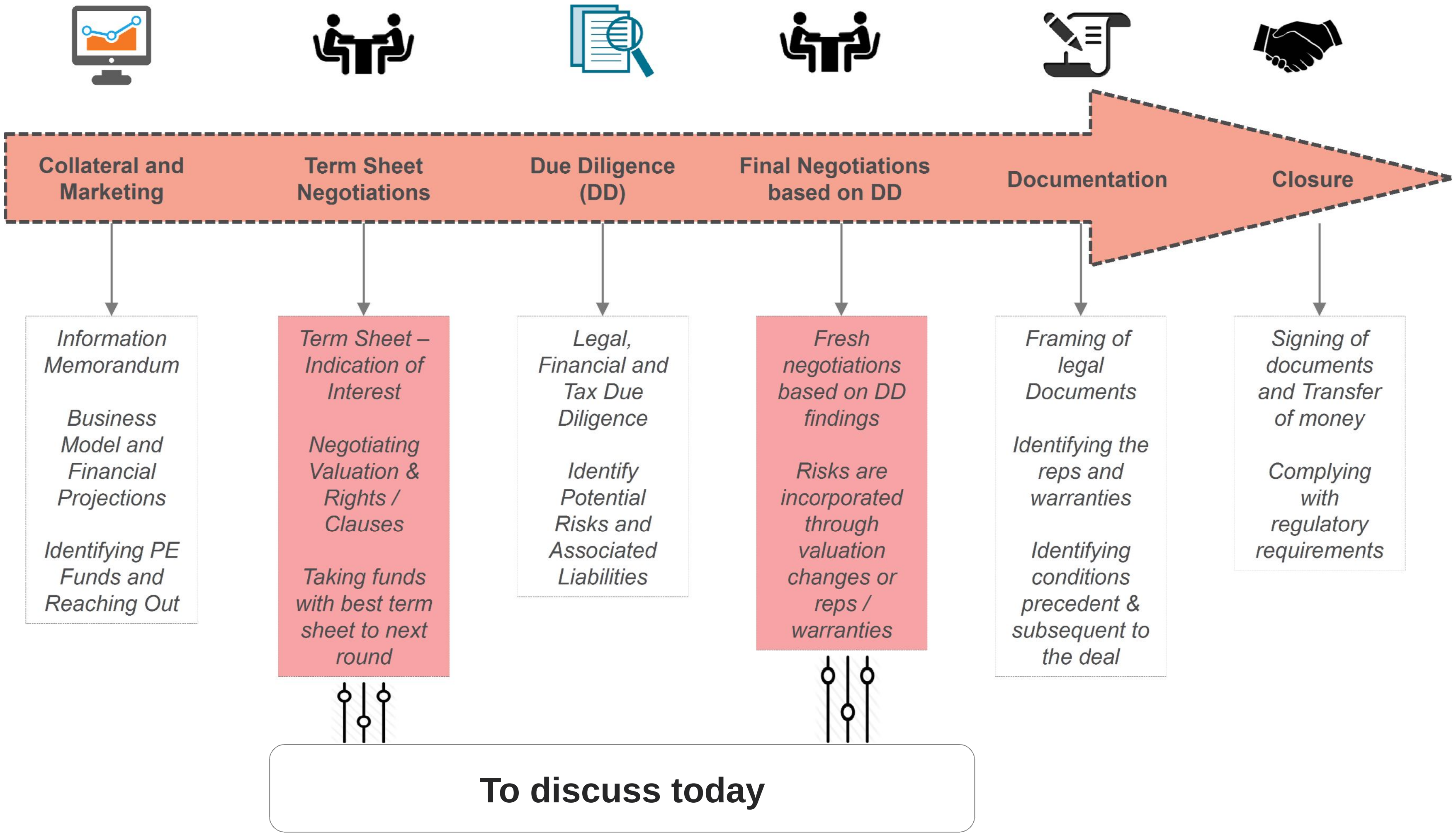
Click icon to add picture

Deal Valuation and Final Negotiations in Private Equity

April 2017

AVENDUS
the next level is the only level

PE Syndication Process



- # A. Valuation

Valuation Methods

- **Frequently used**
  - 1. Discounted Cash Flow (DCF)
  - 2. Relative Valuation
    - Trading Comps
    - Transaction Comps
- **Less Frequently used**
  - IRR Analysis
  - Replacement Method
  - Option pricing models, etc.

1. DCF – Basic Concept

Company Value
(Enterprise value / Equity value)

PV of projected free cash flow
(FCFF / FCFE)

PV of terminal value

Discounted Cash Flow

3 levers of DCF

3 **WACC (Weighted Average Cost of Capital)**

1 **Financial Projections**

2 **Terminal Growth Rate**

1. DCF - 3 levers of Discounted Cash Flow

1. Financial Projections Reference Points	
Revenue Growth	· Industry size and growth rate · Industry competitive dynamics and the Company's relative positioning within the same · Company's historical performance
Margins	· Company's historical performance · Industry wide average margins and expected trends · Company's operating leverage
Working Capital Requirements	· Industry wide average working capital requirements (Inventory days, Accounts receivable days, Accounts Payable days etc) · Company's historical performance
Fixed Asset Turnover Ratio	· Industry wide average fixed asset turnover ratio · Company's historical performance · Company's business model (outsourcing vs. in-house production)

2. Terminal Value Reference Points	
Steady State Growth Rate	· Steady state industry growth rate · Economy's long term growth rate

3. WACC Reference Points	
Leverage	· Company's historical leverage · Company's existing debt capacity · Company's future financing needs and projected cash flow from operation
Beta	· Peer group's average beta · Peer's leverage ratio v/s Company's
Risk Free Rate	· Use the government security which has the same duration as the duration of your cash flows. It is safe to use yield on 10 year government bond

1. DCF – Things to keep in mind

Things to keep in mind:-

- Wherever possible (especially in listed companies), use market value weights instead of book value weights to come up with the cost of capital
- Use target debt/equity structure (and not historical) while calculating the cost of capital
- While calculating tax on the operating income, try and converge it with the marginal tax rate during the later years of your projections
- Include only interest bearing liabilities as debt. Do not use cash and cash equivalents as part of working capital
- Most analysts estimate risk premiums by looking at historical data. Choose a period that adequately captures positive and negative economic and business cycles
- Discounted cash flow valuations are usually based upon the assumption that your firm will survive as a going concern. If you are valuing a young firm or a distressed firm where there is a significant likelihood that the firm will not make it as a going concern, then we need to build that in through multiple scenarios, assigning probabilities to each scenario

2. Relative Valuation

Relative valuation techniques aim to estimate the value of a company by looking at the pricing (share price / market cap / enterprise value) of 'comparable' companies relative to a common variable like earnings, ebitda, cash flows, book value or sales

Relative Valuation

Comparable trading peers

Comparable transactions

Universally used ratios	*Universal ratios include P/E, EV/EBITDA, EV/EBIT, PEG (Price Earnings to Growth) Ratio*
Sector specific ratios	*Ratios used specifically for an industry: Cement (EV/Ton), Retail (EV/Sqft), Hospitals (EV/Bed)*

2. Relative Valuation - Industry Specific Multiples

Cement	EV/Ton
Airlines	EV/Passenger
IT (Information Tech)	EV/Employee
Infrastructure	Price/Book, EV/IC*,EV/NAV
Oil and Gas	EV/BOE**, EV/EBITDAX^
Hospitals	EV/Bed
Hospitality (Hotels)	EV/Room
Retail	EV/Sqft , Price/Sales
Telecom	EV/Subscriber
Banking / Financial Services	Price/Book

**IC – Invested Capital, **BOE – Barrel Or Equivalent, ^EV/EBITDAX – EBITDA Excluding Exploration Revenues*

2. Relative Valuation – Choosing Peers

Trading Multiples

Factors to consider while choosing trading comparable peers

Same industry	Peers should have similar product portfolio, serve similar customer segments and have same growth drivers as that of the Company under consideration
Same type of market (geographies)	Peers operating in the markets (geographies) that have the same maturity level and growth trajectory as that of the Company under consideration
Size	Peers should ideally be of similar size. If similar size companies are not available, then the larger peers can be selected. However a size discount may be applied in such cases

Transaction Multiples

Factors to consider while choosing transaction

Strategic vs Financial	For a fund raise situation, one should look for transactions involving investment by a financial investor
Majority vs Minority	If the transaction involves buy out of a majority / minority stake by PE firm, then only transactions in which majority / minority stake has been acquired by PE player should be considered.

Adjustments made to multiples

Premium	Discount
Control Premium, Leadership position in the industry, Consistent/Superior financial performance (e.g. higher ROCE/growth), Premium for professionally managed company	Size discount, Liquidity discount

2. Relative Valuation – Things to keep in mind

- Match apples to apples – TTM Multiples to TTM earnings, LFY Multiples to LFY earnings
- Remember to leave out the outliers – they can impact the averages massively, especially in a thin data set
- Scan the numbers for anything amiss – any company growing abnormally , abnormal profits, sudden dip in profits need to be explained, and often need to be adjusted for. Normalize the financials to exclude any extraordinary and non-operating events to calculate the multiple
- The EV calculations need to use the right cash number (adjust restricted cash, etc.)
- Determine the long term average/median valuation multiples of comparable peer set and compare it with their current multiples. If the current multiples don't reflect normalized valuation because of the economic cycle, use the long term average (Ex: exceptionally lower multiples in 2009 because of a long list of reasons)
- In transaction multiples, calculate the multiple after taking earn-outs as well into account

2. Valuing a Start Up through Relative Valuation

Possible Metrics

- **GMV (Gross Merchandise Value)**
- **Number of Subscribers**
- **MAU (Monthly Active Users)**
- **Price/Sales**

Things to Consider

- The story
  - Cash burn (Quantum and Quality)
  - Size and Scale of the Market Opportunity
  - Defensibility of the Business Model (Network Effects, Competitors)
- Multiples at which similar deals have happened in the market. Generally, many companies in one sector tend to get funded together
- Adjustments for the growth rate of startups. Generally, startups tend to have widely fluctuating growth rates (from 20% to 1000% per annum)

2. Industry Specific Multiples – Case Study (Internet)

- This case study pertains to the PE funding of an educational subscription company which creates video content for students from class VI to class XII in India
- Since the company is in a very early phase, it is difficult to estimate the cash flows. The company was growing at a annual growth rate of around ~80%. Hence, it was not possible to do a DCF
- Hence, relative valuation was used for valuing the company
- Since the company was EBITDA negative, Price to Sales was the ratio used

Method Used	*Relative Valuation (Trading, Transaction Comps)*
Ratio	*Price to Sales*
Peers	*Education and Subscription/SaaS companies globally. Examples are Education (Lynda, Pluralsight), SaaS (Box, Evernote, Spotify, Salesforce)*
Median Multiple of peers	*6x (illustrative number)*

- This multiple was then adjusted for the fact that our client had a far higher visible growth as compared to peers in the trading and transaction multiples set
- Hence, a regression was carried out between the multiple (Price/Sales) and Growth Rate of companies (Past 2 years) in the peer set. The equation came out to be: y = 9x + 4 (illustrative numbers)
- Plugging the 80% growth (x), we get a multiple of 9.4x (illustrative number)

Final Multiple	*9.4x (illustrative numbers)*

Value vs Price – What they don't teach you in B-schools

	Buyers (Demand)	Sellers (Supply)
+ **VALUATION DRIVERS**	• Very keen on space / asset • Desperate to close deals (unused dry powder, fund life coming to an end) • Very competitive scenario with a number of bidders involved in the process • Part of a larger thesis like a roll up	• No other investible opportunity in the industry in which seller operates • Good growth prospects driven by identified upcoming kickers / events • Superior return metrics (Return on Capital Employed, Return on Capital) compared to the industry
– **VALUATION DAMPENERS**	• Not a focus area for the fund. Evaluating a one-off opportunity • Low competitive scenario. Fund is the only bidder for the asset and it knows it • Expecting a dull market resulting in expectations that valuations will stay depressed • Low conviction on thesis / company	• Low growth and return metrics as compared to other industry players • Number of large, investible assets in the space, some of which are on the block • Poor positioning / Lack of foreseeable growth • Industry wide systematic problems which might hinder profitability / cash flow

- # B. Negotiation

AVENDUS
the next level is the only level

Contractual Documents

Contractual Documents

SHA (Shareholder Agreement)

- Lays down the terms and conditions which will govern the conduct of shareholders after the investment has been made
- Includes Exit Rights, Affirmative Voting Rights, Equity Protection, Anti Dilution (if any) and other such matters

SPA / SSA (Share Purchase / Subscription Agreement)

- Lays down the terms and conditions of share purchase
- Typically less detailed than SHA
- Mainly Includes
  - Commercial terms of purchase
  - Representations and Warranties
  - Conditions Precedent / Subsequent
  - Indemnities by various parties

Other Documents

- Employment agreements
- Transition documents
- Documenting Earn Outs / Promote for founders

Key Rights Sought By PE Investors

Type of rights	Details	Reasons
Information rights	• Right to receive monthly MIS reports • Right to receive quarterly/annual financials	To receive regular updates on the company's performance
Protective rights	• Anti – Dilution rights to ensure investor stake is maintained (pro-rata) • Tag-along/Drag-along rights: To protect itself in case if Company management decides to divest part or entire company	To protect the interests of a minority investor
Affirmative rights and Board seat	The company may be required to take a positive vote from the investor on the following matters (indicative): • Entry into new lines of business • Any M&A, JV, strategic tie-ups, etc. • Raising fresh rounds of equity • Addition of debt resulting in debt/equity ratio exceeding _____x or Debt/EBITDA exceeding ________x • Cumulative capex in excess of _____% of the agreed annual business plan	To enable the investor to be involved in key (Board level) decisions to ensure that the management team sticks to the agreed business plan

Exit	• Obligation on the promoters to provide exit through one of the following mechanisms
	  ◦ IPO at the end of a certain timeframe (typically 5 years)
	  ◦ Sale of shares to another financial investor
	  ◦ Buy back by the Company/promoters
	  ◦ Sale of the entire company to a strategic partners (as a last resort)
		To ensure a liquidity event for the investment

Indemnity	• Tax, Business and Title Indemnity • Any Specific Indemnities which are high risk and uncovered through due dilligence • Cap and Duration	To protect the PE investors from any frauds perpetrated by promoters

Click icon to add picture

- *Thank You*

AVENDUS

the next level is the only level