



Valuation and Pricing of a company for M&A Deals

WIRC – Seminar on Merger & Acquisition and Corporate Restructuring
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M&A Transaction - Key Drivers

M&A Transaction – a corporate strategy dealing with the buying, selling, hiving and amalgamating of businesses / companies to help an enterprise grow inorganically.

Strategic reasons

- Achieve growth and survive
- To gain better competitive position / market access
- Desire to be the market leaders – focus on core competencies
- To achieve economies of scale and scope - Synergies

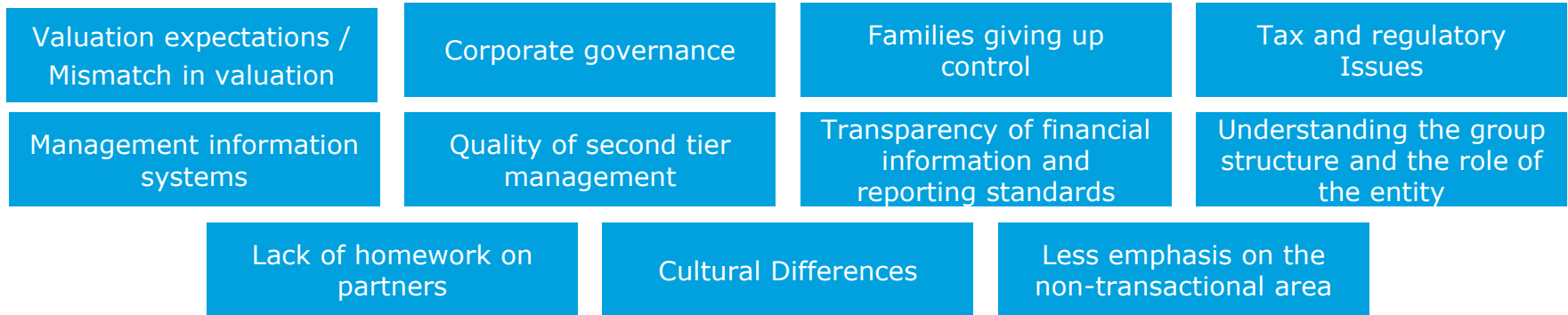
Capability acquisition

- Growth in terms of new technology, competence, capability, or
- market space through inorganic route
- Diversification by entering into a new segment / geography

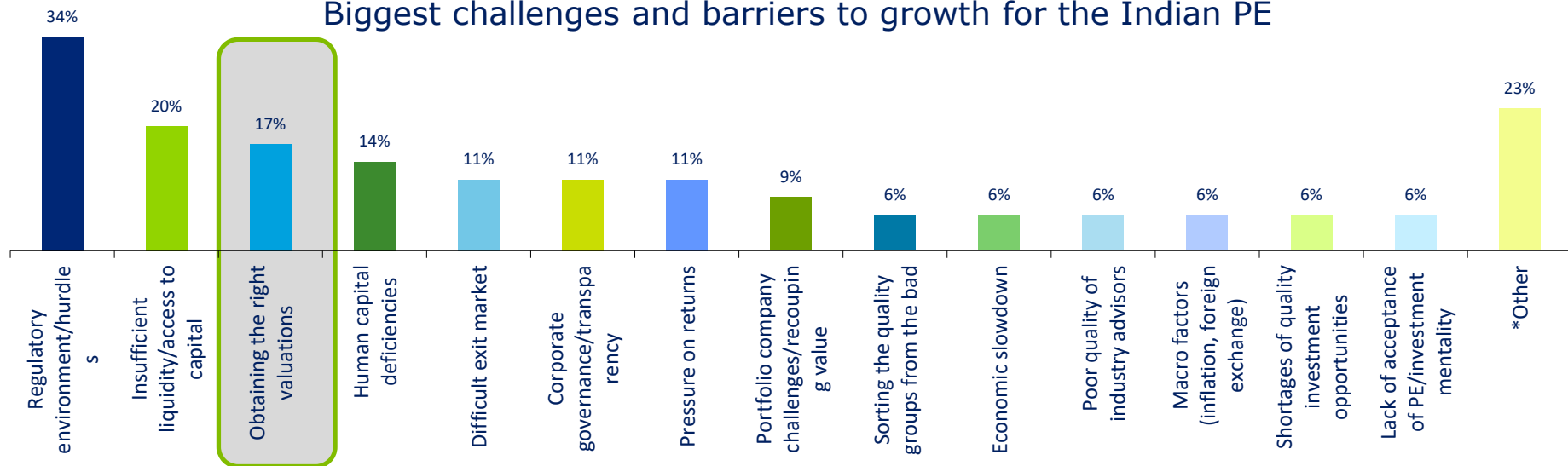
Financial Reasons

- Fund Raising
- Utilization of excess cash
- Cost synergies

Dealing in India - An Easy Difficulty



Biggest challenges and barriers to growth for the Indian PE



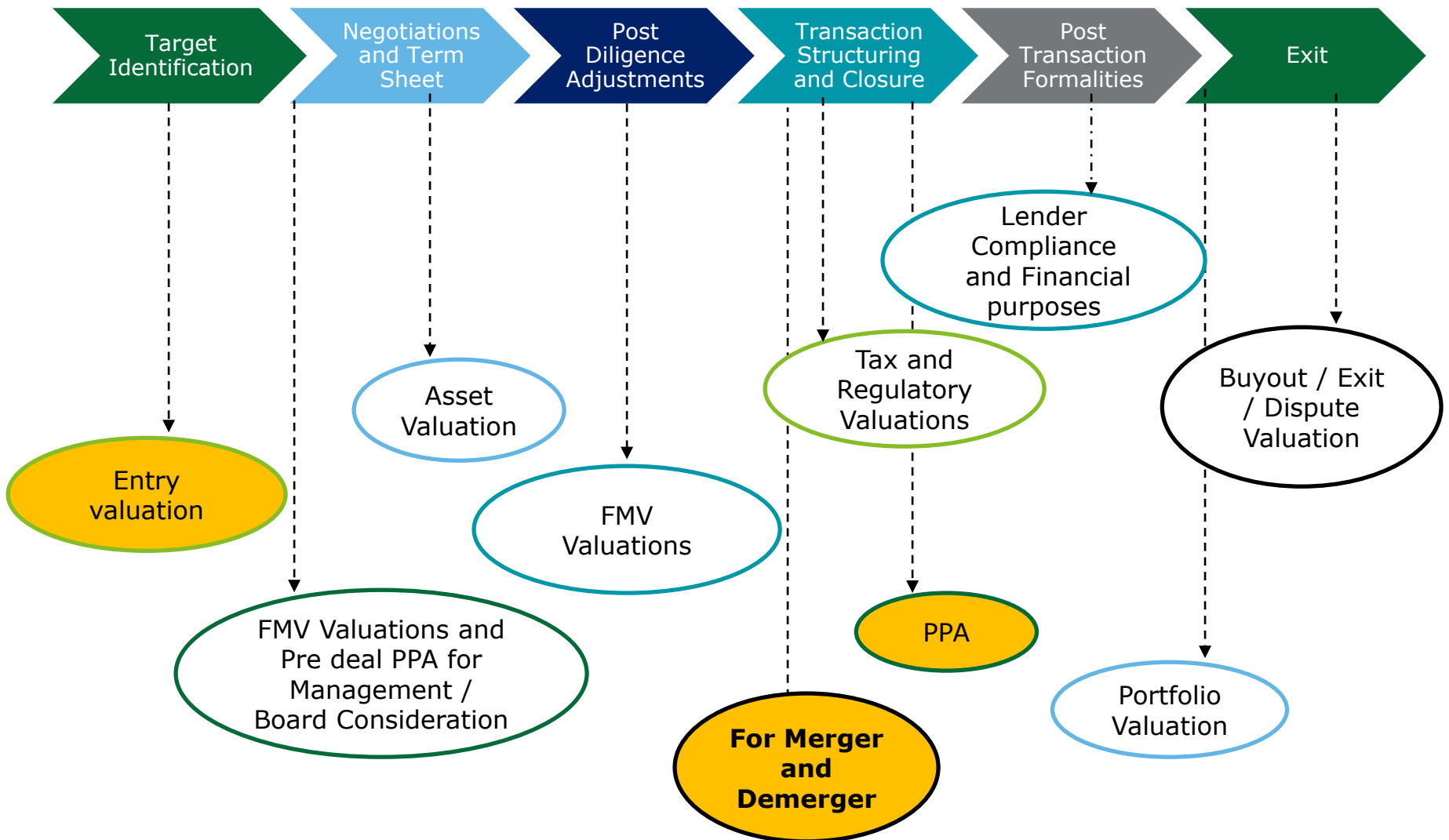
'Other' includes: liberalisation of the market, political instability, lack of debt finance, enforceability of contracts, cross-border growth, uncertainty caused by forthcoming elections, reduced appetite of foreign investors, fundraising problems

Source: Deloitte PE Survey 2010



Importance
of
Valuation

Valuations and the Deal Cycle



Valuation – an integral part of the deal

What requires a Valuation - the Purpose

Business Valuation	Regulatory	Intangibles	Financial Reporting	Private Equity
Restructuring of Companies	FEMA - issue / transfer of shares	Brand or Trade Names, Non Compete Agreement	Purchase Price Allocation	Entry
Purchase/ Sale/ Merger/ Acquisition Transaction	Transfer Pricing / Tax - withholding tax/ capital gains tax	Customer Contracts & Relationships	Impairment Testing	Financial reporting - Private Equity - IPEVC Valuation guidelines
Litigation/ Dispute / Family Settlements	Valuation under SEBI Regulations	Software and Technology	Financial Instruments - Options, ESOPs, Derivatives	Subsequent rounds of funding
Fund raising	The Companies Act requirement	Intellectual Property	Ind AS reporting	Exit

CORPORATE RESTRUCTURING ~ M&A



Valuation

What is a Valuation?

Value is an economic concept where what a willing buyer is willing to pay and what a willing seller is willing to take overlap.

Valuation means the procedure and technique of estimating the value of a specific Asset / Liability at a stated time and place and for a specific purpose.

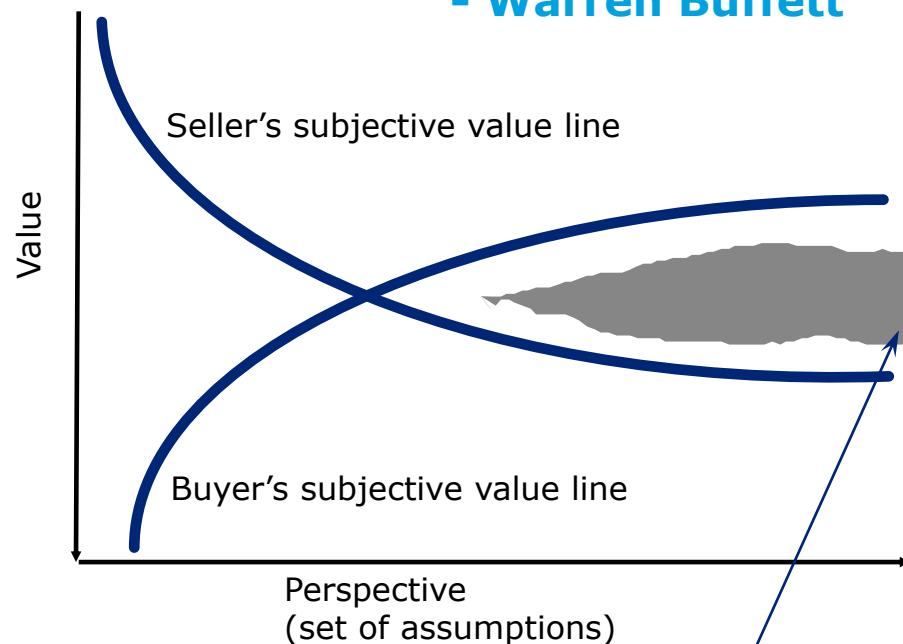
- Principles of valuation

- Business value vs Asset value
- Business value more than assets
- Absolute value vs Relative value
- Value hovers within a range not a precise number
- Valuation v/s price

- 3 key points to remember:

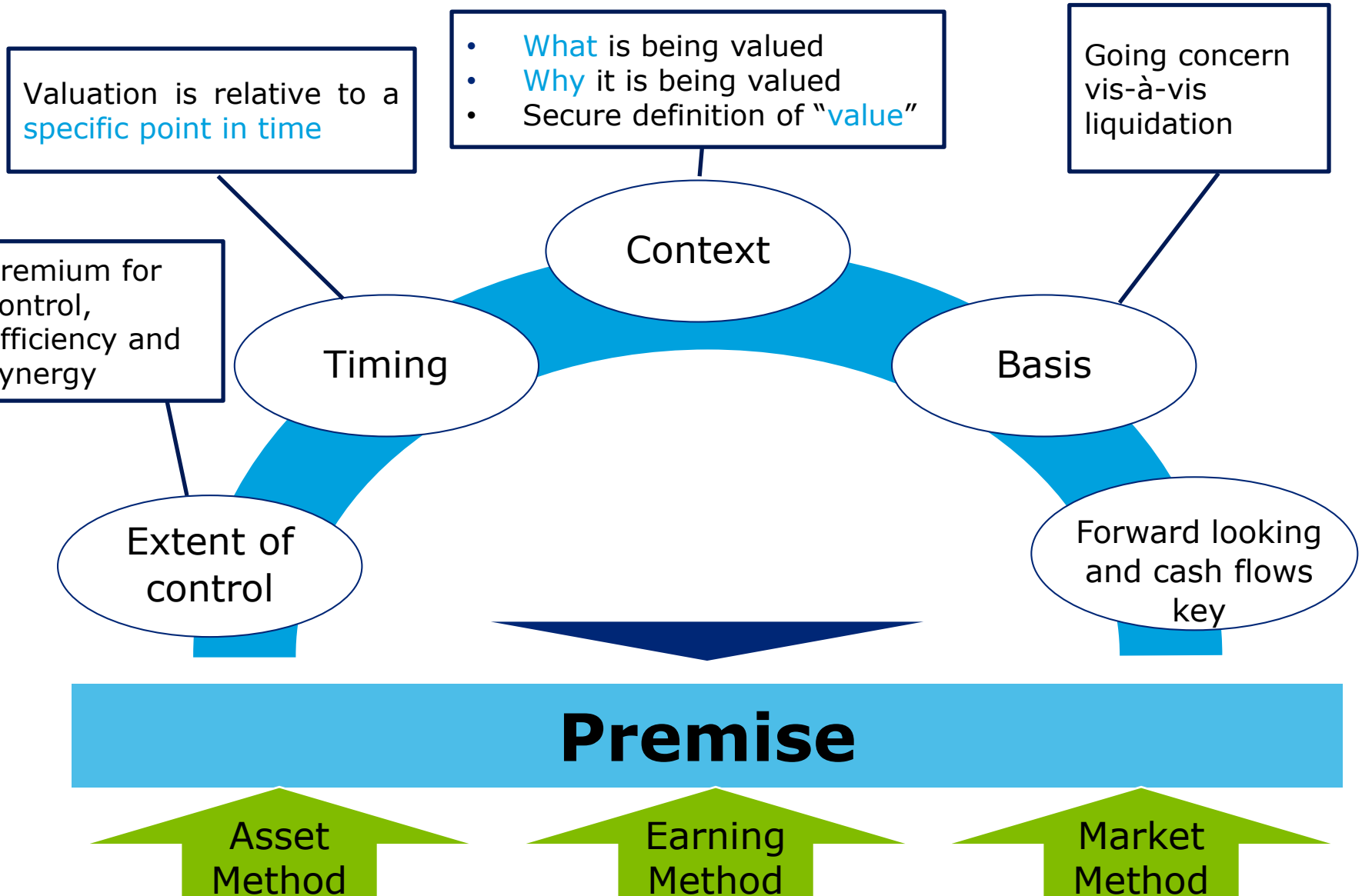
- Valuation involves “informed subjectivity”
- Price is different from value
- Deal is made at a Negotiated Price

"Price is what you pay. Value is what you get."
- Warren Buffett



Area in which
a market exists

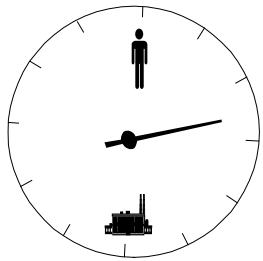
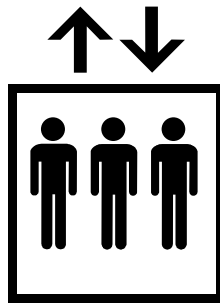
Valuation - A Perspective



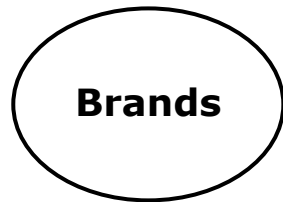
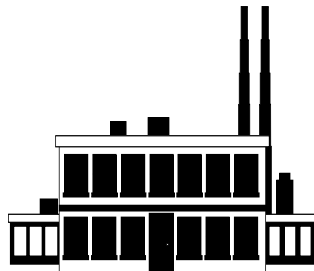
Where is the value?

What underpins the cash flows of this business - fixed assets, people (or one person), know-how ?

People business



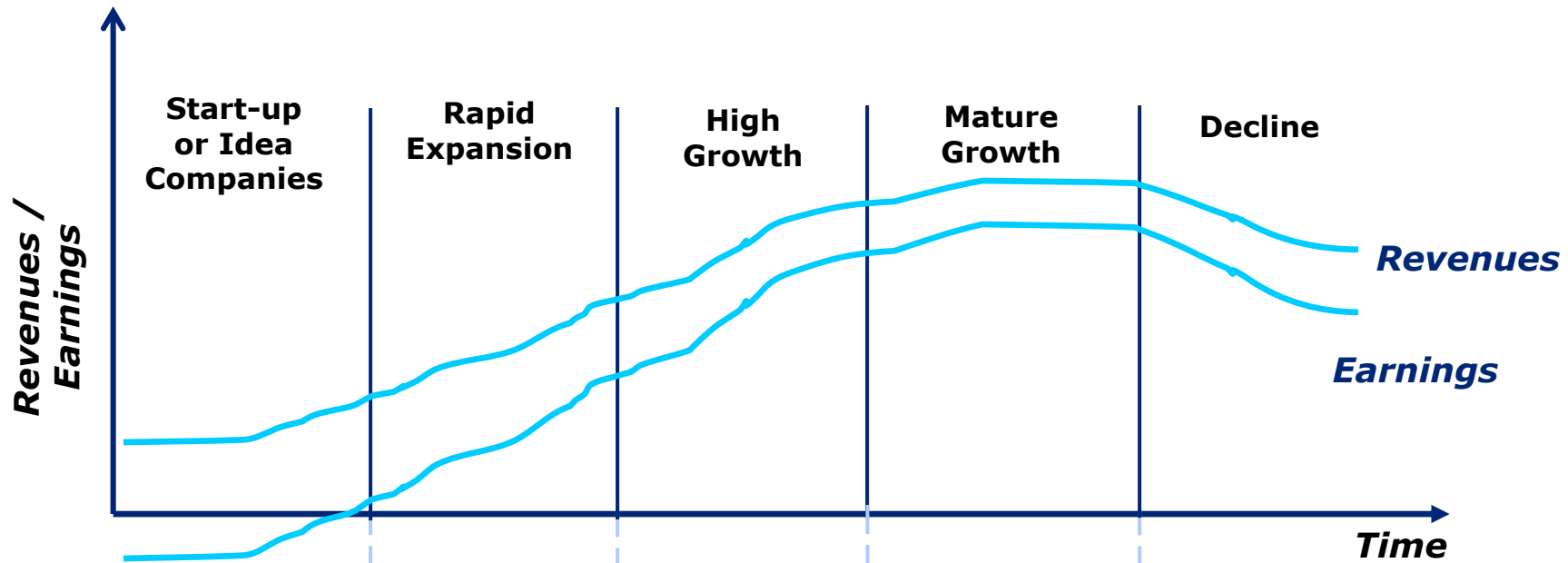
Asset business



Once you have worked out what drives the value make sure that it is still there after you have acquired the business!

Identifying key value drivers & key risk areas

Valuation in Real life




Revenue / Current Operations	Non-existent or low revenue /negative operating income	Revenue increasing/Income still low or negative	Revenue in high growth/Operating income also growing	Revenue growth slows/Operating income still growing	Revenue and operating income growth drop
Operating History	None	Very limited	Some operating history	Operating history can be used in valuation	Substantial operating history
Comparable Firms	None	Some, but in same stage of growth	More comparables, at different stages	Large number of comparables, at different stages	Declining number of comparables, mostly mature
Source of Value	Entirely future growth	Mostly future growth	Portion from existing assets/Growth still dominates	More from existing assets than growth	Entirely from existing assets

Valuation Methodologies

Asset based

Net Asset Value

- 
- More than one right way to value
 - Approaches are not exclusive; but complement each other

Earnings based

- Discounted Cash Flow
- Earnings Capitalisation
- Royalty Relief method
- Contribution / Excess earnings method
- Incremental Cashflows method

Value of Business / Equity / Intangibles

Market based

- Market Price
- Comparable Companies Multiples
- Comparable Transaction Multiples

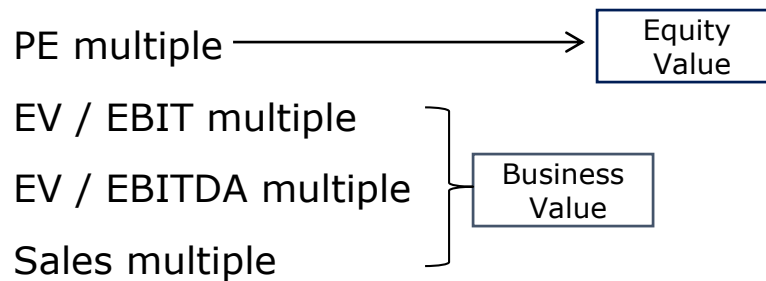
Earnings based methodology - Discounted Cash Flow - Some key points

- Cash flow projections
- Constant prices vs Inflation
- Length of discrete period - cyclical business
- Assumptions related to:
 - ✓ Growth in market, sales volume, etc.
 - ✓ Increase in sales price, RM cost, manpower, etc.
 - ✓ Changes (expectation) in direct and indirect taxation
 - ✓ Working capital
 - ✓ Capex
 - ✓ CAPM : R_f , R_m , Beta, Company Specific Risk Premium
 - ✓ Terminal Growth Rate
- Check implied multiples and exit multiples

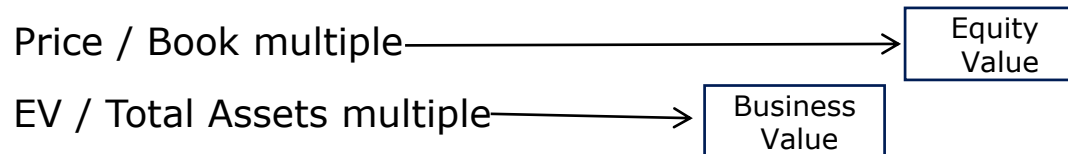
Market based methodology

- Generally used multiples

- Earnings based



- Asset based



- Others



Market based methodology - Comparable Companies Multiples - Some key points

- Check for speculative element - shareholding pattern, volumes, etc.
- Time from: 1 year, 6 months
- CCM / CTM
- Selection of companies / transactions for apple to apple comparison
- Adjustments (Discounts / Premiums) for differences with the comparable company / transaction
- Business level - size, margins, growth, etc.
- Equity level - control, minority discount, etc.
- Industry specific appropriate multiples

Asset based methodology - Some key points

- Net worth (book value) sometimes does not reflect the correct value.
- Assets which are of enduring nature but have been expensed as revenue, for example; returnable containers - bottles in a soft drinks business
- Assets of which the historical cost does not capture the real cost, for example: dies, jigs and fixtures, which have been made based on a company's design & drawings and the cost reflects only the material and labour cost paid to the die maker.
- Replacement value of assets:
 - ✓ Cost of new asset
 - ✓ Similar condition
 - ✓ Same utility
 - ✓ Life of assets – total and balance
 - ✓ Technical life
 - ✓ Economic life
- Capitalisation cost of new asset.

Valuation Methodologies

- Methods throw a range of values
- Consider relevance of each methodology depending upon the purpose & premise of valuation - decide on primary and corroborative methods
- Selecting the final value / range of values
 - Subjective weighting:
 - ✓ In professional judgement the conclusion is based on experience and judgment given the quality of information and the approaches applied
 - Mathematical weighting
 - ✓ In mathematical weighting specific weights are assigned to each approach and the weighted average calculated
- The methods require subjectivity since the weights selected in mathematical weighing are subjective – Ultimately subjective judgement of the valuer.

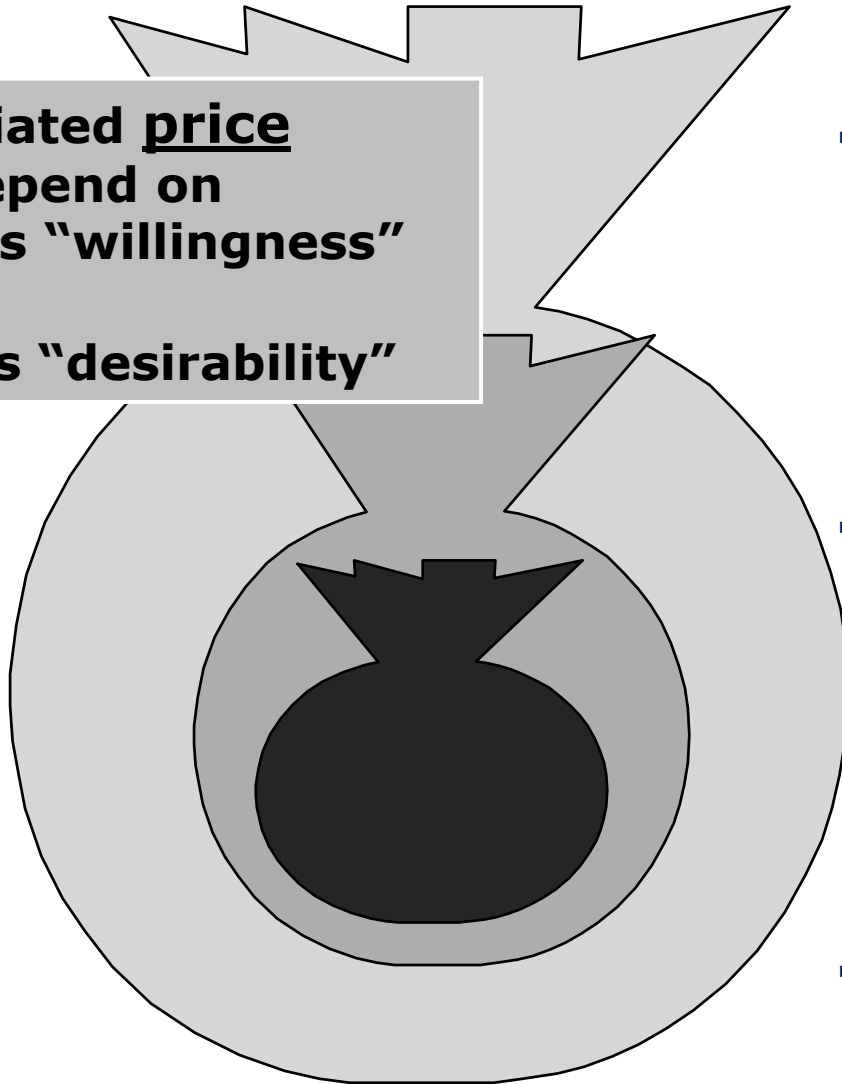
Final Recommendation - common sense and reasonableness



Issues in Valuation

Value, Investment & Price

Negotiated price will depend on buyer's "willingness" and seller's "desirability"



Value

Investment

- Efficiency premium: acquirer's ability to extract better performance from the business than what has been factored into the market price or standalone value
 - ✓ Financial leverage and cost
 - ✓ Improvement in consumption norms
 - ✓ Reduction in operating cost
- Synergy premium: savings or performance enhancement emerging from integration of the two businesses
 - ✓ Improving stranglehold in the marketplace
 - ✓ Purchase volume discounts
 - ✓ Sourcing logistics
 - ✓ Savings in tax (elimination of a tax layer)
- Control premium : an allowance that control of target company will add/protect acquirer's worth
 - ✓ Competition blocking
 - ✓ Entry advantage

Valuation - Issues & Challenges

Most research findings indicate that the desired anticipated results do not necessarily fructify

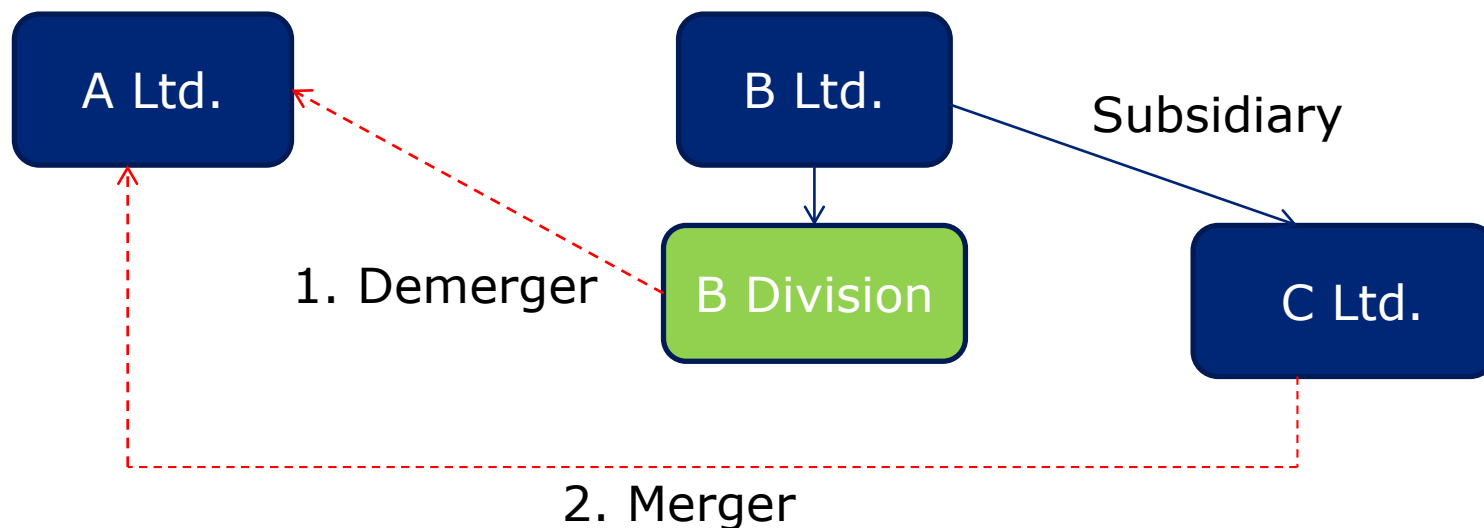
- Overestimation of “efficiency” and “synergy” benefits
- Unquantifiable benefits
- Consequential cost / liability / loss of key managers
- Accounting - different GAAPs
- Jurisdiction - different regulations, settlement mechanism
- Multiple currencies, valuation impact of volatility
- Inter-holdings in merging companies
- Deal Structure - Merger / Demerger / Slump Sale / Intangible
- Structuring a deal - emerging sectors - Healthcare, Education - unorganized sectors
- Exotic instruments - optionally convertible / differential voting rights
- SEBI guidelines - Takeover / Preferential pricing, Takeover - Direct / Indirect, Delisting / Open offer / Reverse Book Building
- Premium / Discount

Valuation exercise should reflect the VUCA of the underlying business being valued– Volatility, Uncertainty, Complexity and Ambiguity



Case Study

Case Study



Company	Ownership	Business
A Ltd.	Listed	<ul style="list-style-type: none"> • Large Conglomerate • Presence in several businesses • Trading, Manufacturing and Marketing
B Ltd.	Listed	<ul style="list-style-type: none"> • Large Conglomerate • Manufacturing, Retailing
B Division	Segment	<ul style="list-style-type: none"> • Manufacturing
C Ltd.	100% subsidiary of B Ltd.	<ul style="list-style-type: none"> • Marketing and Distribution of the products of B Division

Case Study - Valuation Approach

Valuation Methodologies	A Ltd.	B Division	C Ltd.
Market Price Method	<ul style="list-style-type: none"> Market price reflects revenues and profitability of several businesses 	<ul style="list-style-type: none"> Cannot split market capitalisation to reflect the value of the segment. If significant segment, one may derive from value of company / multiples. 	Not applicable
Comparable Companies Multiples Method	<ul style="list-style-type: none"> Multiples of companies comparable to each business 	<ul style="list-style-type: none"> Multiples of manufacturing companies applied to the division results Multiples adjusted to reflect growth, capacity expansion in recent past, newly product launches etc. 	<ul style="list-style-type: none"> Multiples of marketing and distribution companies
	<ul style="list-style-type: none"> Relative valuation difficult as each company / division in different segment, different risk reward profiles, governed by different laws 		

Case Study - Valuation Approach

Valuation Methodologies	A Ltd.	B Division	C Ltd.
Discounted Free Cash Flow Method	<ul style="list-style-type: none"> • WACC and TVG to be seen on a relative basis • COE based on several businesses 	<ul style="list-style-type: none"> • Segment profit and loss account and balance sheet • Segment projections • Cost allocations etc. • WACC and TVG to be seen on a relative basis 	<ul style="list-style-type: none"> • WACC and TVG to be seen on a relative basis
Comparable Transaction Method	<ul style="list-style-type: none"> • Not much information available in public domain. • Transactions - non-control stake, strategic / financial investments, synergies may not reflect in the price paid for the transaction. 		
Other Issues	<ul style="list-style-type: none"> • Due Diligence adjustments • Weightages to different methodologies • Focus on resultant shareholding of A Ltd. since listed 		



Conclusion

Valuations - Pitfalls

Confusing Value with Price

Confusing strategic value for a buyer with fair market value

Interpreting Goodwill

Asserting that a valuation is "always a scientific fact, not an opinion"

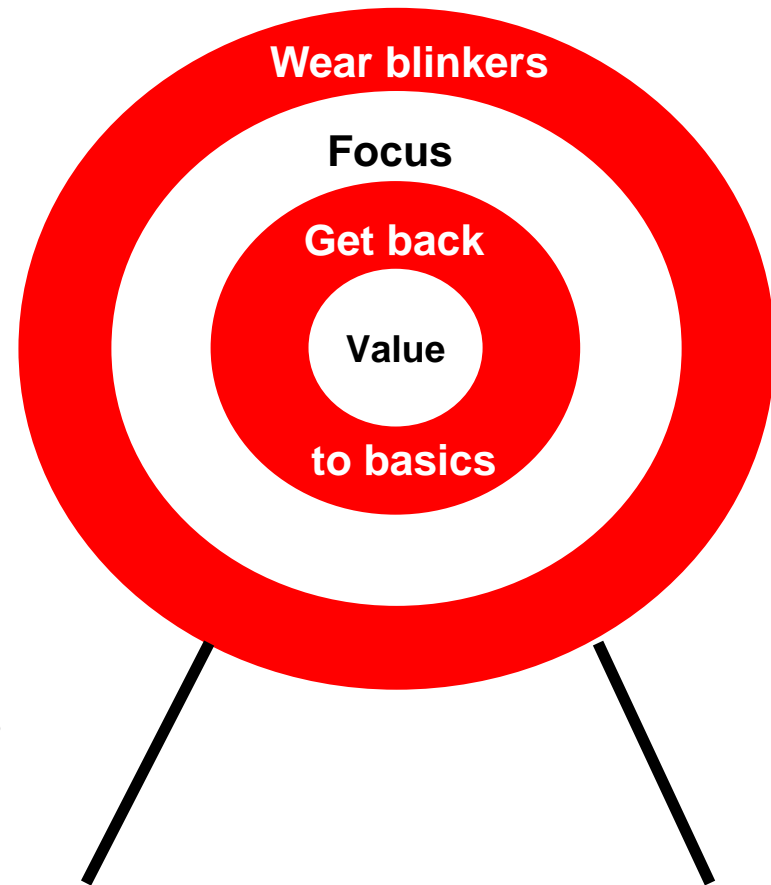
Valid for any valuation date

A valuation is valid for everybody

It is important to avoid pitfalls....

In Summary

- Of late, valuations have been soft targets for dispute / litigation of listed companies
- Valuer to keep in mind fairness to all stakeholders
- Instances of minority shareholders delaying the restructuring process
- Balance needs to be achieved through transparency, fairness and best Corporate Governance practices
- Feel the deal - Don't look for precision.
- Accept that there is a reasonable possibility of erring
- Always remember the basics
- Keep it simple
- Scenario analysis
- Don't ignore 'black swan' events
- Long term averages - mean reversion
- Don't blindly follow the 'experts'
- 'Herd mentality' may not always help
- Keep a check on 'bias'
- **Smell test - common sense and reasonableness**



"All in all, its hard to build assets competitively, but its harder to value them..."



THANK YOU

This document discusses various methods and process of valuation. The style contained herein is intended to make aware the valuation process in relation to general issues and concerns. The approach might be different in light of specific issues that are in nature different in context and character.

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