & Phelps U.S. Risk Premium Report which is now available. The Report and companion Calculator can be used to develop cost of equity capital estimates, an essential input in any discounted cash flow analysis.

Our International in Focus section discusses the concept of unit of account for an investment and why it is so important as it

pertains to the fair value measurement standards issued by the FASB and the IASB (ASC Topic 820 and IFRS 13, respectively).

Finally, our Spotlight article discusses the return of Hilary Eastman to Duff & Phelps. Hilary left Duff & Phelps in 2006 to serve as Senior Technical Manager at the International Accounting Standards Board where she was the primary author of IFRS 13 *Fair Value Measurement*.

In every issue you will find Industry market multiples which are useful for benchmark valuation purposes. We hope that you will find this and future issues of this newsletter informative and reliable resources.

[Read this issue to find out more.](#)

# Private Equity Investors Optimistic About 2013

Has private equity successfully rebounded from the crisis? What investment strategies are most attractive within this asset class? Are there attractive opportunities in Europe? These are just a few of the questions answered in the “Alternative Investments Outlook 2013: Limited Partner Survey.”

Published in Q1 2013 by Duff & Phelps, in collaboration with mergermarket, the Alternative Investments Outlook 2013 report synthesizes interviews with 100 Limited Partners (“LPs”) operating across North America and Western Europe. Those surveyed included fund-of-fund investors, pension and sovereign wealth funds and other investors, such as family office insurance funds and other asset managers. The survey aimed to capture the views of private equity investors on the investment environment and their outlook for the future.

## Confidence in the Future

Two-thirds of survey respondents indicated that they will adjust their allocation to private equity. And, more tellingly, the majority will increase (76%) or significantly increase (19%) the amount of capital dedicated to the asset class. This is a strong indication that the level of confidence in private equity is returning, following the prolonged period of global economic crisis which began in 2008.

Nearly half of LPs say that their private equity investments have surpassed their expectations. And, 63% of LPs report that their investments in private equity are outperforming relative to other investments in their portfolios.

However, it is important to acknowledge that LPs are somewhat tempered in their expectations for returns on 2013 vintage funds. Historical expectations of 15-20% or more net returns are no longer the norm. According to the survey pool, approximately 46% of LPs expect net returns of 13-15% for 2013 vintage funds, with North America-based investors appearing slightly more bullish than their Western European counterparts.

## Corporate Disposals Attracting Attention of Private Equity Investors

Corporate disposals and private equity portfolio companies represent the most attractive opportunities for private equity investors in 2013, according to survey respondents. There is a robust environment for corporates seeking to deleverage and private equity investors seeking high quality investments, such as non-core businesses and spin-offs. Distressed assets and private companies, including family-owned businesses, are viewed as being less attractive.

## Outlook for Western Europe

There are some clear indications of enthusiasm about the alternative investments climate in Europe. When looking at individual countries, Germany is cited as most attractive, followed by the UK and Ireland, and then the Nordic region. Northern Europe is most frequently mentioned by LPs as fitting with their investment strategies, particularly among North American LPs who take a more optimistic view of that geography.

North American LPs are less enthusiastic about funds investing in Southern Europe, except those who are targeting distressed assets in that geography. On the other hand, European LPs view Southern Europe – including Portugal, Spain and Italy – as offering attractive opportunities. European investors are also more likely to look at funds with exposure to Eastern Europe, versus their North American counterparts.

Macro-level economic concerns are also influencing LPs and the investments they make. The economic environment and political uncertainty, as well as the ongoing Eurozone crisis, are the greatest concerns for LP investors on both sides of the Atlantic.

## Evolution of GP and LP Interactions

The LPs themselves are communicating more regularly with the private equity funds General Partners (“GPs”), and this dynamic is changing the nature of GP-LP relations. The wide majority (91%) of LPs acknowledge a change in the relationship with the GPs, citing that they are receiving more direct feedback about fund investment strategies, and are asking more questions in general. Topics such as renegotiation of management fees (46%) and pushing for more warranties in place (46%) are also being broached with the GPs.

When choosing a fund manager, 70% of LPs said that transparency was the most important factor (ahead of strategy and performance). The robustness of the valuation process was cited as one example of the transparency LPs seek.

While communications between LPs and GPs has increased, the survey results suggest that there is still room for improvement. LPs are “generally” happy with current communication on fund performance, but some issues remain.

In fact 63% of LPs cite timeliness of reporting as the most common problem with valuation information, and three out of four LPs asked GPs for greater transparency in the last 24 months.

The full report can be found on our website. To learn more about the Alternative Asset Advisory practice or the LP Survey, please contact **Chris Franzek**, Managing Director in New York and head of Alternative Asset Advisory at +1 212 871 7549 or **Mathias Schumacher**, Managing Director, in London at +44 (0)20 7715 6720.

## Technical Notes

# The 2013 Duff & Phelps U.S. Risk Premium Report is Now Available

Duff & Phelps is pleased to announce the release of the *2013 Risk Premium Report* (the “Report”). This marks the 18th year that the Report has been published.<sup>1</sup> The Report and its online companion application, the Duff & Phelps Risk Premium Calculator, (the “Calculator”) can be used to develop levered and unlevered cost of equity capital estimates using the capital asset pricing model (CAPM) and various buildup models. Cost of equity capital is the rate of return necessary to attract funds to an equity investment, and, as such, relates to the risk characteristics of the subject investment.

The Report publishes both size premia and risk premia (calculated as a function of eight different measures of “size”) that can be used to calculate the cost of equity capital. Fundamental risk measures are also analyzed, and risk premia based upon them are developed which can also be used in estimating the cost of equity capital. Fundamental risk measures are based on accounting ratios, and can be especially important for smaller companies where there are often few or no “pure play” companies to use in developing a proxy beta.

The Report can be used by corporate finance officers for pricing or evaluating mergers and acquisitions, raising private or public equity, property taxation, stakeholder disputes, and to evaluate investments for capital budgeting decisions. The Report can also be used by CPAs who deal with valuation for financial reporting or client valuations issues, and judges and attorneys who deal with valuation issues in mergers and acquisitions, shareholder and partner disputes, damage cases, solvency cases, bankruptcy reorganizations, property taxes, rate setting and transfer pricing.

The introduction of the Calculator in 2011 remains a very important milestone in the

history of the Report. The Calculator was developed to streamline how the Report’s valuation data is used when estimating an entity’s cost of equity, as well as to provide the user with a complete audit trail.

Every year Duff & Phelps continues to enhance the Report’s functionality and usefulness based in part on the feedback received from users. For example, in the 2013 Report, Duff & Phelps added an expanded section on using the data to value smaller companies. The section on using the Report’s “regression equation method” to calculate custom, interpolated size premia was also expanded. These new sections not only provide additional information about the characteristics of the companies that comprise the Report’s 25 “Size Study” portfolios, but also arm valuation professionals with additional, intuitive support for adjustments made to risk premia using the regression equation method.

In most cases the subject company’s size will not exactly match the average size characteristics of the selected guideline portfolio in the Report, or, equivalently, the selected decile in the SBBI Yearbook.<sup>2</sup> The Report’s “regression equation method” enables the user to further refine cost of equity estimates by either (i) calculating custom, interpolated size premia in between any of the 25 size portfolios; or (ii) interpolating size premia for companies smaller than the average company included in Portfolio 25, which is comprised of the smallest companies in the study’s universe.

Also new in the Report is a special section on an issue that is a major challenge for financial and valuation professionals today—the likely distortion of asset prices, due (at least in part) to the massive central bank intervention programs that have been a hallmark of the current post-Financial Crisis period. This issue

has spurred a necessary reassessment of the fundamental inputs traditionally used to estimate the cost of capital.

Duff & Phelps managing director Roger Grabowski suggests that some of the basic building blocks that have traditionally been used to estimate the cost of capital, such as the equity risk premium (ERP) and the risk-free rate, may become distorted during times of flight to quality or high levels of central bank intervention (e.g. quantitative easing, or “QE”).<sup>3</sup> Grabowski says, “The QE programs implemented by central banks tend to depress yields on government bonds, arguably in an artificial way. If these rates are indeed artificial, and are not sustainable, then choosing a long-term risk free-rate becomes significantly more problematic today than it was prior to the 2008 Crisis.”

“The equity risk premium, which has always been a challenge to quantify, is even more difficult to estimate today”, says Grabowski. If the Federal Reserve drives down long-term interest rates, Grabowski believes it becomes more difficult for investors to hold these low-yielding assets, which may create an incentive for investors to move into riskier asset classes, like equities. “This shift may in itself be yet another mispricing of risk”, says Grabowski.

Duff & Phelps regularly reviews fluctuations in global economic and financial conditions that warrant periodic reassessments of the ERP and risk-free rate.

Visit [www.duffandphelps.com/CostofCapital](http://www.duffandphelps.com/CostofCapital) for more information.

To learn more contact **Roger Grabowski**, Managing Director, at +1 312 697 4720 or **James Harrington**, Director, at +1 312 697 4938.

1. The Report has been published annually since 1996.

2. Ibbotson @ SBBI @ Valuation Yearbook (Morningstar, Chicago).

3. Roger Grabowski, FASA, is a managing director in the Duff & Phelps Chicago office and part of the firm’s Valuation Advisory Service practice. He is co-author with Dr. Shannon Pratt of *Cost of Capital: Applications and Examples*, 4th Edition (John Wiley & Sons, 2010), and the upcoming 5th Edition of the same publication

## International in Focus

# The Importance of “Unit of Account” in Determining the Fair Value of an Investment

With IASB issuing IFRS 13 *Fair Value Measurement* in May 2011 and FASB issuing amendments to ASC Topic 820 *Fair Value Measurement* by way of ASU 2011-4, IASB and FASB completed a major convergence project. The result: IFRS 13 and ASC Topic 820 are virtually identical, resulting in a common IFRS and U.S. GAAP framework for measuring and disclosing fair value. Yet, even with an identical definition of fair value and related measurement framework some variations in interpretation may lead to different IFRS and U.S. GAAP fair value measurements.

This is because the *unit of account*, a key concept in accounting that specifies *what* is to be measured at fair value, is driven by other accounting standards, not IFRS 13 or ASC Topic 820. Simply put, the “unit of account” refers to the level of aggregation at which an asset or a liability is recognized in the financial statements; for example, if an entity’s holding of financial instruments is to be measured at the individual instrument level or at the aggregate investment level. Depending on the perspective taken as to unit of account, the fair value measurement conclusion may be significantly different and could result in an immediate write down for certain private equity positions, or could cause actively traded positions to be valued at an amount other than the market price. The unit of account attempts to describe the specific way in which an investment is owned, including the legal rights and obligations of ownership and its relationship to other ownership rights in a complex capital structure.

How does one determine the proper unit of account? IFRS 13 and ASC Topic 820 do not provide such guidance, nor do they determine when an asset, a liability or an entity’s own equity instrument should be measured at fair value. The requirements of IFRS 13 and ASC Topic 820 apply when other accounting standards permit or require

measurement at fair value. The accounting standard that drives the use of fair value is also expected to identify the unit of account for the measurement, but that is not always the case.

How does one navigate the lack of unit of account guidance? When FASB first issued ASC Topic 820 in 2006 (Statement No. 157), it contained language that preparers of financial statements used as “crutches” to compensate for limited unit of account guidance. Such crutches included the concepts of *highest and best use* and *in-use valuation premise*, which is an intuitive way of grouping assets used together within a business and employing them in a value-maximizing way. Armed with those concepts, preparers of financial statements were able to justify their fair value measurements from the perspective of market participants, as is still required, by aggregating financial instruments consistent with economic phenomena that fair value is meant to portray.

However, in the specific case of financial instruments, the Boards concluded that sufficient guidance existed in other accounting standards to consistently determine unit of account, and therefore decided to eliminate the crutches of highest and best use and the in-use valuation premise in the final fair value guidance issued in 2011. Shortly after IFRS 13 came into effect in January 2013, it became clear that because of the impact of other IFRS standards, the lack of clear unit of account guidance for investments in groups of financial instruments is problematic.

IASB’s recent revisions to IFRS 10 Consolidated Financial Statements state that the fair value of controlled investments held by investment entities should be determined in accordance with IFRS 9 Financial Instruments. IASB has received questions on the proper interpretation of the unit of account for non-actively traded securities:

- One interpretation is that because IFRS 10 and IAS 28 *Investments in Associates* refer to measuring fair value in accordance with IFRS 9 — in which the unit of account is a single share — it follows that the unit of account in IFRS 10 and IAS 28 is also a single share. A problem with this view is that actual transactions for non-actively traded securities rarely take place on a single share basis.
- Another interpretation is that the unit of account is determined by IFRS 10, IAS 27 Consolidated and Separate Financial Statements and IAS 28, all of which refer to the entity’s “investment,” which is not necessarily a single share. This interpretation is more aligned with how market participants transact.

In response, IASB made two tentative decisions in March 2013. First, that the unit of account for investments in subsidiaries, joint ventures and associates is the investment as a whole. Second, that the fair value measurement of an investment comprising quoted financial instruments should be the product of the quoted price of the instrument (P) multiplied by the quantity (Q) held (i.e.  $P \times Q$ ). This approach would fully align IFRS with U.S. GAAP in valuing financial instruments, especially those held by alternative asset funds. An exposure draft on the issue is expected in the near future.

Ultimately, in the absence of unit of account guidance to the contrary, fair value measurements should be consistent with how market participants would transact in their economic best interest, which upholds economic logic.

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## Spotlight

# Hilary Eastman, Former IASB, Returns to Duff & Phelps

Hilary Eastman, CFA, has returned to Duff & Phelps in London as a director in the Office of Professional Practice (OPP). Hilary left Duff & Phelps in 2006 to serve as Senior Technical Manager at the International Accounting Standards Board (IASB). Most notably, Hilary was the primary author of IFRS 13 *Fair Value Measurement* and was the leader of the IASB-FASB team responsible for the joint fair value measurement project. She also worked on the revisions to IFRS 3 *Business Combinations* in 2008 and has been involved in the development of the IFRS Foundation's educational material on IFRS 13.

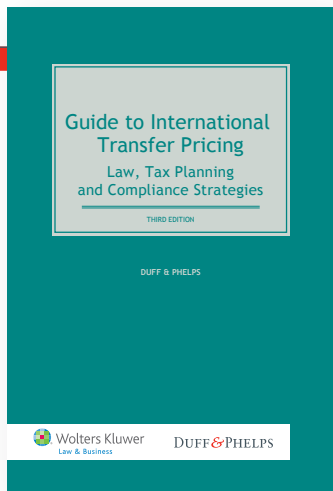
Hilary began her career in Pricewaterhouse Coopers' (PwC) Corporate Value Consulting practice, focusing on financial and tax reporting valuations. In 2003 she transferred from San Francisco to Amsterdam as the business expanded internationally. In 2005, she moved to the London office. That same year, Duff & Phelps acquired Standard & Poor's Corporate Value Consulting, which included PwC's legacy valuation business.

In her new role at Duff & Phelps, Hilary will focus primarily on valuation issues related to financial reporting under IFRS. As part of the OPP, she will support project teams with IFRS-related inquiries and provide technical

reviews and counsel. She will also serve as a thought leader and key contributor to Duff & Phelps publications, reports and studies.

Hilary's transition from her IASB role underscores Duff & Phelps' commitment to keeping abreast of regulatory developments that impact our clients. Our professionals monitor the latest developments and consistently provide input to the main standard-setting and regulatory groups as they develop implementation guidance and new rules with valuation implications.

Contact **Hilary Eastman**, Director, at **+44 (0)20 7715 6789**.



## Guide to International Transfer Pricing

Law, Tax Planning and Compliance Strategies, Third Edition

The pricing of goods and services within a multi-divisional organization, particularly in regard to cross-border transactions, has emerged as one of the most contentious areas of international tax law. This is due in no small measure to the rise of transfer pricing regulations as governments seek to stem the flow of tax revenue overseas, making the issue one of great importance to multinational corporations.

The Duff & Phelps Guide to International Transfer Pricing covers an array of critical transfer pricing issues. The guide's relevance is further enhanced by the inclusion of 14 country chapters covering domestic transfer pricing issues in a variety of key national jurisdictions.

Available for order now at [www.kluwerlawonline.com](http://www.kluwerlawonline.com)

# North American Industry Market Multiples

## As of March 31, 2013

Industry	Market Value of Equity to Net Income		MVIC to EBIT		MVIC to EBITDA	
	U.S.	Canada	U.S.	Canada	U.S.	Canada
<b>Energy</b>	16.9	14.7	17.2	14.0	10.7	6.5
Energy Equipment & Services	21.8	12.0	14.9	9.6	10.3	5.6
Integrated Oil & Gas	10.5	—	8.8	—	5.1	6.4
<b>Materials</b>	15.5	12.7	12.7	13.4	9.1	7.6
Chemicals	16.2	13.7	12.8	11.7	9.6	7.2
Diversified Chemicals	16.2	—	12.3	—	9.4	—
Specialty Chemicals	17.9	—	14.0	—	10.4	—
Construction Materials	17.9	—	27.2	—	13.9	—
Metals & Mining	13.5	10.3	12.1	12.9	8.9	7.1
Paper & Forest Products	15.2	29.3	10.3	20.1	7.6	13.2
<b>Industrials</b>	16.9	12.4	13.1	12.6	9.7	8.8
Aerospace & Defense	14.3	9.0	11.2	12.2	8.9	9.9
Industrial Machinery	16.6	6.6	13.4	13.9	9.8	9.5
Commercial Services & Supplies	16.9	18.3	12.8	13.8	8.9	9.1
Road & Rail	17.2	12.9	13.1	12.2	8.0	7.8
Railroads	17.4	—	17.0	—	8.9	—
<b>Consumer Discretionary</b>	15.8	15.4	12.7	12.9	9.2	9.4
Auto Parts & Equipment	8.7	—	12.4	—	7.4	5.5
Automobile Manufacturers	—	—	20.0	—	13.2	—
Household Durables	11.7	—	13.3	—	10.7	—
Leisure Equipment & Products	17.3	—	12.3	—	9.6	—
Textiles, Apparel & Luxury Goods	14.4	—	11.6	—	9.9	—
Restaurants	22.5	21.3	15.3	12.3	9.3	9.1
Broadcasting	14.0	—	11.1	10.7	9.1	9.2
Cable & Satellite	17.0	14.6	17.9	12.3	8.7	7.4
Publishing	13.9	12.2	12.7	8.3	7.6	6.1
Multiline Retail	14.7	—	10.9	—	6.8	—

Industry	Market Value of Equity to Net Income		MVIC to EBIT		MVIC to EBITDA	
	U.S.	Canada	U.S.	Canada	U.S.	Canada
<b>Consumer Staples</b>	15.7	16.1	13.2	14.0	9.7	9.4
Beverages	20.0	20.1	17.6	14.2	12.3	10.3
Food Products	16.9	13.1	14.2	13.3	10.5	9.7
Household Products	20.6	—	14.3	—	10.7	—
<b>Health Care</b>	18.7	14.8	14.8	19.6	11.4	11.3
Health Care Equipment	21.9	—	15.2	—	12.1	—
Health Care Services	20.1	16.5	13.9	10.5	9.5	8.4
Biotechnology	15.8	6.0	18.6	—	20.1	—
Pharmaceuticals	17.4	—	12.8	26.0	9.5	12.7
<b>Information Technology</b>	20.1	16.8	17.1	18.5	13.1	13.8
Internet Software & Services	22.5	22.0	24.6	21.0	15.5	11.2
IT Services	19.0	11.2	14.2	18.5	10.3	16.0
Software	28.0	32.5	22.7	24.1	16.7	16.6
Technology Hardware & Equipment	16.9	12.0	16.1	13.6	12.0	8.9
Communications Equipment	17.1	8.9	18.3	14.4	13.1	9.6
Computers & Peripherals	18.4	—	16.4	—	13.5	—
Semiconductors	25.3	—	21.6	—	16.3	—
<b>Telecommunication Services</b>	15.1	14.0	15.3	13.6	6.6	7.3
Integrated Telecommunication Services	9.5	15.0	14.9	12.8	6.1	7.1
Wireless Telecommunication Services	14.6	—	16.1	—	6.1	—
<b>Utilities</b>	19.4	13.7	15.2	27.2	9.6	12.3
Electric Utilities	17.8	—	14.9	—	8.9	—
Gas Utilities	19.6	—	14.7	—	9.5	—

Industry	Market Value of Equity to Net Income		Market Value of Equity to Book Value	
	U.S.	Canada	U.S.	Canada
<b>Financials</b>	13.3	10.1	0.9	1.1
Commercial Banks	12.8	10.1	0.9	1.7
Investment Banking and Brokerage	19.4	3.7	1.0	0.6
Insurance	13.0	—	1.0	—

An industry must have a minimum of five company participants to be calculated. For all reported multiples in the U.S. and Canada, the average number of companies in the calculation sample was 100 (U.S.), and 33 (Canada); the median number of companies in the calculation sample was 51 (U.S.), and 11 (Canada). Sample set includes publicly-traded companies (private companies are not included). Source: Data derived from Standard & Poor's Research Insight and Capital IQ databases. Reported multiples are median ratios (excluding negatives). MVIC = Market Value of Invested Capital = Market Value of Equity plus Book Value of Debt. EBIT = Earnings Before Interest and Taxes for latest fiscal year. EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization for latest 12 months.

# European Industry Market Multiples

## As of March 31, 2013

Industry	Market Value of Equity to Net Income	MVIC to EBIT	MVIC to EBITDA
<b>Energy</b>	11.8	14.8	9.0
Energy Equipment & Services	15.7	15.4	9.1
Integrated Oil & Gas	—	—	—
<b>Materials</b>	13.0	12.0	7.5
Chemicals	16.3	12.6	8.2
Diversified Chemicals	—	—	—
Specialty Chemicals	16.7	12.7	8.6
Construction Materials	16.1	14.5	10.3
Metals & Mining	11.5	10.7	7.3
Paper & Forest Products	12.9	9.7	6.2
<b>Industrials</b>	13.4	12.5	8.9
Aerospace & Defense	14.9	15.8	12.2
Industrial Machinery	13.5	12.3	8.4
Commercial Services & Supplies	15.6	12.6	8.6
Road & Rail	15.6	15.1	6.6
Railroads	23.6	—	6.8
<b>Consumer Discretionary</b>	14.1	12.6	8.7
Auto Parts & Equipment	9.8	8.9	5.9
Automobile Manufacturers	—	—	—
Household Durables	13.7	11.5	8.1
Leisure Equipment & Products	13.7	11.5	9.6
Textiles, Apparel & Luxury Goods	14.2	14.4	8.7
Restaurants	16.1	14.7	9.6
Broadcasting	12.1	7.8	7.9
Cable & Satellite	—	—	—
Publishing	13.7	12.0	8.7
Multiline Retail	—	—	—

Industry	Market Value of Equity to Net Income	MVIC to EBIT	MVIC to EBITDA
<b>Consumer Staples</b>	13.4	14.6	9.5
Beverages	23.6	19.9	10.4
Food Products	12.2	13.6	9.3
Household Products	—	—	—
<b>Health Care</b>	17.7	15.8	11.9
Health Care Equipment	17.5	14.7	11.4
Health Care Services	10.2	11.9	9.8
Biotechnology	26.5	33.0	16.3
Pharmaceuticals	20.1	19.7	15.3
<b>Information Technology</b>	15.5	12.7	9.3
Internet Software & Services	19.4	17.6	12.7
IT Services	14.3	10.2	8.1
Software	18.3	14.5	10.8
Technology Hardware & Equipment	15.0	12.1	8.9
Communications Equipment	14.2	12.0	7.9
Computers & Peripherals	13.5	14.6	10.0
Semiconductors	16.5	20.5	10.6
<b>Telecommunication Services</b>	14.6	13.2	8.3
Integrated Telecommunication Services	14.6	10.6	6.8
Wireless Telecommunication Services	—	—	—
<b>Utilities</b>	17.1	17.3	10.0
Electric Utilities	16.2	12.1	7.4
Gas Utilities	—	—	—

Industry	Market Value of Equity to Net Income	Market Value of Equity to Book Value
<b>Financials</b>	11.8	0.9
Commercial Banks	8.9	0.5
Investment Banking and Brokerage	15.3	1.1
Insurance	10.2	1.1

An industry must have a minimum of 5 company participants to be calculated. For all reported multiples in Europe, the average number of companies in the calculation sample was 93 and the median number of companies in the calculation sample was 39. Sample set includes publicly-traded companies (private companies are not included). Source: Data derived from Standard & Poor's Research Insight and Capital IQ databases. Reported multiples are median ratios (excluding negatives). MVIC = Market Value of Invested Capital = Market Value of Equity plus Book Value of Debt. EBIT = Earnings Before Interest and Taxes for latest fiscal year. EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization for latest 12 months.

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