

CREcER Conference – “Desafios e Oportunidades na Adoção das IFRS: Outras Perspectivas”

IFRS and the stock market

September 2009 **Márcio Prado – Latam Utilities Chief Analyst**

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IFRS and Stock Valuation

➤ **“IFRS implementation will have no impact on stock prices.”**

Source: Anonymous Naive Equity Research Analyst.

➤ **What is the rational of such a statement?**

➤ 1) Stock prices are defined on a discounted cash flow basis;

➤ 2) While IFRS will have major impact on the accounting reports from companies...

➤ 3) ...as IFRS implementation will be neutral from a cash flow perspective, it shall have no impact on stock prices.

IFRS and Stock Valuation

➤ **Academic evidence: "We find statistically significant negative abnormal returns for firms reporting a negative reconciliation adjustment on UK GAAP earnings. The results are consistent with IFRS altering investors' beliefs about stock prices".**

Source: Market Reaction and Valuation of IFRS Reconciliation Adjustments. Horton, Joanne and Serafeim, George.

IFRS and Stock Valuation

- **Why academic evidence fails to confirm analysts' intuitive view of a neutral impact from IFRS implementation?**
- **Is IFRS not neutral from a cash flow perspective?**
- 1) From the most relevant perspective of tax expenses, it certainly is neutral from a cash flow perspective;
- 2) It is important to mention that, as IFRS alters accounting figures such as net profit – which might be a base for executives' variable compensation -, IFRS might have a cash flow impact.
- 3) However, we doubt that this is the reason for stocks reacting to IFRS implementation for cash impact would be marginal and would not be enough to explain the extent of impact in stock prices found in academic evidence.

IFRS and Stock Valuation

- **Why academic evidence fails to confirm analysts' intuitive view of a neutral impact from IFRS implementation?**
- **Stock prices are defined on DCF basis, or are they?**
- 1) It is true that DCF analysis has been one of the most important tools for investors and analysts to gauge the fair value of companies, however...
- 2) ...a proper DCF model is burdensome to build, highly subjective and based on companies' reported balance sheets. For these reasons...
- 3) ...investors continue to rely on multiples-based valuation methods...
- 4)...and, although counter-intuitively, DCF-based investors will probably change their DCF analysis on the back of new balance sheet. Even when this change has been neutral from a cash base.

IFRS and Stock Valuation

➤ Is the market so inefficient?

- 1) From a LT perspective, probably not.
- Investors will adapt DCF models and multiples to account for new balance sheets and new accounting variables (such as net profit), but this shall take some time.
- 2) From a ST perspective, probably yes.
- Fast-reaction financial markets normally react first and make questions later.
- 3) So that, IFRS impact on stock prices probably will be a short-lived phenomenon.

I IFRS and Stock Valuation

II Two IFRS implementation examples

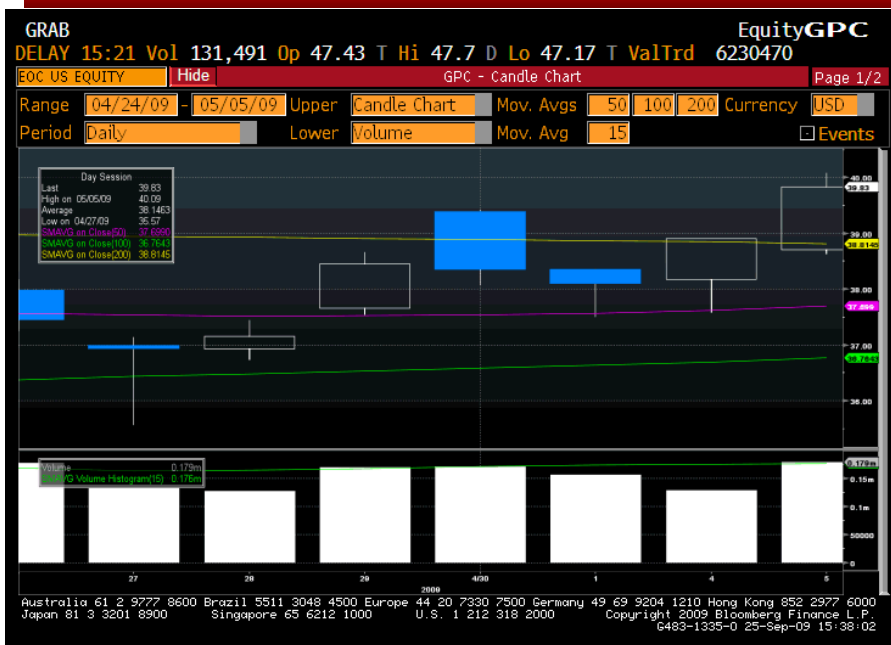
III IFRS and IFRIC 12 concerns

IV Appendix

Two IFRS implementation examples: Endesa and Cesp

- Endesa Chile has fully implemented IFRS in 1Q09 results reporting;
- CESP has partially implemented IFRS in 4Q08 results reporting.

ENDESA CHILE



Source: Bloomberg and Santander Investment.

CESP



Two IFRS implementation examples: Endesa and Cesp

ENDESA CHILE

- **Company extensively addressed the IFRS implementation issue with investors;**
- **Took part in several investors' events to discuss the issue;**
- **Published a presentation with a roadmap to the expected accounting changes IFRS would bring.**

CESP

- **Company has clearly not anticipated it would partially implement in 4Q08 results;**
- **Only after the market reaction, company organized an investors' conference call.**

Two IFRS implementation examples: Endesa and Cesp

- 1) Equity Research Analysts and Investors will not anticipate the IFRS changes, unless...
- 2) ...companies' Investor Relations areas help them anticipate these changes.
- 3) Companies' Investor Relations areas are of utmost importance to help diminishing the volatility and ST impacts on stock prices that could arise from IFRS implementation.

I IFRS and Stock Valuation

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IFRS and IFRIC 12 concerns

- Regulatory Asset Base;
- Regulatory Assets and Liabilities;
- Rate-Regulated activities particularities seem to being taken into account by IASB recent Draft.

APPENDIX

Santander LATAM Utilities Valuation Table

Company	Mkt Cap (US\$)	Price (local\$)	TP09 (local\$)	Rec.	P/E			EV/EBITDA			Div Yield (%)		
					2009	2010	2011	2009	2010	2011	2009	2010	2011
Brazil													
Cemig	9,234	27.25	33.6	Buy	9.0	9.2	9.5	6.5	6.6	5.9	6%	5%	5%
Copel	4,260	28.49	28.6	Hold	7.4	9.0	9.4	5.2	5.4	5.1	2%	2%	2%
CPFL (b)	8,759	33.4	39.1	Buy	12.6	12.3	10.8	7.9	7.0	6.3	8%	8%	9%
EdB (b)	2,134	27.3	36.5	Buy	6.7	7.2	7.5	5.6	5.2	5.3	8%	7%	8%
Light	2,685	24.09	27.9	Buy	4.6	8.3	7.0	5.0	4.3	4.2	11%	6%	7%
Eletrobras*	14,987	24.22	NR	NR	6.7	7.8	8.1	5.9	4.8	4.1	3%	3%	2%
Integrated Avg					7.8	9.0	8.7	6.0	5.5	5.2	6%	5%	6%
CTEEP*	3,916	48	NR	NR	8.5	8.2	8.3	5.7	5.8	6.0	11%	12%	11%
Transmission Avg					8.5	8.2	8.3	5.7	5.8	6.0	11%	12%	11%
AES Tiete*	4,260	20.45	NR	NR	11.7	10.3	10.0	6.5	6.2	6.1	8%	9%	10%
Tractebel	6,998	19.62	26.1	Buy	11.5	11.5	10.6	7.5	6.9	5.3	1%	4%	4%
Cesp (a)	3,416	19.09	26.2	Buy	-2.7	8.3	10.3	6.9	6.1	5.6	0%	3%	10%
Generation Avg					11.6	10.0	10.3	7.0	6.4	5.7	3%	5%	8%
Eletropaulo	3,181	34.79	34.5	Hold	5.7	7.0	6.3	5.1	4.5	5.1	18%	14%	14%
Equatorial	996	17.25	12.72	Buy	7.1	10.3	10.2	5.4	5.4	5.1	11%	8%	7%
Coelce	1,077	25.31	23.5	Buy	6.0	5.6	5.2	3.7	3.6	4.7	16%	17%	17%
Celesc	723	34.3	32.8	Uperf.	3.6	5.9	6.1	3.5	3.0	2.1	7%	4%	4%
Distribution Avg					5.6	7.2	7.0	4.4	4.1	4.2	13%	11%	11%
Sabesp (a)	3,611	29	39.9	Buy	4.9	6.4	5.0	4.2	4.6	4.1	5%	4%	5%
Copasa	1,531	24.4	31.3	Buy	6.9	5.8	4.4	4.1	3.6	3.2	9%	6%	11%
Sanitation Avg					5.9	6.1	4.7	4.2	4.1	3.7	7%	5%	8%
Brazil Average					7.5	8.3	7.9	5.5	5.1	4.8	8%	7%	8%
Argentina													
Pampa (a)	482	1.4	2.0	Hold	7.8	9.0	7.6	3.9	3.1	2.2	0%	0%	0%
Transener (a)	96	0.8	1.0	Uperf.	4.6	5.0	3.8	5.2	4.5	3.8	0%	0%	0%
Edenor (a)	256	1.1	1.5	Uperf.	10.0	6.5	4.8	3.1	2.8	2.7	0%	0%	0%
Argentina Average					7.5	6.8	5.4	4.1	3.5	2.9	0%	0%	0%
Chile													
Endesa (b)	12,986	47.5	63.10	Buy	10.8	10.0	9.0	9.9	9.2	8.3	4%	5%	6%
Enersis (b)	11,839	18.1	22.20	Hold	10.7	10.4	9.2	6.9	6.7	6.4	6%	6%	6%
Gener	3,515	237.2	240.0	Buy	37.5	35.3	13.7	15.4	16.8	9.6	1%	1%	2%
Colbun	4,160	129.2	133.0	Buy	35.2	27.4	18.4	17.2	13.1	9.0	0%	1%	1%
IAM	1,145	624.9	630.0	Buy	25.9	24.7	24.1	6.0	5.4	4.9	8%	7%	7%
Chile Average					24.0	21.6	14.9	11.1	10.3	7.6	4%	4%	5%

Source: Santander estimates.

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