Fundamental Analysis - assessing financial health of a company

Presented at
Seminar on Business Valuation, Mutual Funds and Alternative Investments – Beginner's Guide

Organized by
WIRC - ICAI

Presented by:
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Mumbai

Fundamental Analysis
- a perspective

Do senior management sound this way?

"We need an end to short - termism ... at least until next week."

Do shareholders carry this view?

"Long-term I like intelligence, good looks, and sincerity. Short-term I like semiprecious stones and gold."

Does retail investor feel this way?

HE MIGHT AS WELL GET USED TO IT ... I'M SELLING HIM A LIFETIME ANNUITY NEXT WEEK!

How does financial statements currently help us?

"We're in good shape. Nobody understands our financial statement."

Mantra for Gauging Financial health

- Every business needs to be viewed in context of:
  - Economic cycle
  - Geography of operations
  - Industry
  - Business model as adopted by the company.

- For discerning investor's / finance professional the best starting points are:
  - Comparative studies with competitors financial position (domestic and global)
  - Comparative studies over time periods (if company has been operating over a number of years)

- The above studies would thrown variations / differences which would need to be explained by the operating management team. Whether such rationale appeals to the directors approach to business would depend on individuals experiences.

Lets pick two examples from our own experiences here – Joi (capex / opex & free calls & Flipkart

Understanding Financial Health of a business

- To understand Financial health of a business the following dimensions need to be studied:
  - Margins (ROCE, ROI, ROE)
  - Asset Utilization
  - Capital structure including liquidity analysis
  - Commitments and obligations (generally ignored in practice)

- **Except for the 4th parameter Dupont Analysis covers interrelationship between various other parameters**
  - **ROE = Profit Margin (Profit/Sales) * Total Asset Turnover (Sales/Assets) * Equity Multiplier (Assets/Equity)**

Balance Sheet

as at 31ˢᵗ March 2017

(₹ in crores)

Particulars			Note No.	As at 31ˢᵗ March 2017	As at 31ˢᵗ March 2016	As at 1ˢᵗ April 2015
ASSETS						
1	**Non-Current Assets**					
	(a)	Property, Plant and Equipment	4	668.66	643.04	526.03
	(b)	Capital Work-In-Progress	4	126.57	151.68	218.38
	(c)	Goodwill	5	86.11	86.11	86.11
	(d)	Other Intangible Assets	5	184.80	187.41	192.11
	(e)	Financial Assets				
		(i) Investments	6	440.23	533.89	429.50
		(ii) Loans	9	4.40	7.09	7.59
		(iii) Other Financial Assets	11	12.28	10.98	13.09
	(f)	Current Tax Assets (net)	16	36.47	35.41	33.62
	(g)	Other Non-Current Assets	17	70.34	48.42	74.45
	Total Non-Current Assets			1,629.86	1,704.03	1,581.38
2	**Current Assets**					
	(a)	Inventories	15	556.25	494.20	534.72
	(b)	Financial Assets				
		(i) Investments	7	1,353.18	568.87	287.05
		(ii) Trade Receivables	8	607.65	550.71	506.01
		(iii) Cash and Cash Equivalents	13	45.80	66.15	43.96
		(iv) Bank balances other than (iii) above	14	4.67	6.18	5.00
		(v) Loans	10	18.48	15.53	14.94
		(vi) Other Financial Assets	12	5.00	4.14	3.50
	(c)	Other Current Assets	18	74.69	57.28	53.36
	Total Current Assets			2,665.72	1,762.98	1,458.54
	TOTAL ASSETS			4,295.58	3,467.01	3,039.92
EQUITY AND LIABILITIES						
EQUITY						
	(a)	Equity Share Capital	19	51.27	51.27	51.27
	(b)	Other Equity	20	3,348.08	2,599.32	2,253.31
	Total Equity			3,399.35	2,650.59	2,304.58
LIABILITIES						
1	**Non-Current Liabilities**					
	(a)	Financial Liabilities				
		(i) Other Financial Liabilities	23	1.68	2.25	2.85
	(b)	Provisions	24	24.97	21.86	18.68
	(c)	Deferred Tax Liabilities (net)	26	83.63	75.36	51.35
	Total Non-Current Liabilities			110.28	99.47	72.88
2	**Current Liabilities**					
	(a)	Financial Liabilities				
		(i) Borrowings	21	-	1.12	5.78
		(ii) Trade Payables	22	328.47	316.33	298.33
		(iii) Other Financial Liabilities	27	365.66	310.82	284.59
	(b)	Other Current Liabilities	28	63.08	66.36	54.05
	(c)	Provisions	25	12.81	9.24	11.63
	(d)	Current Tax Liabilities (net)	29	15.83	13.08	13.08
	Total Current Liabilities			785.95	716.95	662.46
	TOTAL LIABILITIES			896.23	816.42	735.34
	TOTAL EQUITY AND LIABILITIES			4,295.58	3,467.01	3,039.92

See accompanying notes to the financial statements 1 to 63

Statement of Profit and Loss

for the year ended 31st March 2017

(₹ in crores)

Particulars	Note No.	For the year ended 31st March 2017	For the year ended 31st March 2016
INCOME			
Revenue from Operations	30	5,298.65	5,063.06
Other Income	31	110.10	70.62
Total Income		5,408.75	5,133.68
EXPENSES			
Cost of Materials Consumed	32	2,025.82	2,058.51
Purchases of Stock-in-Trade		244.22	208.67
Changes in inventories of Finished Goods Work-in-Progress and Stock-in-Trade	33	(7.90)	18.04
Excise Duty on sale of goods		433.28	332.03
Employee Benefits Expense	34	507.45	457.16
Finance Costs	35	5.68	5.84
Depreciation and Amortisation Expense	36	98.24	87.82
Other Expenses	37	870.90	872.11
Total Expenses		4,169.69	4,037.18
Profit before Exceptional Items and Tax		1,239.06	1,096.50
Exceptional Items	38	94.34	27.00
Profit before Tax		1,144.72	1,069.50
Tax Expense			
Current Tax	48	362.66	298.77
Deferred Tax	48	8.27	24.01
Net Tax Expense		370.93	322.78
Profit for the year		773.79	746.72
Other Comprehensive Income			
Items that will not be reclassified to profit or loss			
Remeasurement of Defined Benefit Plan		(2.79)	(0.31)
Income tax relating to items that will not be reclassified to profit or loss	48	0.81	0.09
Total Other Comprehensive Loss		(1.98)	(0.22)
Total Comprehensive Income for the year		771.81	746.50
Earnings Per Equity Share			
Basic (₹)	43	15.09	14.57
Diluted (₹)		15.09	14.56

QUESTION?

How does this work in the modern business context wherein 70% "value" in intangibles

"Our employees are our greatest asset. I say we sell them."

Integrated Approach not just Finance function

BUSINESS EXECUTION

Summary points

Slide captures few important thoughts about the approach to fundamental analysis.

- Understanding a business in the context of economic environment it operates in.
- Similar businesses can operate with different model. Analysis has be to understanding imperative of these different models.
- Annual report (not financial statement) is the statement to be referred. The relevant number has to be chosen basis the decisions to be taken. One number (balance sheet number) doesn't fit all. Book value, market value, replacement value.
- The primary predicate is maximization of "ROE".
- The orientation should be - "And-And" – Short term & long term.
- The integrative approach to management should be visible.

Valuation of companies: Understanding the Value drivers

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Few quotable quotes for Finance professionals

Few jargons which raise red flag:

Pivoting

Innovation

Disruption

Agility

Scalable

unit economics

Economic view

- Its not about return on capital but about return of capital

Philosophical view:

- Life is long enough to be experienced with patience rather than greed

Change in Narrative in 12 months

September 2015

- Flipkart USD 16 billion. Snapdeal USD 5 billion. Other Indian startups in the unicorn club include mobile advertising technology company InMobi ($2.5 billion), taxi consolidator Olacabs ($5 billion), mobile payments company Paytm ($2billion), online restaurant guide Zomato ($1 billion), online classifieds firm Quikr ($1 billion) and data analytics outsourcing company Mu Sigma ($1 billion). Promising candidates are Oyo Rooms (currently $400 million), Bigbasket ($400 million) and Grofers ($100 million).

- "FOMO" driven valuation was very evident.

August 2016

- Flipkart USD 5.58 billion. Snapdeal USD 4 billion. Other Indian startups in the unicorn club include mobile advertising technology company InMobi ($0.8 billion), taxi consolidator Olacabs ($2.4 billion), mobile payments company Paytm ($5billion), online restaurant guide Zomato ($0.5 billion), online classifieds firm Quikr ($1 billion) and data analytics outsourcing company Mu Sigma ($1 billion). Promising candidates are Oyo Rooms (currently $400 million), Bigbasket ($400 million) and Grofers ($100 million).

- Cutting down on burn rates and Unit economics have to be visible. "**There is a strong focus on capital efficiency and moats around the business.**"

Impact of SoftBank and Softbank Vision fund on the current narrative

Examining value – OYO rooms

Oyo in Numbers

Oyo's booked revenue* has grown exponentially...

₹1,598.7 cr

₹1,067.4 cr

₹36.1 cr

| March 2015 | March 2016 | March 2017 |
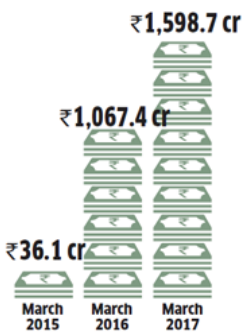
*Booked revenue is the revenue earned from bookings made from Oyo platform

...and the scale of growth too has jumped...
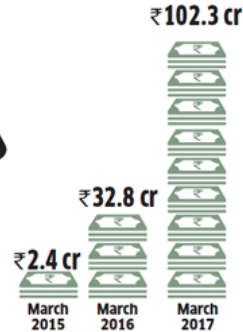
March 2014: 105 rooms in 11 hotels across 2 cities

June 2017: 70,000 rooms in 7,000 hotels in 200 cities

January 2016: 1 million hotel check-ins

June 2017: 5 million check-ins

...but Oyo's share of revenue is small, albeit growing rapidly...

₹102.3 cr

₹32.8 cr

₹2.4 cr

| March 2015 | March 2016 | March 2017 |

Note 17 Operating Expenses	Year Ended March 31, 2015	Amount in (₹) Year Ended March 31, 2014
Minimum Guarantee	3,61,98,948.20	0.00
Inventory of Properties	1,04,05,873.75	0.00
Commission Expense	57,88,440.75	14,89,070.93
Property related Expenses	62,15,950.00	0.00
Minimum Tariff Loss	30,18,470.85	0.00
Consumables	23,83,509.93	0.00
Photography Expenses	21,93,064.00	7,500.00
Credit card charges	1,68,255.53	9,944.10
Payment Gateway Charges	82,686.94	0.00
	6,64,55,199.95	15,06,515.03

LOSSES
(in ₹ cr)

FY 2014-15	FY 2015-16	FY 2016-17P
21	496	325

Total funding raised – USD 450 million (INR 2700 crores approx)
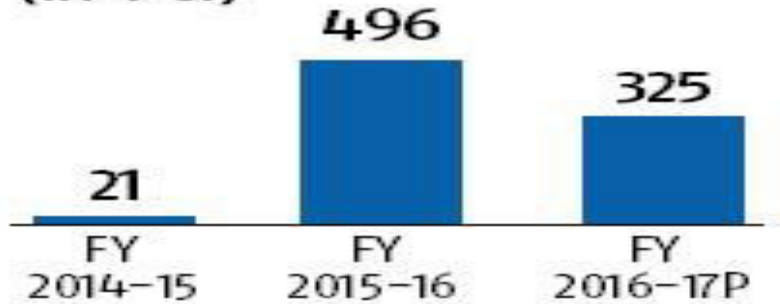
Re-examining value - Flipkart

March 2017 numbers

Mixed Bag

Revenue:
FY16: ₹15,403 crore
FY17: ₹19,854 crore
Increased by **29%**

Loss:
FY16: ₹5,223 crore
FY17: ₹8,771 crore
Increased by **68%**

Cash in Hand fell by 13% to ₹3,579 crore

Investments in Mutual Funds/Bonds fell sharply by 78% to ₹1,114 crore

Advertisement & Business Promotion Expenses:
FY16: ₹1,086 crore
FY17: ₹1,188 crore
Increased by **9.4%**

Finance Costs:
FY16: ₹806 crore
FY17: ₹4,308 crore
Increased by **434%**

Employee Benefit Expenses (most of which are salary and bonuses):
FY16: ₹1,880 crore
FY17: ₹2,052 crore
Increased by **9%**

- To put the number in perspective:

- Value ascribed by walmart – INR 117,000 crores approx.

- Snapdeal in the same period had revenues of INR 900 crores and total expenses of about INR 3200 crores. Employee cost of INR 600 crores.

> "SoftBank's capital campaign continued this week on the news that the firm's Vision Fund is deploying $300 million into dog-walking startup Wag."

What is driving the business world?

Traditional view of "Value drivers"

Value Drivers are characteristics of a business that either reduce the risk associated with owning the business or enhance the prospect that the business will grow significantly in the future.

There are many items that create value including:

> *proprietary technology,*
> *market position,*
> *brand name,*
> *diverse product lines, and*
> *patented products.*

The items common to all industries, which drive up value ("Value Drivers") include:

- A stable, motivated management team *(spice jet)*
- Operating systems that improve sustainability of cash flows *(Amazon)*
- A solid, diversified customer base *(Marriot)*
- Facility appearance consistent with asking price (?)
- A realistic growth strategy (??)
- Effective financial controls (???)
- Good and improving cash flow (????)

Examining value drivers in current context

Facebook & whatsapp

- Whatsapp acquired for USD 19 billion by FB.
- The deal was finalized at $19 billion, which includes $4 billion in cash, about $12 billion worth of Facebook shares and the remaining $3 billion as restricted stocks.
- Restricted stock units to WhatsApp employees represented 7.9% of Facebook's shares.

Google & Deepmind

- Deepmind was acquired by google in 2014 for USD 600 million.
- The company is yet to generate any significant revenues.
- Could be construed as a failure when one cursorily examines the transaction.
- It is still given lot of autonomy under the new Alphabet / google configuration? What is the value driver?

Discuss – covenants are also value drivers for a company:
1. Covenant around non compete
2. Covenant around buy back clause
3. Convertible covenant

Value drivers examined

Quick views on each of the situations mentioned in this slide.

Discuss this in context of :

- Life cycle-
  - Young Growth business
  - Growth companies
  - Mature Companies
  - Declining & distressed companies

- Special Situations:
  - Financial services company
  - Cyclical / commodity companies
  - Intangibles play in company

The next few slides are to share with participants some view on how valuation is examined in context of the start up / venture capital.

Few additional thoughts on capturing value drivers in startup environment

How do we address?

Established business have predict-ability of cashflows

When the business is nascent or in the ideation stage, valuation becomes a difficult proposition.

Few approaches often used are described in this slide.

All these approaches get refined with every incremental deal.

Valuation Approach	Principle / drivers
Berkus	Based on assessment of 5 key success factors
Risk factor summation	based on a base value adjusted for 12 standard risk factors
Scorecard	weighted average value adjusted for similar companies
Comparable transaction	based on rule of 3 with a KPI from similar company
discounted cash flow	Sum of present value of future cash flows
Scenario Analysis	weighted average of 3 valuation scenarios
Venture capital	based on ROI expected by investor

BERKUS Method

The Berkus Method is meant for pre-revenue startups.

Most often "pre-revenue" valuation to a start-up that has potential of reaching over $20 million in revenues within five years will be dependant on the 5 parameters.

Once a company crosses pre-revenue stage, this approach would be inappropriate to apply

- The premise is that it establishes a ceiling of USD 2.5 million
- Every element of business adds additional comfort and thereby better valuation.

If Exists:	Add to Company Value up to:
Sound Idea *(basic value)*	$1/2 million
Prototype *(reducing technology risk)*	$1/2 million
Quality Management Team *(reducing execution risk)*	$1/2 million
Strategic relationships *(reducing market risk)*	$1/2 million
Product Rollout or Sales *(reducing production risk)*	$1/2 million

Risk Factor summation

Refined and evolved version of Berkus model

The base value is the value of similar businesses in similar geography. This is the most tricky part of the approach.

The premium or discount is generally in multiples of an amount based on high or low risk rating.

The Risk Factor Summation Method

INITIAL VALUE			$1,500,000
1. MANAGEMENT RISK	Very low	+$500,000	$2,000,000
2. STAGE OF THE BUSINESS	Normal		
3. LEGISLATION/POLITICAL RISK	Normal		
4. MANUFACTURING RISK	Normal		
5. SALES AND MANUFACTURING RISK	Normal		
6. FUNDING/CAPITAL RAISING RISK	Normal		
7. COMPETITION RISK	Very high	-$500,000	$1,500,000
8. TECHNOLOGY RISK	Low	+$250,000	$1,750,000
9. LITIGATION RISK	Very low	+$500,000	$2,250,000
10. INTERNATIONAL RISK	Normal		
11. REPUTATION RISK	Very low	+$500,000	$2,750,000
12. POTENTIAL LUCRATIVE EXIT	Normal		

BOX VALUATION			$2,750,000

Scorecard Valuation

Some criteria's used for evaluation:

Management (30%),

Size of opportunity (25%),

Product or Service (10%),

Sales channels (10%),

Stage of business (10%) and

Other factors (15%)

Weight is arrived based on what is expected out of similar business and Vs. Average project is the readiness of the project being evaluated vs other projects.

The Scorecard Valuation method

		Weight	vs. average project
1.	TEAM CAPACITY	40%	125%
2.	PRODUCT/TECHNOLOGY READINESS	30%	100%
3.	MARKET SIZE	20%	15%
4.	COMPETITION	10%	75%

***

INITIAL VALUE	$1,500,000
MULTIPLIER	117,5%
BOX VALUATION	**$1,760,250**

Comparable transaction method

Similar to PE / PBV / Evby EBITDA

Monthly Recurring Revenue (Saas), HR headcount (Interim), Number of outlets (Retail), Patent filed (Medtech/Biotech), Weekly Active Users or WAU (Messengers)

The Comparable Transactions Method

	Sold for	Revenue multiple	WAU multiple
SIMILAR BOX #1	$957	3,0 x	2,3 x
SIMILAR BOX #2	$647	3,3 x	6,4 x
SIMILAR BOX #3	$327	1,9 x	1,5 x
SIMILAR BOX #4	$737	5,4 x	0,2 x
SIMILAR BOX #5	$6,248	8,6 x	5,7 x
SIMILAR BOX #6	$39,087	7,3 x	4 x
SIMILAR BOX #7	$6,576	12,1 x	31 x
SIMILAR BOX #8	$4,258	8,3 x	3,5 x
SIMILAR BOX #9	$3,798	3,4 x	1,1 x

* * *

	Revenue	WAU
MY BOX INDICATORS	$900	1,000
WEIGHTED AVERAGE MULTIPLES	7,6	6,7
BOX VALUATION BASED ON...	**$685**	**$6,736**

The next slide is to share with participants some view on how emerging technologies would disrupt the market.

This slide is a summary of a study conducted by techforesight.com

The presenter is not supporting or ascribing to the ideas proposed herein.

Closing remarks – Whats in store for future

TABLE OF DISRUPTIVE TECHNOLOGIES

A dashboard of 100 wonderful, weird (and possibly worrying) ways the world might change in the foreseeable future

POTENTIAL FOR SOCIO-ECONOMIC DISRUPTION — HIGH → LOW

TIME* — SOONER → LATER

* Time is defined as ubiquity or mainstream use not invention

Legend

Ghost Technologies: Fringe science & technology. Defined as highly improbable, but not actually impossible. Worth watching.

Horizon 3: Distant future 20 years + [Explore].

Horizon 2: Near future 10–20 years hence [Experiment].

Horizon 1: Happening now [Execute].

How to read entries

Sn — Abbreviation of technology
Smart nappies — Description of technology
1 — Theme (See next right)
DE — Examples (See right hand panel)

Themes

Each of the 100 technologies has been subjectively categorised according to five broad themes, which are:

- **DE** Data Ecosystems
- **SP** Smart Planet
- **EA** Extreme Automation
- **HA** Human Augmentation
- **MI** Human-Machine Interactions

The Small Print

Conceived and created by Richard Watson and Anna Cupani, Imperial Tech Foresight.

www.techforesight.com

This presentation has been prepared for ICAI .

The presentation is intended only to serve as reference point and cannot substitute studied opinions on specific matters. All opinions and interpretations expressed are that of the presenter. ICAI does not endorse or ascribe to the views / opinions / interpretations.

This presentation was made in August 2018 in Mumbai.

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