VALUATION OF SHARES, SHARE EXCHANGE RATIO, FAIRNESS OPINION AND PRIVATE PLACEMENTS

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Agenda

- Valuation overview
- Share Exchange Ratio
- Fairness opinion in case of Merger Schemes
- Valuation for Private Placements under the Companies Act, 2013

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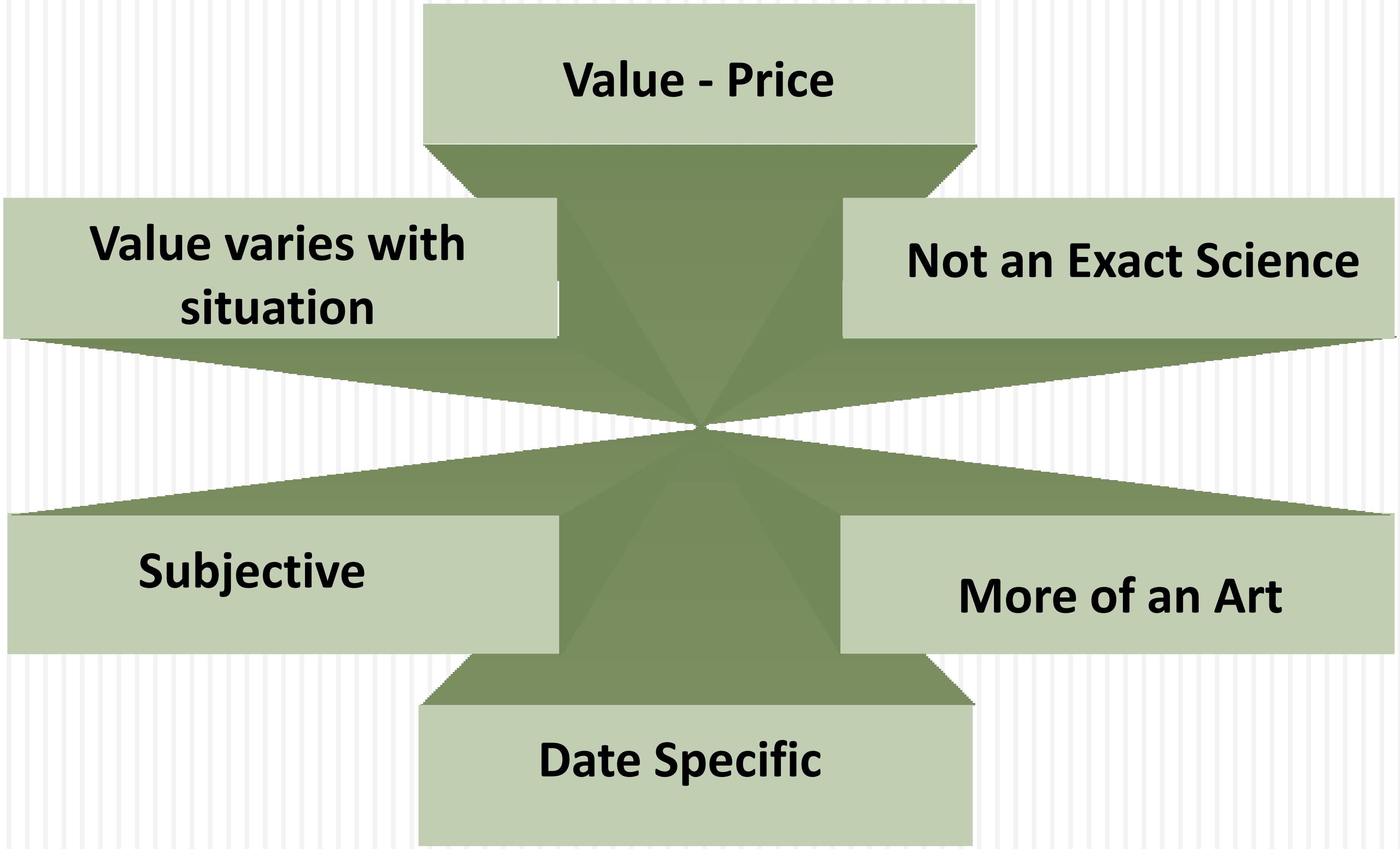
Valuation overview

Valuation concept



Why Valuation?

- Merger/ Demerger
- Private Equity
- IPO/ FPO
- Family Separation
- PPA
- Portfolio Value of Investments
- Regulatory Approval
- Litigation
- Test of Impairment
- Buyback of Shares
- Purchase / Sale of Business

Steps in Valuation

- Obtaining information
- Data analysis and review
- Discussions with the management of the company
- Selection of method
- Conducting sensitivities on assumptions
- Assigning Weights
- Recommendation
- Reporting

Sources of Information

- Historical data such as audited results of the company
- Management Discussion and Industry Overview
- Future projections
- Stock market quotations
- Representation by the management
- Data on comparable companies
- Market surveys, news paper reports

Analysis of Company

- SWOT Analysis
- Profitability Analysis- Past and vis-à-vis industry
- Ratio Analysis
- P&L Ratios
  - Expense & Profitability ratios
- Balance Sheet Ratios
  - Quick Ratio/ Current Ratio
  - Turnover Ratios
  - Liquidity Ratios
  - Debt Equity- of Company & Industry

Principal Methods of Valuation

Earning Based Approach

- Discounted Cash Flow
- Earnings Multiple Method

Market Approach

- Market Price
- Market Comparables

Asset Based Approach

- Net Assets Method
- Replacement Value / Realizable Value

Discounted Cash Flow Method

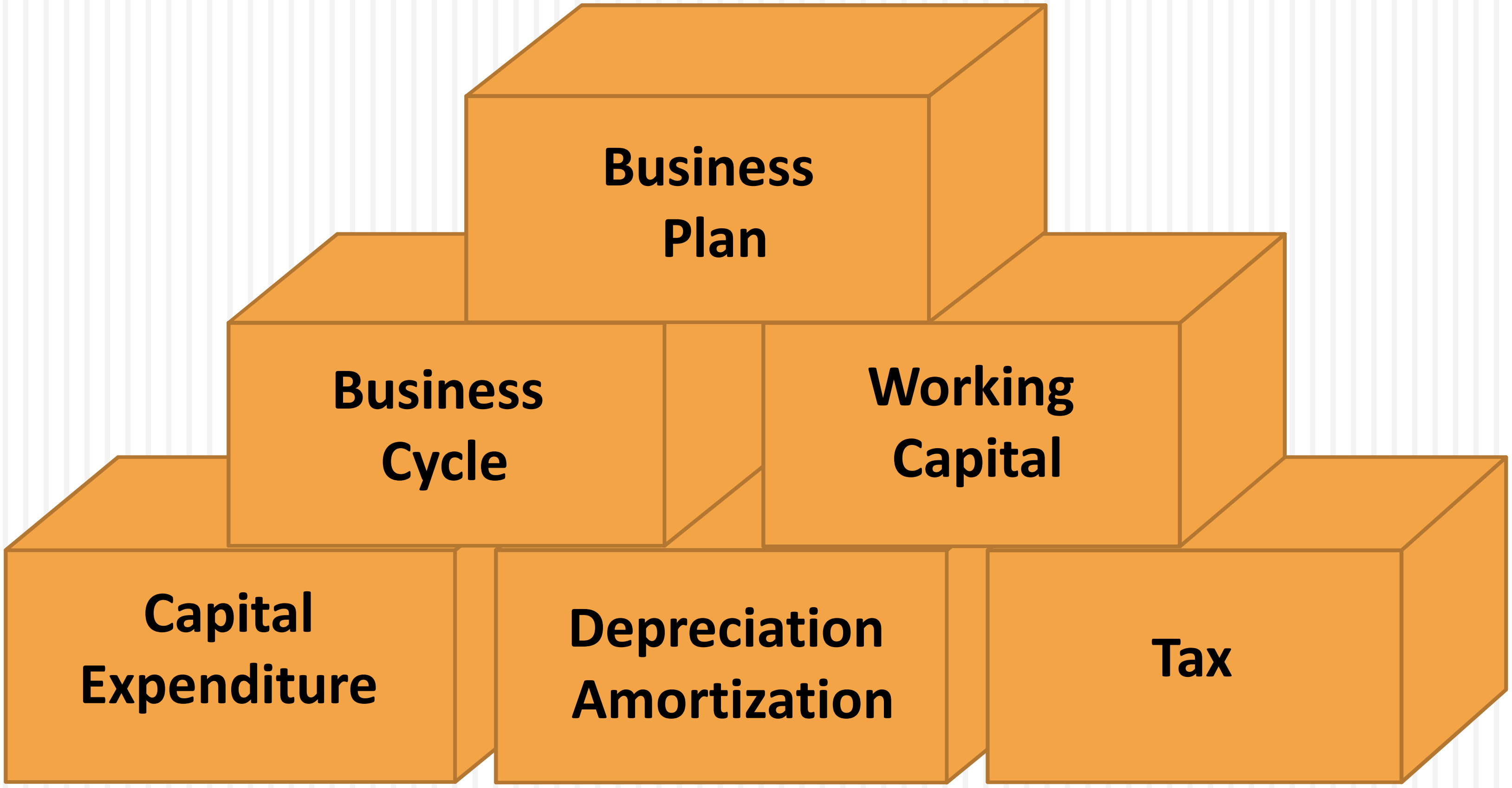
- Values a business based on the expected cash flows over a period of time
- Involves determination of discount factor and growth rate of profitability
- Value of business is aggregate of discounted value of the cash flows for the explicit period and perpetuity
- Considers cash flow & not profits

DCF - Parameters

- Cash Flows
  - Projections
  - Horizon Period
  - Growth Rate

- Discounting
  - Cost of Equity
  - Cost of Debt
  - Weighted Average Cost of Capital (‘WACC’)

Cash Flows


Business
Plan
Business
Cycle
Working
Capital
Capital
Expenditure
Depreciation
Amortization
Tax

DCF – Discounting

- Weighted Average Cost of Capital (WACC)

$$WACC = \left\{ \frac{D}{(D + E)} \times Kd \right\} + \left\{ \frac{E}{(D + E)} \times Ke \right\}$$

D = Debt

E = Equity

Kd = Post tax cost of debt

Ke = Cost of equity

Cost of Equity

- In CAPM Method, all the market risk is captured in the beta, measured relative to a market portfolio, which atleast in theory should include all traded assets in the market place held in proportion to their market value.

Ke = (Rf + (β x Erp))

Where , Ke = Cost of Equity
Rf = Risk free return
Erp = Equity risk premium
β = Beta

DCF – When to use?

- Most appropriate for valuing firms:
  - Limited life projects
  - Large initial investments and predictable cash flows
  - Regulated business
  - Start-up companies

Earnings Multiple Method

- Commonly used Multiples:
  - Price to Earnings Multiple
  - Enterprise Value / EBITDA Multiple

- Parameters:
  - Capitalization Rate / Multiple
  - Future Maintainable Profits

Maintainable Earnings

- Based on past performance and/ or projections
- Elimination of material non-recurring/ non operational / exceptional items
- Adjustment if capacity is under-utilized or recently added
- Profits of various years averaged (simple or weighted)

Earnings Multiple Method

- Multiple to be applied represent the growth prospects / expectations of the Company

- Factors to be considered while deciding the multiple:
  - Past and Expected Growth of the Earnings
  - Performance vis-à-vis Peers
  - Size & Market Share
  - Historical multiples enjoyed on the Stock Exchange by the Company and its peers

Market Price Approach

- Evaluates the value on the basis of prices quoted on the stock exchange
- Thinly traded / Dormant Scrip – Low Floating Stock
- Significant and Unusual fluctuations in the Market Price
- It is prudent to take weighted average of quoted price for past 6 months
- Regulatory bodies often consider market value as important basis – Preferential allotment, Buyback, Takeover Code

Market Comparables

- Generally applied in case of unlisted entities
- Estimates value by relating an element with underlying element of similar listed companies.
- Based on market multiples of Comparable Companies
  - Book Value Multiples
  - Industry Specific Multiples
  - Multiples from Recent M&A Transactions.

NAV Formula

Total Assets (excluding Miscellaneous Expenditure and debit balance in Profit & Loss Account)	
Less: Total Liabilities	
NET ASSET VALUE	

OR

Share Capital	
Add: Reserves	
Less: Miscellaneous Expenditure	
Less: Debit Balance in Profit & Loss Account	
NET ASSET VALUE	

Adjustments to Valuation

- Investments
- Surplus Assets
- Auditors Qualification
- Preference Shares
- ESOPs / Warrants
- Contingent Liabilities
- Tax Benefits

Issues in Business Valuations

- Selection of methods
- Loss making companies
- Start-up companies
- Difficulty in obtaining comparable multiples
- Thinly traded / Dormant Scrip - Low Floating Stock, Unusual fluctuations in Market Price
- Issues in forecasting
- Illiquidity discount & control premium

Judicial Pronouncements

- "It is fair to use combination of three well known methods - asset value, yield value & market value"

  Hindustan Lever Employees ' Union Vs. HLL (1995) 83 Com. Case 30 SC

- "Exchange Ratio not disturbed by Courts unless objected and found grossly unfair"

  Miheer H. Mafatlal Vs. Mafatlal Industries (1996) 87 Com Cases 792

  Dinesh v. Lakhani Vs. Parke-Davis (India) Ltd. (2003) 47 SCL 80 (Bom)

- "DCF Method is an acceptable method. A combination of methods can be accepted for valuation. Intrinsic value cannot include control premium"

  Mrs Renuka Datla V/s Solvay Pharmaceutical B.V. & Ors. (2003)

Judicial Pronouncements

- "Valuation will take into account number of factors such as prospective yield, marketability, the general outlook for the type of business of the company, etc. Valuation is an art, not an exact science. Mathematical certainty is not demanded, nor indeed is it possible"

  Viscount Simon Bd in Gold Coast Selection Trust Ltd. vs. Humphrey reported in 30 TC 209 (House of Lords)

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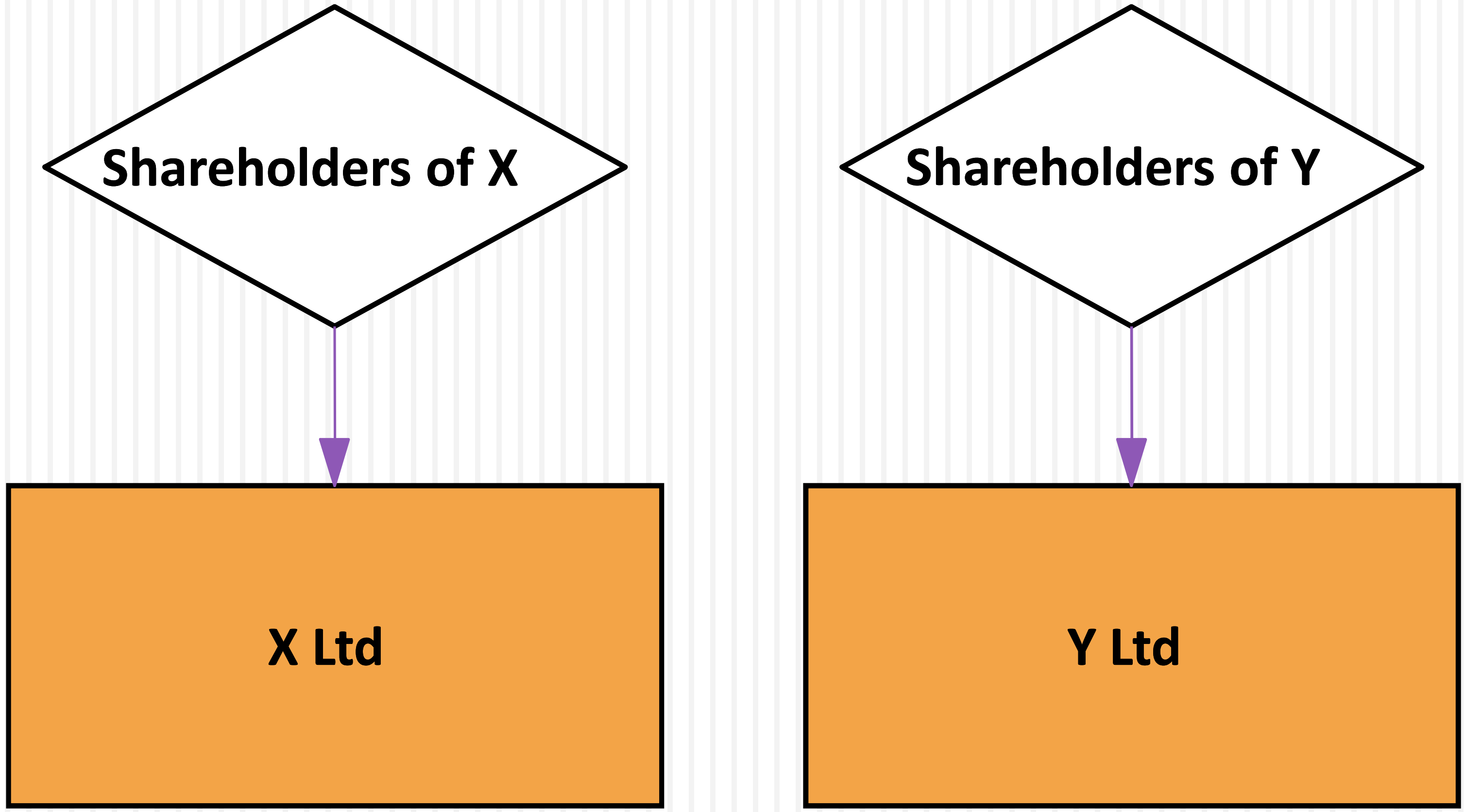
Share Exchange Ratio

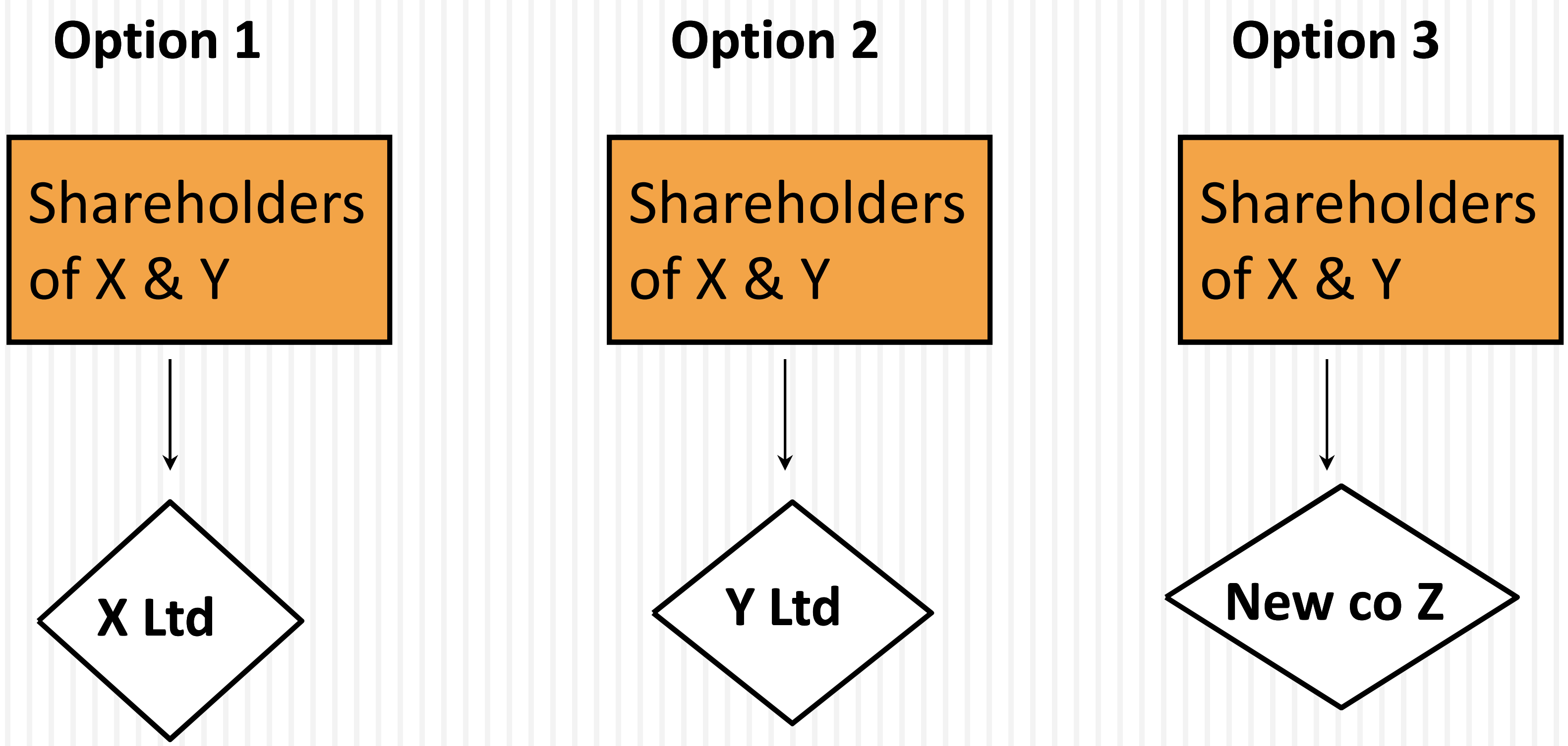
Merger

- In common parlance it means combination of two or more commercial organizations into one
- Merging company loses its separate identity
- It is fusion of two or more existing companies
- All assets and liabilities of one or more Companies are transferred to another Company
- Merger and Amalgamation terms are used interchangeably

Before Merger



After Merger



Merger Valuation

- For the purpose of Merger Valuation :
  - Attempt is not to arrive at absolute values of the shares of the companies, but at their relative values, on a stand alone basis, to facilitate determination of the share exchange ratio
- Based on the determined Share Exchange Ratio, the shareholders of the transferor company are issued shares of transferee company as a consideration

Recent Mergers - Share Exchange Ratios

- Merger of Ranbaxy Laboratories Ltd into Sun Pharmaceutical Industries Ltd
  - 4 equity shares of Sun Pharma of INR 1 each for every 5 equity shares of Ranbaxy of INR 5 each
- Merger of Sterling Holiday Resorts (India) Ltd with Thomas Cook India Ltd
  - 4 equity shares of Thomas cook of INR 1 each for every 100 equity shares of Sterling of INR 10 each
- Merger of Mount Everest Mineral Water Ltd with Tata Global Beverages Ltd
  - 3 equity shares of TGBL of INR 1 each for every 4 equity shares of MEMWL of INR 10 each
- Merger of Wyeth Ltd with Pfizer India Ltd
  - 7 equity shares of Pfizer India of INR 10 each for 10 equity shares of Wyeth India of INR 10 each

Fairness Opinion

Meaning of Fairness Opinion

- A Fairness Opinion is a conclusion reached by an independent expert on the reasonableness of the transaction price from a financial perspective
- In other words, it is the financial “fairness” of the transaction price
- A Fairness Opinion reduces the risk of erroneous decisions
- It does not directly establish a company’s value but judges whether it is fair and reasonable

Compliances for Merger

- In case of listed company, fairness opinion from merchant bankers to be obtained
- The merchant banker shall give a fairness opinion
- This shall be made available to the shareholders at the time of approving the resolution under Clause 24

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Private Placement

Private Placement / Further issue of shares

- Private placement is
  - “Any offer of **securities*** or invitation to subscribe securities
  - To a select group of persons by a company (other than by way of public offer)
  - Through issue of a private placement offer letter and which satisfies the conditions specified in section 42 of Co. Act 2013”

**It is also to be noted that the provisions for private placement applies to the issue of "securities" and not "shares". Thus the new provisions have widened the scope and cover a whole host of instruments such as equity shares, preference shares, bonds, debentures and other marketable securities etc.*

- Provisions for further issue of shares now applicable to both, private as well as public companies [Section 62]

Provisions under Co. Act 2013

- Offer or invitation shall be made to not more than 50 or such higher number of persons as may be prescribed (excluding QIB's and employees offered securities under ESOP) in a FY
- Any offer or invitation not in compliance with the provisions of section 42 of Co. Act 2013 shall be treated as a public offer and all provisions of this Act, and the SCRA and SEBI Act shall be required to be complied with

Provisions under Co. Act 2013

- No fresh offer or invitation shall be made unless allotments with respect to any offer or invitation made earlier have been completed
- All monies to be paid by cheque or DD but not cash
- Company shall allot its securities within 60 days from the date of receipt of the application money for such securities
- If company is not able to allot the securities within that period, it shall repay the application money to the subscribers within 15 days from the date of completion of 60 days
- If the company fails to repay the application money within the aforesaid period, it shall be liable to repay that money with interest at the rate of 12% p.a. from the expiry of the 60th day

Valuation

- Valuation report by Registered Valuer is required
- The following valuation methodologies may be considered:
  - Asset based approach
  - Earning based approach
  - Market approach
- Selection of method on case to case basis

Registered Valuer

- Any valuation of shares / assets required under Co. Act 2013 to be performed by a Registered valuer
- The qualification, experience as well as the process of registration as a Registered valuer have been prescribed in the draft rules* (section 247 of the Co. Act 2013)
- The provisions relating to Registered valuers have not been notified but till the rules are notified, Chapter III of Co. Act 2013 prescribes that during this time the pricing of shares must be valued by a SEBI registered merchant banker or a chartered accountant that has been in practice for at least 10 years


Thank You!