




Profits and Projections

Evaluation





When you are courting a nice girl, an hour
seems like a second. When you sit on a
red-hot cinder a second seems like an
hour. That's relativity.

—Albert Einstein



Is anything wrong in the below illustrated financials?

| Balance Sheet | Mar-20 |
|---------------------------------|---------------|
| Intercompany receivables | 50 |
| Investments | 20 |
| Loans & Advances | 60 |
| Trade Receivables | 50 |
| Cash and Bank Balances | 20 |
| Other Current Assets | 10 |
| Deferred Tax (net) | 10 |
| Less: Trade Payables | (50) |
| Less: Short Term Provisions | (20) |
| Less: Long Term Provisions | (40) |
| Less: Other Current Liabilities | (80) |
| Book Value | 30 |
| | |
| Equity Share Capital | 10 |
| Reserves & Surplus | 20 |
| Book Value | 30 |

| Profit & Loss Account | Mar-20 |
|----------------------------------|---------------|
| Income from outsourcing services | 500 |
| Total Revenues | 500 |
| Cost of Goods Sold | 300 |
| Employee Cost | 100 |
| Other Expenses | 80 |
| Depreciation | 60 |
| Interest Expense | 40 |
| Total Expenses | 580 |
| Profits Before Tax | (80) |
| Taxes | - |
| Profits After Tax | (80) |

Amounts in INR Millions

Sherlock Holmes and Dr. Watson decide to go on a camping trip. After dinner and a bottle of wine, they lay down for the night, and go to sleep.

Some hours later, Holmes awoke and nudged his faithful friend.

"Watson, look up at the sky and tell me what you see."

Watson replied, "I see millions of stars."

"What does that tell you?"

Watson pondered for a minute.

"I deduce that the time is approximately a quarter past three. I suspect that we will have a beautiful day tomorrow. What does it tell you, Holmes?"

Holmes was silent for a minute, then spoke: "Watson, you idiot. Someone has stolen our tent!"

**BEFORE EVALUATING ANY NUMBERS, UNDERSTAND AND
EVALUATE THE BUSINESS**



Projections



Free Cash Flows

Profits After Tax

(+) Depreciation

(+/-) Other Non-Cash Items like Deferred Tax, etc.

(+) Interest (net of tax)

(-) Investment in working capital

(-) Investment in capital expenditures



**Free Cash
Flows to Firm
(FCFF)**

Evaluation – Projections – Capex

| Particulars (INR MM) | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | TV |
|-----------------------------|---------------|---------------|---------------|---------------|---------------|------------|
| PAT | 200 | 240 | 288 | 346 | 415 | 435 |
| Add: Dep | 20 | 24 | 29 | 35 | 41 | 44 |
| Add: Int (net of tax) | - | - | - | - | - | - |
| Less: WC Movements | (2) | (2) | (3) | (3) | (4) | (4) |
| Less: Capex | 22 | (50) | (60) | - | - | (150) |
| FCF | 240 | 212 | 254 | 377 | 452 | 325 |

Evaluation – Projections – Capex

➤ **Capex**

➤ **Capacity Utilization**

- Manufacturing
- Service
- Toll Projects
- Cost Plus Markup

➤ **Ratios**

- Compare with past
- Compare with industry
- Capex % to Revenues / Gross Block / Capex per tonne / per bed / per room

➤ **What if projected capex is nil?**

➤ **Is negative capex correct?**

➤ **Capex Cycle**

Evaluation – Projections – Working Capital

| Particulars | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | TV |
|-----------------------|---------------|---------------|---------------|---------------|---------------|------------|
| PAT | 200 | 240 | 288 | 346 | 415 | 435 |
| Add: Dep | 20 | 24 | 29 | 35 | 41 | 44 |
| Add: Int (net of tax) | - | - | - | - | - | - |
| Less: WC Movements | (375) | 42 | (30) | (50) | 4 | 28 |
| Less: Capex | (20) | (24) | (29) | (35) | (41) | (44) |
| FCF | (175) | 282 | 258 | 296 | 419 | 463 |

Evaluation – Projections – Working Capital

➤ **Working Capital**

➤ **What is included in working capital?**

- Is long term loans & advances part of working capital?
- What about short-term debt?
- Is proposed dividend included?
- What about current maturities of long term debt?
- What about margin money deposits?
- Operating Cash?

➤ **Working Capital Ratios**

- % to revenues, turnover ratios (debtor days / creditor days / inventory)
- Compare to past as well as to the industry

➤ **Intercompany receivables / payables**

- **Can a business have negative working capital throughout its life?**
- **How should the same be treated in terminal value calculation?**

Evaluation – Projections – Borrowings

- **Borrowings / Cost of Borrowings / Interest**
 - **Repayment Schedule**
 - Affects Debt Equity Ratio / WACC
 - Industry Debt Equity Ratio
 - Current v Projected Debt Equity Ratio
 - **Inter-company / related party borrowings**
 - Whether interest bearing
 - Substance over form of the instrument viz. whether debt or equity
 - **Idle Cash v Borrowings**
 - **Treatment of Bank Overdraft – Current Liability or Debt?**
 - **Treatment of Preference Share Capital**
 - **Rate of Interest**

Evaluation – Projections – Revenues

➤ Revenues

➤ Growth

- Past v Future (IRCTC)
- Industry Comparison (Zomato / Uber Eats, Airlines, Telecom)
- Market Share (Dream11 / Reliance Jio Infratel tower business)
- Geography (Alcohol / Poker / Uber-Didi)
- Outside Factors (FDI Regulations / Mining Leases)
- Start-ups v existing set-ups

➤ Capacity Utilization

➤ Seasonality (Hospitality / Travel / Mining)

➤ Composition (Old v New, Manufacturing v Trading, Outside v Captive)

➤ Compound Annual Growth Rate (CAGR)

Evaluation – Projections – Operating Margins

➤ **Operating Margins**

➤ **Trend**

- Past v Future (Cost plus model)
- Industry Comparison (Cement / Life insurance companies / QSR)
- Cost Analysis – Variable v Fixed
- Operating Costing

➤ **Raw Material Price (imported v Indigenous)**

➤ **Employee Cost**

➤ **Royalty Payments**

➤ **Ad Spends and Business Development**

➤ **Foreign Exchange Fluctuations**

Evaluation – Projections – Depreciation

- **Depreciation**

- **Owned v Rented**

- **Relation with Capex and Gross Block**

- **EBITDA / EBITDAR**

Profitability

Evaluation – Profitability

- **Erstwhile CCI Guidelines**
- **PECV Method**
- **Capitalization Rate**
- **Inverse of Multiple**
- **Non-Recurring Items of Income / Expenditure**
- **Non-Operating Items of Income / Expenditure**
- **Prior-Period Items**

Evaluation – Profitability

- **Foreign Exchange Gain / Loss**
- **Interest Income**
- **Income Tax Refund**
- **Bad Debts**
- **Gain / Loss on Sale of Fixed Assets**
- **Income Tax Expense**
- **Other Operating Income**
- **Other Income**
- **Interest Expense**

Evaluation – Profitability – Find maintainable profits

| Amounts in INR Million | | Mar-18 | Mar-19 | Mar-20 |
|------------------------|-------------------|--------|--------|--------|
| Example 1 | Profits After Tax | 300 | 350 | 400 |

| | | | | |
|-----------|-------------------|-----|-----|-----|
| Example 2 | Profits After Tax | 400 | 350 | 300 |
|-----------|-------------------|-----|-----|-----|

| | | | | |
|-----------|------------------------|-----|-----|-----|
| Example 3 | Profits After Tax | 300 | 350 | 400 |
| | Non-recurring incomes | 20 | 120 | 120 |
| | Non-recurring expenses | 120 | 120 | 20 |

| | | | | |
|--|--------------|-----|-----|-----|
| | Maintainable | 400 | 350 | 300 |
|--|--------------|-----|-----|-----|


What about tax on non-recurring items adjusted?

Facts to remember while evaluating

- **Accounting Income is less relevant as compared to cash flows**
 - Long Term Debt v Short Term Debt
 - Current Cash v Long Term Cash
 - Current Liabilities v Long Term Liabilities
 - Dividend / Appropriation
- **So are accounting standards**
- **Projected Cash and Projected Surplus Assets**
- **Deferred Tax**
- **Interest Expense**
- **Projected Increase in Equity Capital**

Basic Errors – The Dark Side of **E**valuation

- **Projected Balance Sheet does not tally**
- **Projected Cash is negative**
- **Projected Gross Block less Accumulated Depreciation does not tie up with Net Block**
- **Projected Annual Profit / Loss number does not tie up with movement in Reserves & Surplus**
- **Absolute Numbers of Revenues or Costs are declining**
- **Implied Tax Rates are either too low or too high**
- **Disregarding actuals till date in building up projections**



Get your facts first, and then you can
distort them as much as you please

—Mark Twain

