Case studies - Valuations

CA Kushagra Ladha

18 November 2017

Disclaimer:

The discussion in this document is purely for academic purposes and hence the table/text/figures represent only illustrative examples. The views expressed in the presentation by the speaker are purely personal and cannot be construed as the views of the employer or its associates.

CADBURY INDIA – CASE STUDY

CADBURY INDIA ("CIL") - CASE STUDY Snapshot

- Compulsory buy back of minority shares in CIL
- Huge media attention – Retail investors, MNCs, Law & tax advisory firms, SEBI, Government, etc.
- Landmark judgment for MNC parent companies looking to delist shares of their Indian subsidiaries with minority public shareholding. The judgment of the Hon'ble High Court led to a strong precedence for compulsory buyback under section 100 of the Companies Act, 1956.
- The Hon'ble High Court appointed EY as an independent valuer, after the minority shareholders had challenged the valuation offered by CIL of INR 1340 per share.
- The EY valuation report was again challenged by some minority shareholders, who produced a valuation of INR 2500 per share.
- The High Court upheld EY's valuation of CIL for buying back shares held by minority shareholders and directed CIL to pay INR 2014.5 per share to minority shareholders.
- The High Court, in a detailed judgment, agreed in *toto* with EY's approach and results dismissed all objections raised against the report.
- The key challenge involved for the court appointed valuer (EY), was to form an unbiased, rational and independent view, addressing all the issues raised by minority shareholders, while adhering to the directions issued by the Hon'ble High Court.

COMPANY BACKGROUND (1/2)

- CIL operates in four product categories viz. chocolate confectionery, milk food drinks, candies and gums
- Had five owned manufacturing facilities – Thane, Pune, Gwalior, Bangalore and Baddi (HP)
- The factory at Baddi (HP) had a tax benefits under section 80IC of the Income Tax Act
- The Pune subsidiary, 100% subsidiary of CIL, held about 600 acres of surplus land
- Real estate from where business operations were conducted in Mumbai
- Equity shares of CIL were listed on BSE and NSE but were delisted from both the exchanges by February 2003.
- Post delisting, CIL made several voluntary buybacks offers to purchase equity shares from minority shareholders

Year of buyback	Particulars	Price per share (Rs)	Number of shares bought back
2006	Buyback offer	750	1,352,605
2007	Buyback offer	815	1,153,374
2008	Buyback offer	980	1,020,300
2009	Buyback offer	1,030	1,116,168

(Source: CIL Annual Reports)

- As at July 2009, the minority shareholders held 2.4% in CIL and the balance directly/indirectly held by the holding company

COMPANY BACKGROUND (2/2)

- CIL made an offer to these remaining minority shareholders in 2009 at Rs. 1,340 per share, based on valuation reports from two reputed valuation firms.
- The minority shareholders opposed and approached the H’ble High Court on the contention that CIL has been under-valued and they are being suppressed due to minority shareholding.
- The H’ble High Court ordered a fresh valuation as at 30 September 2009 and appointed EY for the same
  - Initially, EY performed a valuation basis only the Comparable Companies’ Trading mutiple method and produced a valuation of Rs. 1,743 per share
  - The minority shareholders opposed and produced their own valuation of Rs 2,500 per share
  - The minority shareholders convinced the Court to ask EY to perform valuation basis DCF method.
  - The Court obliged and ask EY to perform valuation basis both Comparable companies method and DCF method
  - EY performed valuation basis both the methods and came up with a valuation of Rs. 2,014.5 per share

SELECTION OF VALUATION METHODS

Approach	Methodology	Used	Remarks
Market approach	Market Price method	✗	• The shares of CIL were not listed on any stock exchange. Hence, market price method was not applicable
	Price of Recent Transactions	✗	• There were several voluntary buy backs done prior to the compulsory buyback offer to the minority shareholders. As CIL made offer for compulsory buyback (at a price much higher than the voluntary buyback offer) which was not accepted by the minority shareholders, these voluntary buyback prices were not considered.
	Comparable Companies method	✓	• This method was used considering that there were stocks of comparable companies like Nestle, GSK Consumer Healthcare and Britannia being traded on the Indian stock exchanges
	Comparable Transactions method	✗	• Method not used due to lack of availability of credible and complete data about the transactions in public domain
Income approach	DCF method	✓	• Initially, did not use this method as the financial projections were not provided. However, later with Court orders, CIL provided the same and the DCF method was used
Cost approach	Net Asset Value	For reference only	• Method mostly applicable where value lies in the underlying assets and not in ongoing operations of the business. • CIL's business being a B2C business with huge brand recall, the value lied in the business operations and not the underlying assets of the Company • Though there was value in the real estate owned by the company, however, all of these was being used for business operations.

SWOT ANALYSIS WITH COMPARABLE COMPANIES (1/2)

Particulars	Cadbury India Limited	Nestle India Limited (Nestle)	GlaxoSmithKline Consumer Healthcare Limited (GSK)	Britannia Industries Limited (Britannia)
Product	– Chocolates – Snacks – Beverages – Candy – Gums	– Chocolates and confectionery – Prepared dishes and cooking aids – beverages – Milk products and nutrition products	– Malted products – Biscuits	– Biscuits – Bread – Cake – Dairy products
Key Brands	– Chocolates: Dairy Milk, 5 Star – Snacks: Cadbury Bytes – Beverages: Bournvita – Candy: Halls – Gums: Bubbaloo	– Chocolates and confectionery: Kit Kat, Polo – Prepared dishes: Maggi – Beverages: Nescafe coffee – Milk products: Milkmaid	– Malted products – Horlicks and Boost	– Biscuits: Bourbon, Marie Gold – Dairy products: Milkman Cheese, Lassi
Major raw materials	Cocoa, milk, sugar, malt extracts and edible oil and fats	Coffee, milk, sugar	Malt/malt extracts, milk, milk powder	Flour, sugar, fats and oils
SWOT (Inter-se players)				
- Strengths	- Has 70% share of the Indian Chocolate market - Large distribution	- Market leading brands like Nescafe, Maggi in India with high market share	-'Horlicks' brand has the numero uno slot in the malted beverages category	- Largest biscuit manufacturer in India in terms of value and Second

Source: industry and analyst reports of comparable companies and company websites

SWOT ANALYSIS WITH COMPARABLE COMPANIES (2/2)

Particulars	Cadbury India Limited	Nestle India Limited (Nestle)	GlaxoSmithKline Consumer Healthcare Limited (GSK)	Britannia Industries Limited (Britannia)
	network covering 1 million retail outlets - Manufacturing facility in tax-free zone also - Strong brands like Dairy Milk, 5 Star, Perk, Gems, Bournvita etc	- Large distribution network - Manufacturing facility in tax-free zone also	with very high market share -Diversifying into other product segments under the brand 'Horlicks'	largest in terms of volumes - Several own power brands in the portfolio with high market share - Large distribution network - Manufacturing facility in tax-free zone also
- Weaknesses	- Heavily dependent on the chocolate market - Imported brands such as Toblerone, Mars gaining market share in India	Not available	- Over reliance on the 'Horlicks' brand - No manufacturing facility in tax-free zone but suppliers may be based in such zones	- Heavily dependent on the biscuit market
- Opportunities	- Fast growing confectionery segment - Chocolates are increasingly replacing traditional sweets (Mithai)	– Per capita consumption of most FMCG products is likely to grow – Potential to expand to smaller towns – Nestle India can become an export hub for the parent company	- Expand into the Northern and Western markets of India	– Growing bread and rolls market – Positive outlook for the global biscuit market – Increasing adoption of healthier lifestyle products to strengthen Nutri Choice, Marie Gold.
- Threats	– Downside of a very high market share is that	– Entry of international majors such as Mars	–	- Competition from regional players such

Source: industry and analyst reports of comparable companies and company websites

COMPARABLE COMPANIES VALUATION

CIL - valuation as per Comparable Companies' Multiples method (Rs. million)						
Comparable Companies		Sales		PAT		
	CAGR for period	CAGR of sales	Net Sales of comparables (₹ million)	CAGR of PAT	PAT / Total income margin of comparables	P/E multiple$
Cadbury India Limited	CY 1999 - CY 2008	13.5%	16,677.4	17.7%	10.5%	
Nestle India Limited *	CY 1999 - CY 2008	12.8%	45,019.5	20.7%	12.6%	36.5
GlaxoSmithKline Consumer Healthcare Limited	CY 1999 - CY 2008	10.9%	16,715.9	7.6%	12.2%	22.6
Britannia Industries Limited (consolidated)*@	FY 1999-00 - FY 2008-09	11.8%	34,212.3	15.1%	4.4%	21.8
Multiple considered for valuation analysis#						32.4
Amount of Consolidated PAT for the year ended March 31, 2009						
Equity Value						
Less: Amount paid on buyback of 1,116,168 equity shares from April 01, 2009 to September 30, 2009 at a price of ₹ 1,030 per equity share						
Equity value of CIL as at September 30, 2009 based on CCM method (₹ million)						**56,293.2**

- Nestle and Britannia both had factories located in tax benefit zone in Uttarakhand
- The selected PE multiple of 32.4 was considering factors like stock market trends, size and growth trends of comparable companies *vis-à-vis* CIL, market share of CIL in the chocolate segment.
- The selected PE multiple was higher than the then prevailing PE multiples of BSE Sensex and BSE FMCG Index

FINANCIAL PROJECTIONS

Currency: ₹ mn	Oct-Dec 09	CY10	CY11	CY12	CY13	CY14	CY15	CY16	CY17	CY18	CY19	CY20
Sales growth (%)	n/a	27.4	30.3	21.9	21.9	21.9	17.4	17.4	17.4	11.9	10.0	6.0
Gross profit (GP) margins (%)	38.8	36.5	36.0	36.0	36.0	36.0	34.9	34.6	34.8	34.9	32.6	32.8
EBITDA margins (%)	18.3	12.2	10.0	9.7	9.9	10.1	9.3	9.2	9.7	10.5	9.2	9.4
EBIT margins (%)	6.6	9.8	7.6	7.3	7.4	7.6	6.8	6.8	7.2	8.1	6.8	7.0
PBT margins (%)	15.6	9.6	7.6	7.3	7.4	7.6	6.8	6.8	7.2	8.1	6.8	7.0
PAT margins (%)	12.5	7.0	7.9	8.0	7.9	6.7	6.2	6.1	6.4	7.1	6.1	6.2

Source: Management

* includes relevant depreciation

- CAGR of sales between 2000 - 2009 was around 14.5% while projected CAGR between 2009-2020 is 18.3%
- CAGR of sales between 2004 - 2009 was around 20.1% while projected CAGR between 2009-2014 is 24.6%
- Gross profit margins falling due to upward pressure on key raw material prices. CIL's GP margin for 3-4 years before the Valuation Date was around 39%. The same has come down to 36.5% and 36.2% in CY 2010 and first half of CY 2011, respectively
- Also, the excise and income tax benefit of 2 Units in Baddi was suppose to expiry in FY15 and FY19.

ESTIMATION OF DISCOUNT RATE FOR DCF

WACC/ Cost of equity

Particulars	Notes	Value
Risk-free rate (Rf) (%)	a	*7.0*
Beta	b	0.50
Equity market risk premium (Rm - Rf) (%)	c	*8.0*
WACC = Cost of equity capital (%)	d	*11.0*

Notes

(a) Based on broad 6 mths (ended September 30, 2009) avg of daily YTMs of gilt bonds (with 10years residual maturity). Yield as at September 30, 2009 is 7.20% while average yield for 6 months ending September 30, 2009 is 6.86%. We have considered Rf to be 7.0%.

(b) Based on 3-Year (ended September 30, 2009) adjusted betas of comparable companies [Nestle: 0.464, GSK: 0.562, Britannia: 0.474] from Bloomberg. We have considered Beta = 0.5. Refer: Annexure II.

(c) Expected rate of return on the market portfolio (Rm = 15% p.a.) minus Rf as at September 30, 2009

(d)Weighted Average Cost of capital for CIL is considered to be equal to Cost of Equity as Debt/Equity ratio of CIL is considered at 0 based on debt equity ratios of comparable companies all of whom have negative net debt (i.e. have cash and cash equivalants more than debt)

DCF ANALYSIS - FCFF

Currency: ₹ mn	Oct-Dec 2009	CY10	CY11	CY12	CY13	CY14	CY15	CY16	CY17	CY18	CY19	CY20	Terminal value
Net sales													
Cost of sales													
Gross profit													
Operating expenses													
EBITDA													
Depreciation and amortisation													
EBIT													
Tax on EBIT													
Debt free net income													
Add: Depreciation and amortisation													
Add/ (Less): (Increase)/ Decrease in net working													
Less: Capital expenditure													
Debt free cash flow													
Discount rate (%)													
Present value factor- Mid year discounting													
Present value debt free cash flow													
Terminal value													
Present value for explicit period													
Present value of terminal period													
Enterprise value													
Less: Gross Debt													
Add: Cash and Cash equivalants													
Add: Investments (including investment in IFL less book value of surplus land)													
Equity Value	**64,650.1**												

- Terminal growth rate is estimated at 6% based on overall economic growth, expected long term inflation in the industry
- EBITDA margin in terminal year is based in average of 20 years (CY2000 to CY2020)
- Income tax in terminal year is considered at full corporate tax

VALUATION SUMMARY

Equity valuation analysis of Cadbury India Limited as at September 30, 2009		
Valuation methodology	Weightage	Value (₹ million)
Equity value		
Comparable Companies' Multiples method		
P/E multiple	50%	
Discounted Cash Flows method	50%	
Equity value of CIL	100%	
Add: Value of surplus land of IFL		
Add: Estimated potential value from shifting of Cadbury House office		
Equity value of CIL as at September 30, 2009		
Number of equity shares as at September 30, 2009 (in million)		
Value per equity share as at September 30, 2009 (₹ / share)		**2,014.5**

THE VERDICT (1/2)

Petitioner’s concerns	Court’s view
EY should have used the full growth rate shown by Comparable companies (i.e. Nestle, Amul)	EY had used full growth rate during the explicit projected period inline with the growth rate anticipated for comparable companies.
Takeover of Cadbury Inc, by a global conglomerate – Kraft Inc, has not been considered	It is difficult to see how this takeover would impact Cadbury India’s operations
Cost benefits of shifting of the prime location Cadbury House property to a lower cost location has not been factored in the valuation	It is difficult to correctly assess the true value of the property “if it was developed”, as claimed by the petitioners. However, EY could only make assumptions on best effort basis.
Valuation by DCF, followed by EY was not transparent and unfair	EY was bound by a NDA regarding the mode of valuation and the factors being incorporated in it. Also, EY was appointed by the Court, which didn’t only accept the first report, but revised the parameters and asked for a new report, which gave a higher valuation
While computing the valuation, EY has deducted the cost of buy backs and open offers	The offer to the petitioners were after the series of buybacks and open offers and hence their cost was logical to be deducted.

THE VERDICT (2/2)

Petitioner’s concerns	Court’s view
Discount rate used at 11% is on higher side and appropriate discount rate is 7-8% used by CIL in its actuarial calculations	7-8% discount rate is the specific requirement of AS15 which states that the Government of India bond’s yield should be used as discount rate. However, a company is riskier than the Government.
Terminal growth rate estimated is 6%, however, company is growing at 40% profit and 20% sales	Just as we cannot take an extremely low figure as terminal growth rate, we cannot take an extremely high rate too. Moreover the EY report provides a basis of the 6% rate
A flat income tax rate of 33.99% has been considered, inspite of Cadbury India enjoying tax benefits and profits taxed at lower than 20% rate over the past few years	Tax regimes are expected to change without notice. A flat rate takes into consideration, any future tax changes
Unpublished financials cannot be used for fair valuation	No logic or material to support this contention
Cadbury India treats its shareholders badly, evidenced by a dividend rate capped at 20% inspite of increasing profits	No shareholder is compelled to continue as shareholder to a Company

Valuation puzzles – Some examples

- Valuation of companies with multiple / diversified business lines in India
- Valuation of companies in different geographies
- Valuation of cyclical businesses
- Valuation of companies in niche businesses with no clear listed comparable company
- Valuation of start-ups or companies with not sufficient operating history
- Valuation of concession based finite life infrastructure projects

Any more examples from your experiences?

Questions?

THANK YOU!