WIRC of ICAI
Valuation and M&A

June 25, 2016

Valuation Concept

- Value – Price
- Valuation not an exact Science, More of Art and Subjective assessment
- Value varies with situations
- Date specific

Why Valuation?

Steps in Valuation

- Obtaining information
- Management Discussion and Industry Overview
- Data analysis and review
- Selection of method
- Applying Method
- Conducting sensitivities on assumptions
- Assigning Weights
- Recommendation
- Reporting

Sources of Information

- Historical data such as audited results of the company
- Future projections
- Stock market quotations
- Discussions with the management of the company
- 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

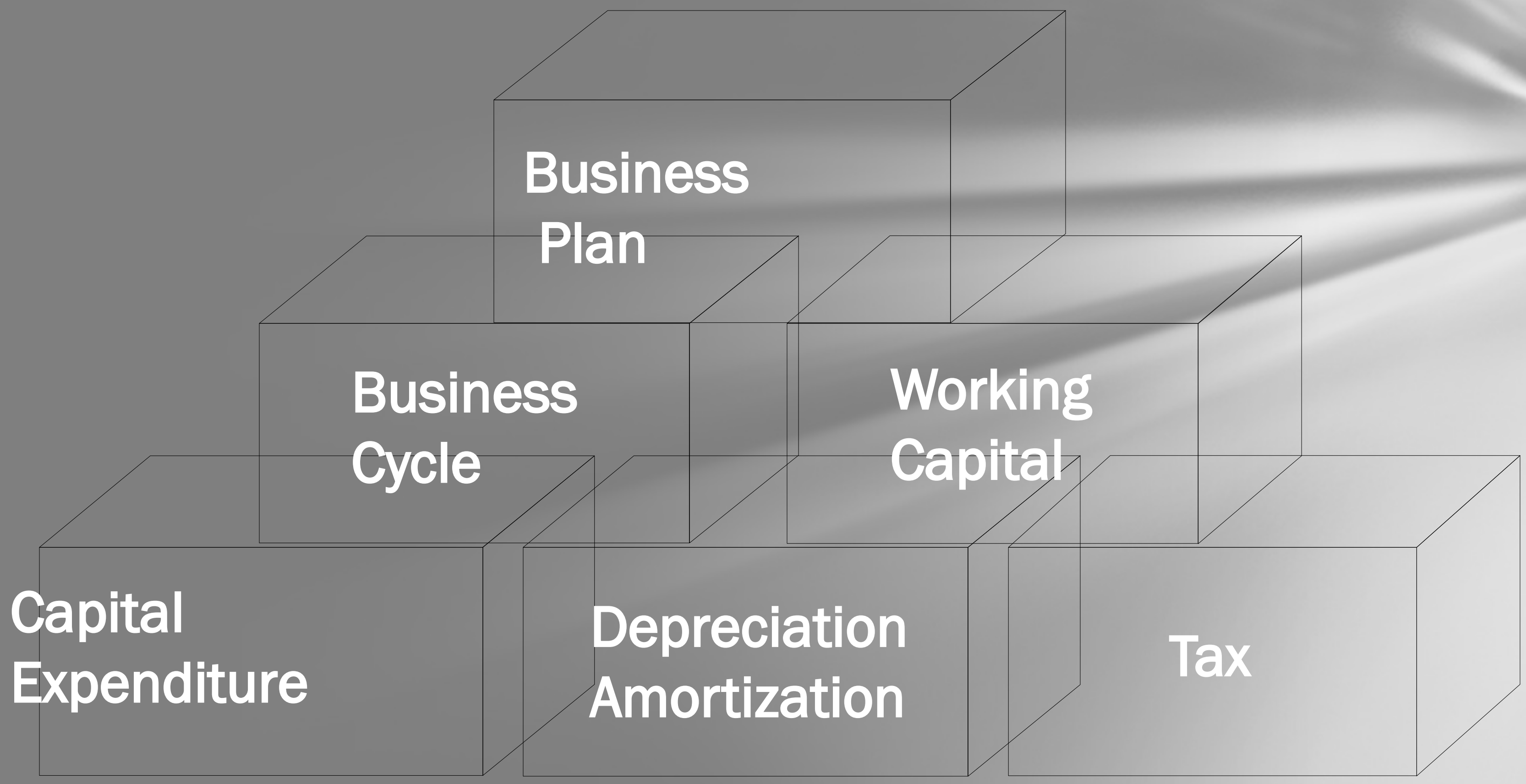
Discounted Cash Flow (DCF)

- Considers Cash Flow and Not Profits
- Cash is King
- Free Cash Flow ('FCF')
  - FCF to Firm
  - FCF to Equity

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 - Projections

Factors to be considered for reviewing projections:

- Industry/Company Analysis
- Dependence on single customer/ supplier
- Installed capacity
- Existing policy/ legal framework
- Capital expenditure – increasing capacities
- Working capital requirements
- Alternate scenarios / sensitivities

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

DCF – Cost of Equity

Cost of Equity = Risk Free Rate + (Beta x Equity Risk Premium)

DCF - Terminal value

Terminal Value is the residual value of business at the end of projection period used in discounted cash flow method.

Terminal Value

Liquidation Approach

Multiple Approach

Stable Growth Approach

Earnings Multiple Method

Commonly used Multiples

Enterprise Value/EBITDA Multiple Method

- Determination of Maintainable EBIDTA
- Capitalisation Rate/Multiple
- Not affected by the pattern of Funding adopted by Company/ Comparable Companies

Enterprise Value/EBITDA Multiple Method

- Based on past performance and /or projections
- Non-recurring & extraordinary items excluded
- EBIDTA of various years are averaged (simple or weighted). Current EBIDTA is accorded the highest weight
- Projected EBIDTA discounted for inflation
- Finally appropriate multiple is applied to arrive at the value

Multiples

- Multiples 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

The Value as per Net Asset Method is arrived as follows:

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

Common Adjustments

Following adjustments may be called for:

- Investments
- Surplus Assets
- Auditors Qualification
- Preference Shares
- ESOPs / Warrants
- Contingent Liabilities/Assets
- Tax concessions
- Findings of Due Diligence Reviews

Selection of Methods

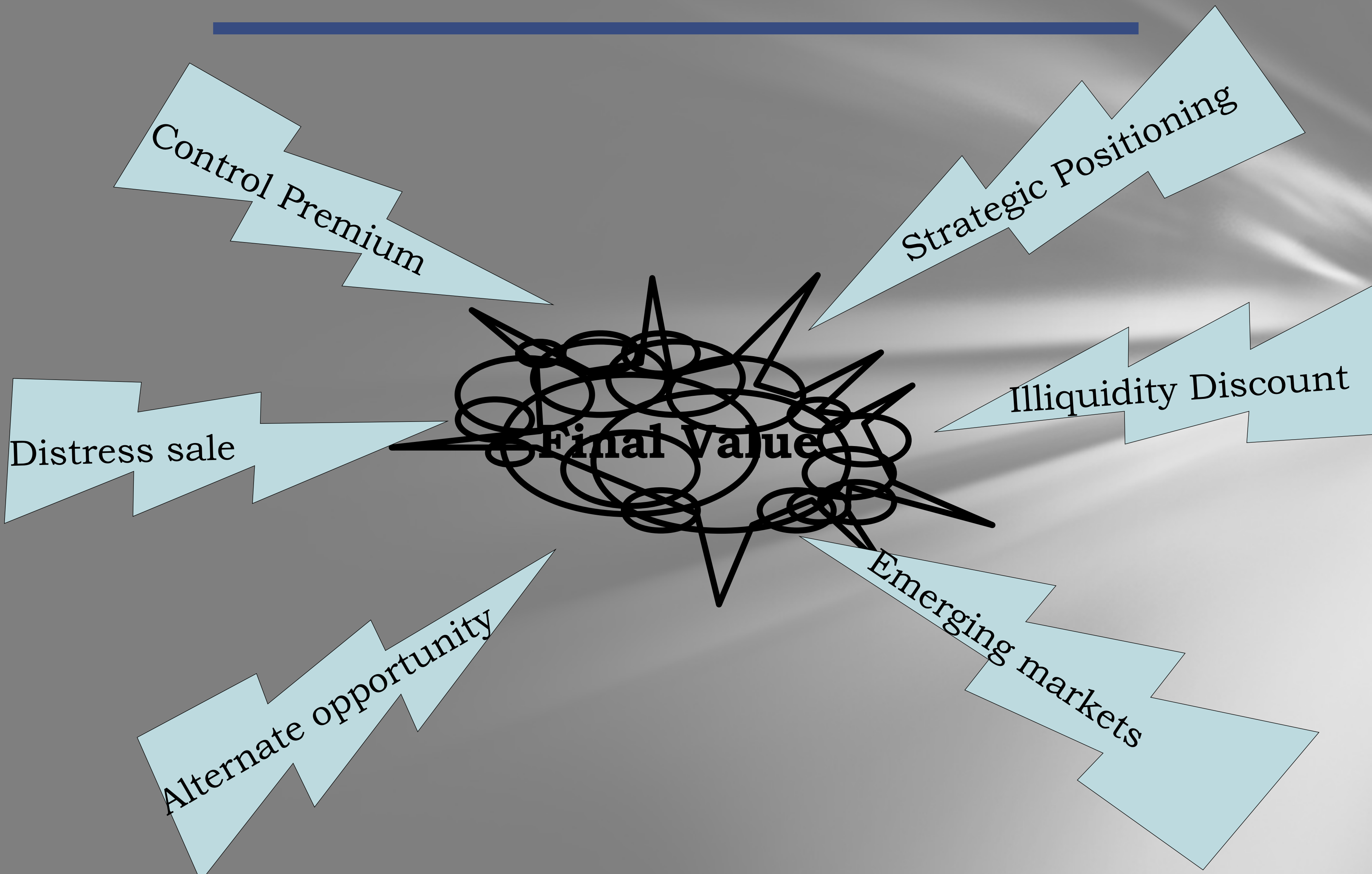
Situation	Approach
Knowledge based companies	Earnings/Market
Manufacturing Companies	Earnings/ Market/ Asset
Brand Driven companies	Earnings/Market
A Matured company	Earnings/Market
Investment/Property companies	Asset
Company going for liquidation	Asset

Generally Market Approach is used in Combination with other methods or as a cross check

Reaching a Recommendation

- Methods throw a range of values
- Consider the relevance of each methodology depending upon the purpose and premise of valuation
- Mathematical weightage
- Professional judgment
- Subjective Value

Other Value Drivers



Final Price is a result of negotiations

Documentation

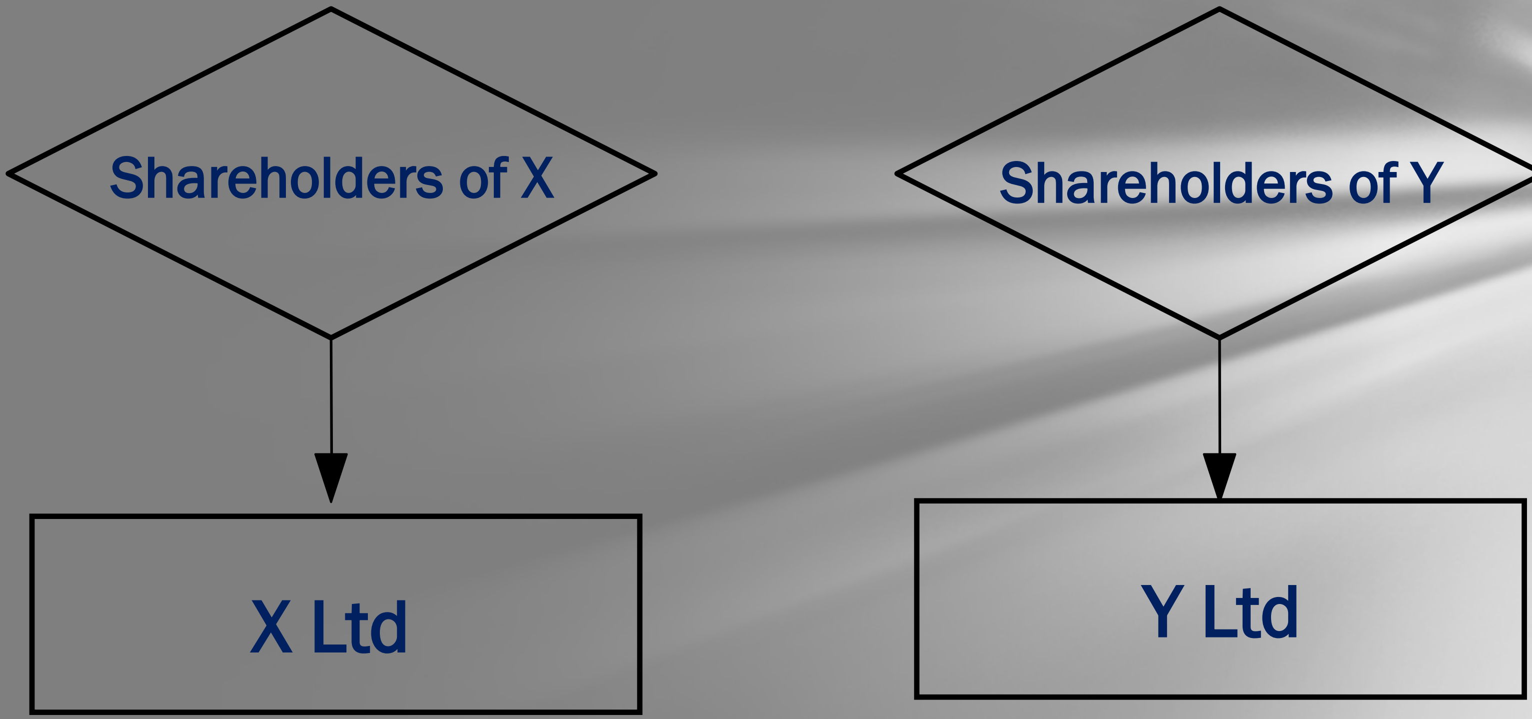
- **Appointment Letter**
  - Purpose & Scope of Valuation
  - Valuation Date
  - Commonly used Methodologies
  - Timelines
  - Fees
  - Limitations
- **Representation Letter**
  - No material omissions on part of the management
  - Confirmation of all inputs/ information used in

Valuation Report

- Introduction/ Background
- Purpose of Valuation
- Key Financials
- Sources of Information
- Methodologies of Valuation
- Important consideration & assumptions
- Valuation Workings
- Fair Value Recommendation
- Exclusions and Limitations

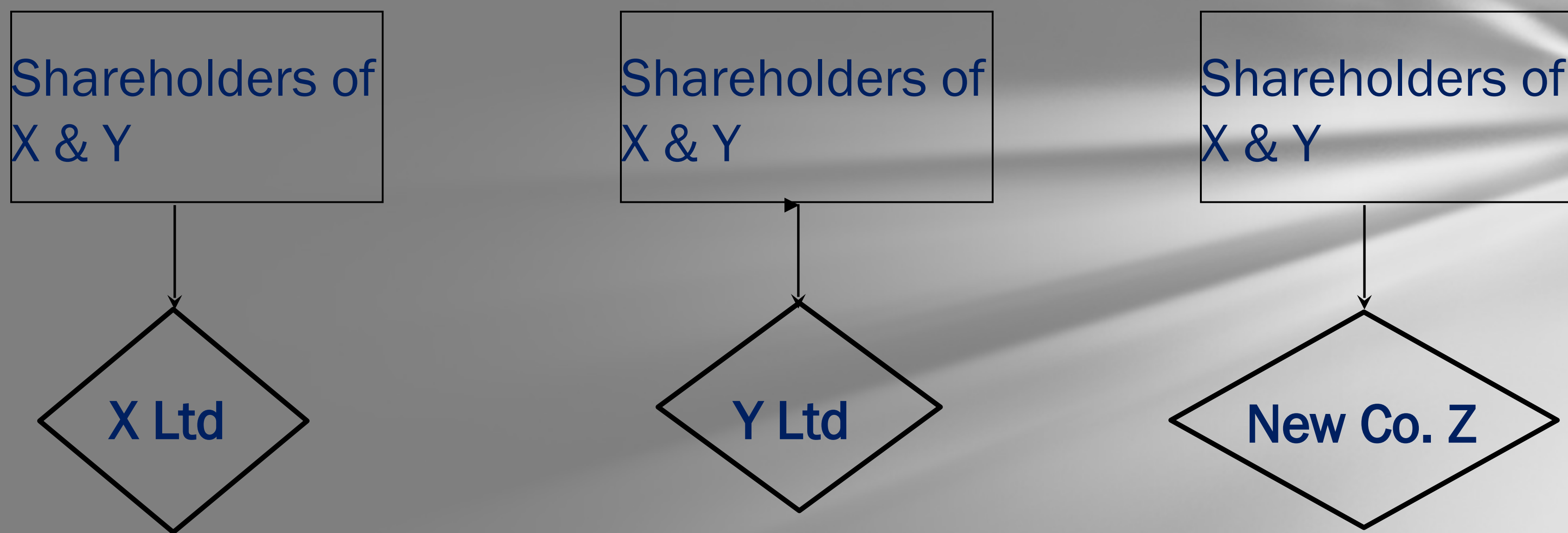
Valuation for Merger

Before Merger



After Merger

Option 1 **Option 2** **Option 3**



Note- Based on the swap ratio, the shareholders of the transferor company are issued shares of transferee company

Exchange Ratio

- The Exchange Ratio is simply the number of Transferee Co.'s shares that are to be issued to the shareholders of Transferor Co. as consideration for the merger
- Depends upon the valuation of businesses of the Transferor and Transferee Companies

Exchange Ratio

Case Laws

"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)*

"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. 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)*

Case Laws

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*

Valuation job must be entrusted to people who know the Company rather than giving to outsiders who will start from scratch

- *Consolidated Coffee V/s Arun Kumar Agrawal (1999) 21 SCL 11 (Kar)*

Cont…

Valuation is not an objective exercise.

Any preconceptions and biases that an analyst brings to the process will find their way into the value.


Thank You