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Maximising Enterprise Value in the not-for-profit sectors 22 September 2010

Corporate finance theory has long established that companies should maximise their Enterprise Value no matter who the shareholders are.

Because not-for-profit organisations have no such macro-measure for their performance, they tend either to spend without counting or to maximise standard financial measures like accounting surplus, which translate into minimising low-yield capital expenditure and maximising grant allocations or donations.

We define the Social Enterprise Value (“SEV”) as the standard present value of free cashflows (of both current and future business) where subsidies and externalities are treated as projected declared dividends (“Social Dividend”); and grants/donations as equity without management control.

It is extraordinary that most not-for-profit organisations are not measuring their Social Dividend in value term.

Such SEV measure will screen off value destroying projects (when taking into account of all aspects, i.e. financial and non-financial) and as there is limited grant/donation resource, it will allow selecting the projects with the highest return on grant/donation.

Such measure, if adopted as an objective function, will also alert charity board members of their full fiduciary responsibilities when analysing merger and acquisition proposals rationally. M&A proposals get accepted on the strength of the arguments that the Enterprise Value of the combined companies is greater than the sum of the Enterprise Values if they were to remain separate entities ($EV(A+B) > EV(A) + EV(B)$ where A and B are two companies). Charity board members will have then the clear objective to decide on M&A proposals. How could charity B reject a proposal to be acquired by charity A if the arguments that $SEV(A+B) > SEV(A) + SEV(B)$ are compelling?

As an example, a housing association plans to build 555 new homes in four phases over a period of six years in a regeneration project.

The PV of the construction cost is £76m while the PV of operating net revenue is £46m only when using the current long term cost of debt for housing associations as the discount rate (5.5% in this example). The project cashflows internal rate of return is 1.75%. So no commercial company would be interested in such a loss making project.

The housing association objective is to maximise Enterprise Value plus Social Dividend (Social Enterprise Value). The Social Dividend includes the rent and maintenance subsidies and the positive externalities. Subsidised services comprise the subsidised



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rents and maintenance higher than market standards. The positive externalities include a 20% reduction of standard carbon footprint, reduction in energy bill for tenants, reduction in ASB and criminality and reduction in unemployment. For example, in the case of carbon footprint, each home in the UK produces approximately six tonnes of CO₂ each year, as the price of one tonne of CO₂ is around £15, the carbon footprint reduction is worth around £10,000 per year.

The PV of the Social Dividend is +£48m so that the Social Enterprise Value is +£18m and the corresponding internal rate of return is 7.3%. Assuming that the PV of the grant received from the government through the project is £41m, the geared return on the £41m equity is 8.20%. So the government could either pay subsidies directly to tenants, buy carbon offsets, etc... to deliver the same Social Dividend or it can invest £41m into the housing association. The latter strategy gives a 8.20% return on investment and so is clearly the better solution, i.e. the £41m grant investment creates value. Finally as the government has limited grant resource, it should compare the 8.20% return it gets on this investment with other project returns. The government will select the project if 8.20% is higher than the opportunity cost for such projects.

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