Business Valuation: Overview & Key Issues

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Partners in Knowledge. Governance. Transformation.
(Under Ministry of Corporate Affairs, Govt of India)

16th September, 2016

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“Price is what you Pay, Value is what you get”

-Warren Buffett

Agenda

- Overview of Valuation
- Principles of Relative Valuation
- Principles of Discounted Cash Flow
- Start Up Valuation
- Tricky Issues

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Overview of Valuation

- **Value is***
  - An **Economic** concept;
  - An **Estimate** of likely prices to be concluded by the buyer and seller of a good or service that is available for purchase;
  - Not a fact.

- **Valuation** is the **process** of determining the **“Economic Worth”** of an **Asset** or Company under certain **assumptions** and **limiting conditions** and subject to the **data** available on the **valuation date**.

** Source -International Valuation Standard Council*

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Key Facts

PRICE IS NOT THE SAME AS VALUE

VALUE VARIES WITH PERSON, PURPOSE AND TIME

TRANSACTION CONCLUDES AT NEGOTIATED PRICES

VALUATION IS HYBRID OF ART & SCIENCE

Standard of Value is the hypothetical conditions under which a business is valued.

While selecting the Standard of Value following points is to be taken care of

- ❖ Subject matter of Valuation;
- ❖ Purpose of Valuation;
- ❖ Statute;
- ❖ Case Laws;
- ❖ Circumstances.

Types of Standard of Value:

FAIR MARKET VALUE

INVESTMENT VALUE

INTRINSIC VALUE

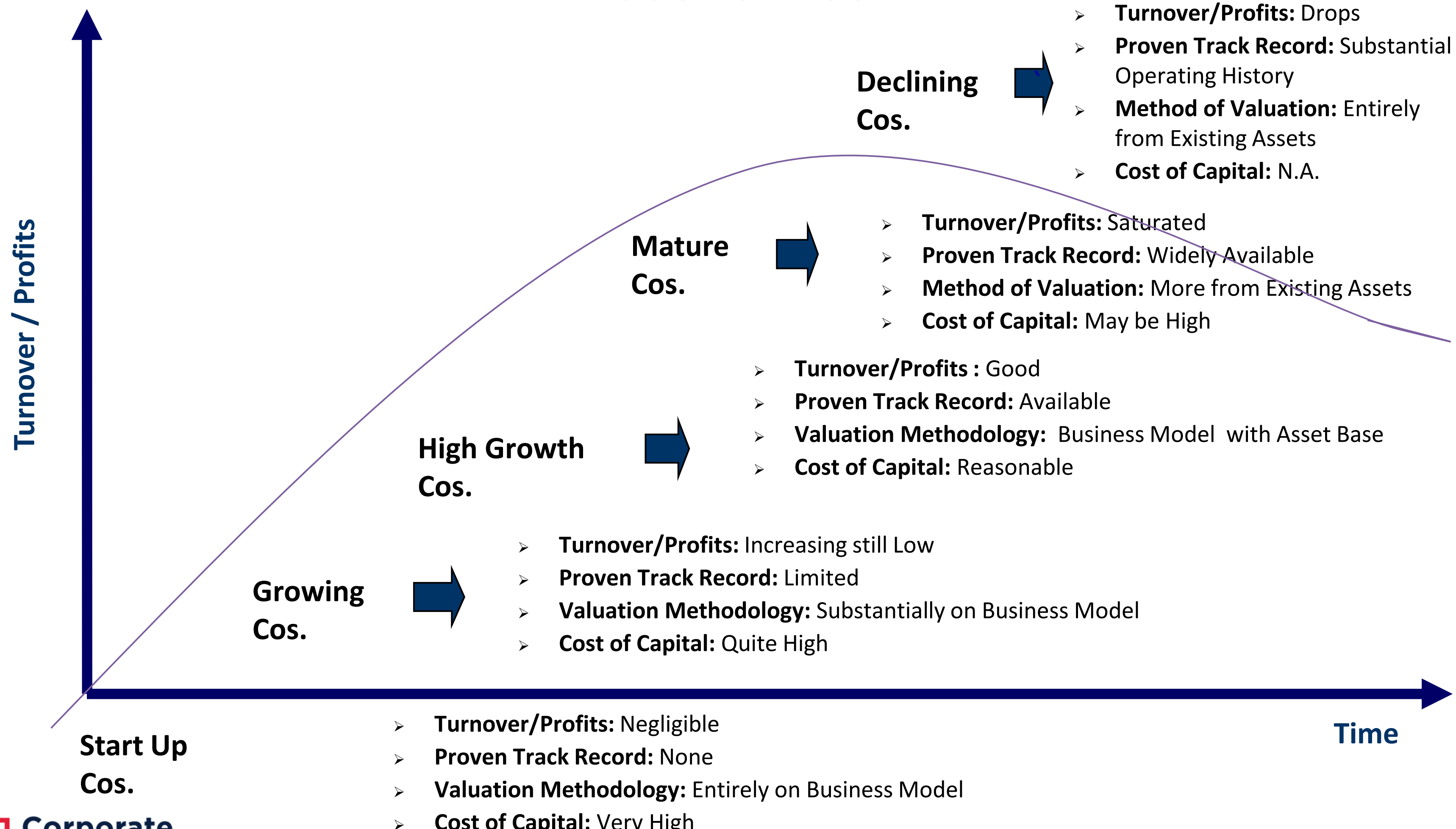
FAIR VALUE

Thesis of Value is Premise of value which relates to the assumptions upon which the valuation is based.

Premise of Value

- **Going Concern –** Value as an ongoing operating business enterprise.
- **Liquidation** **–** Value when business is terminated . It could be ‘forced’ or ‘orderly’.
  - **Value-in-use**
  - **Value-in-exchange**

Valuation across business cycle follow the law of economics



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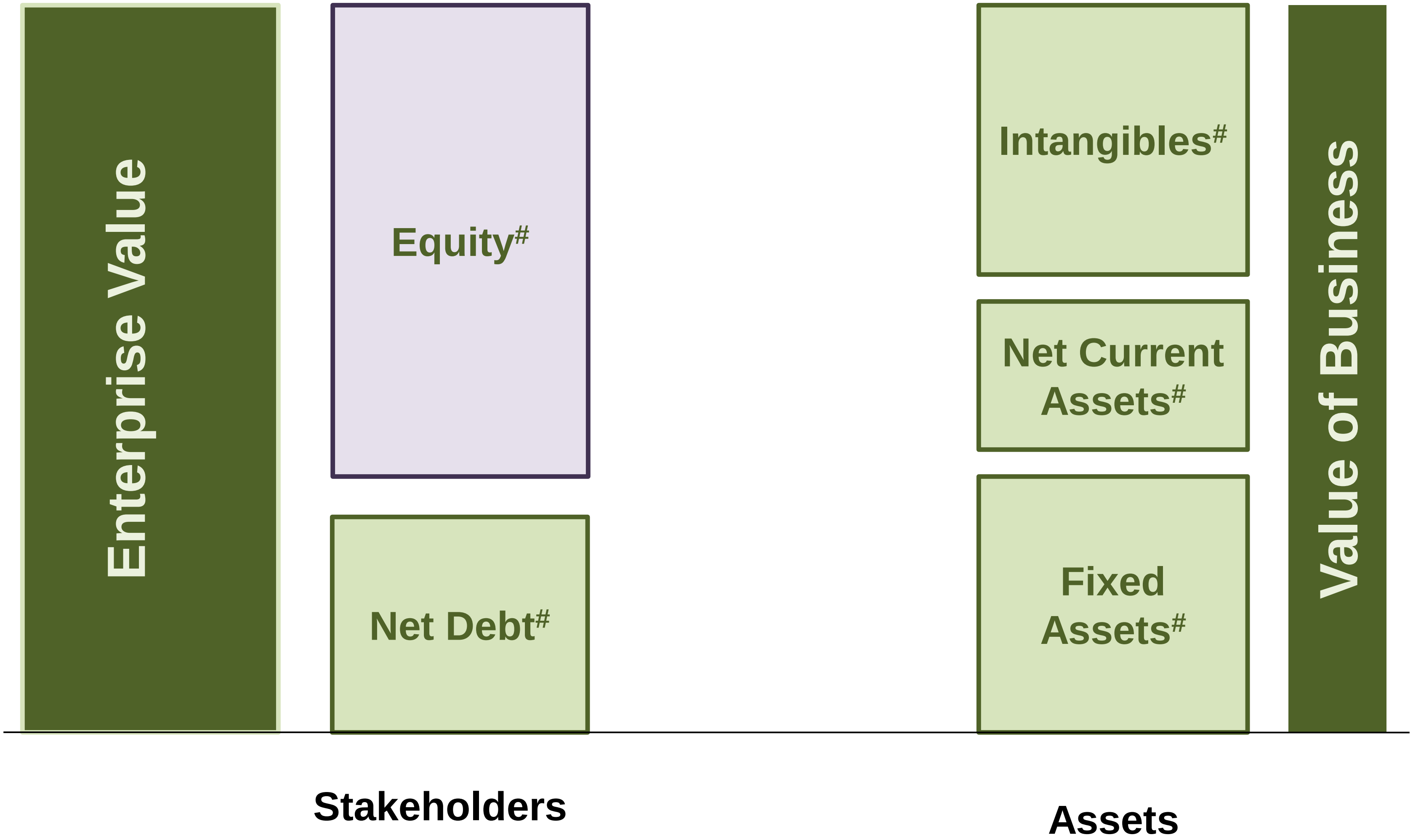
Enterprise / Business Value



Based on Market Values

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Valuation Approaches

Fundamental Method

Income Based Method

- Capitalization of Earning Method (Historical)
- Discounted Cash Flow Method (Projected Time Value)

Asset Based Method

- Book Value Method
- Liquidation Value Method
- Replacement Value Method

Relative Method

Market Based Method

- Comparable Companies Market Multiples Method (Listed Peers)
- Comparable Transaction Multiples Method (Unlisted Peers)
- Market Value Method (For Quoted Securities)

Other Method

- Contingent Claim Valuation (Option Pricing)
- Price of Recent Investment Method
- Rule of Thumb (Multiples: Customers, Rooms, Seats, No. of visitors etc.) - Depends upon Industry

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Need of several valuation methods?

Each has strengths and weaknesses

Different methods useful in different situations

Each gives a different “take” on the value of the company’s stock

Provides a range of valuations instead of point estimates

Helps in Sanity Check

While concluding Value, *all the methodologies must be considered* and then weights applied as per the facts of the case. In other words, Value conclusion should be based on the *Professional Judgement* and Simple Average should best be avoided while concluding Value.

Key drivers of valuation

CASH FLOW

Investor assign value based on the cash flow they expect to receive in the future

- *Dividends / distributions*
- *Sale of liquidation proceeds*

Value of a cash flow stream is a function of

- *Timing of cash Receipt*
- *Risk associated with the cashflow*

That's why DCF is most prominent valuation method

ASSETS

Operating Assets

- Assets used in the operation of the business including working capital, Property, Plant & Equipment & Intangible assets
- Valuing of operating assets is generally reflected in the cash flow generated by the business

Non - Operating Assets

- Assets not used in the operations including excess cash balances, and assets held for investment purposes, such as vacant land & Securities
- <u>Investors generally do not give much value to such assets and Structure modification may be necessary</u>

Need for Restructuring

Valuation Depends upon

Purpose

- Mergers
- Acquisitions / Investment
- Fund Raising
- Sale of Businesses
- Voluntary Assessment

Regulatory

- RBI
- Income Tax
- SEBI
- Stock Exchange
- Companies Act

Accounting

- ESOP
- Purchase Price Allocation
- Impairment / Diminution

Dispute Resolution

- Company Law Board/ Courts
- Family
- Settlement

Value Creation

- Equity Research
- Credit Rating
- Corporate Planning

Choice of Valuation Approaches

Applicability of a particular approach depends upon:

On whose behalf? – one buyer vs another buyer, buyer vs seller;

For what purpose? – independent strategic acquisition, group company consolidation, cross border transaction;

When? – distress situation, industry downturn, boom etc;

Choice of Valuation Approaches

Purpose of Valuation, Stage of Business and Business Model determine Valuation Approaches

In General, Income Approach is preferred;

- The **dominance of profits for valuation of share was emphasised in "McCathies case"** (Taxation, 69 CLR 1) where it was said that *"the real value of shares in a company will depend more on the profits which the company* ***has been making and should be capable of making****, having regard to the nature of its business, than upon the amount which the shares would realise on liquidation".*

- This was also re-iterated by the Indian Courts in Commissioner of Wealth Tax v. **Mahadeo Jalan's case (S.C.)** (86 ITR 621) and Additional Commissioner of Gift Tax v. Kusumben D. Mahadevia (S.C.) (122 ITR 38).

- **However, Asset Approach is preferred in case of Asset heavy companies and on liquidation;**

- **Market Approach is preferred in case of listed entity and to evaluate the value of unlisted company by comparing it with its listed peers;**

Company Specific Factors

It is the alignment of Company's value via-a-vis to its external environment

- **Management, Promoter Group**
- **Operating, Capital and Corporate Finance Strategies**
- **Competitive advantages and cost position**
- **Product / Service offering / differentiation / pricing power**
- **Scale & Diversification**
- **Customer / Supplier concentration**
- **Corporate Governance**
- **Future prospects / Growth potential**
- **Industry peer group and positioning**
- **Regulatory environment**

RELATIVE VALUATION

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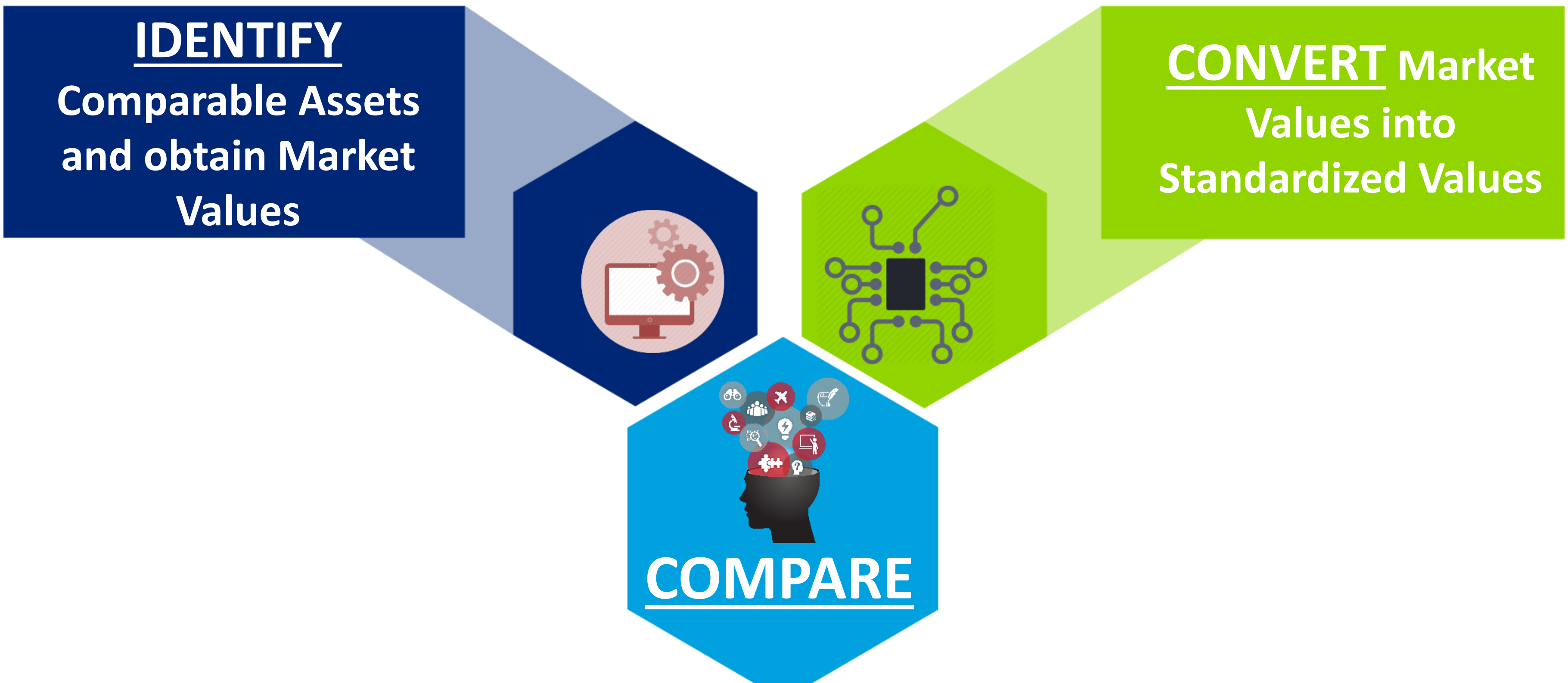
What is Relative Valuation

The Value of an asset is compared to the values assessed by the market for similar or comparable assets.



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Relative Valuation is Pervasive

Standardizing Value

The valuation ratio typically expresses the valuation as a function of a measure of Key Financial Metrics

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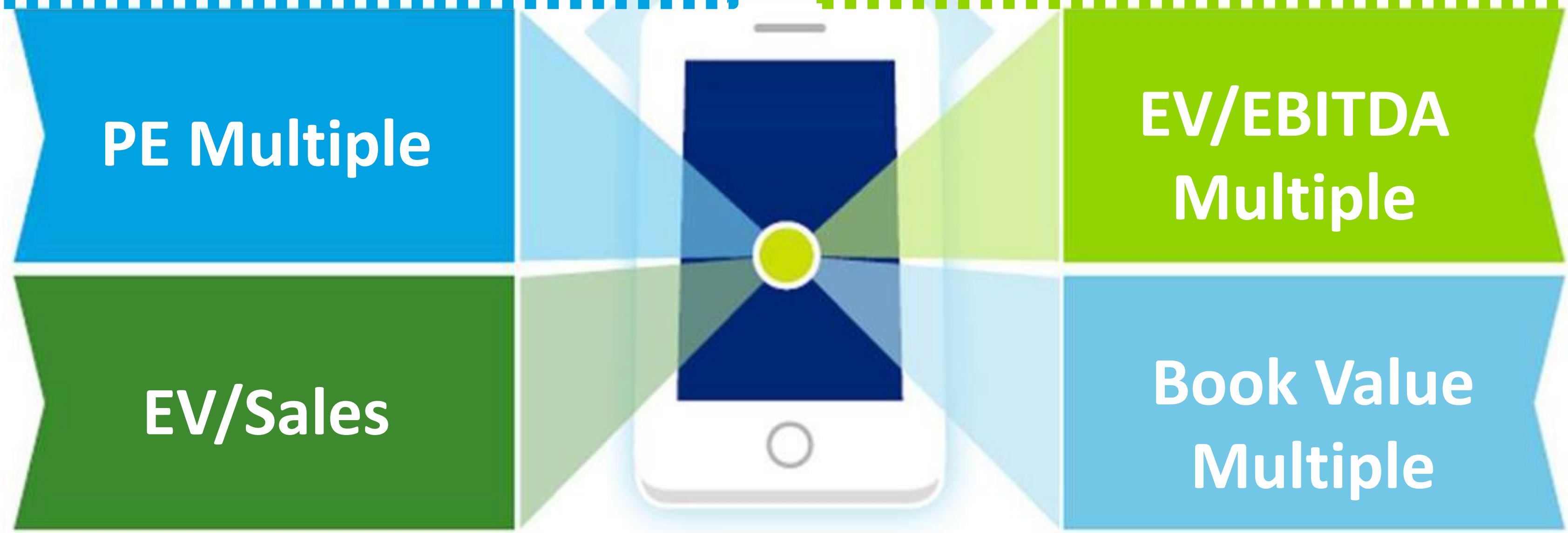
Pros/Cons of Different Multiples

Earnings : Audited Earnings (PAT)
:TTM Earnings (PAT)
Price : Latest / Volume Weighted / Simple
Average of say 6 Months
(+) Easy to apply
Net Profitability linked
(-) Prone to Accounting Adjustments

- Best multiple to apply
- Considers Operational Profits
- Not prone to Accounting Adjustments (Depreciation & Amortizations)
- Values irrespective of Debt levels



(+) Simplest to apply even when in Losses
- Used to Value e-Commerce Companies / Media Companies in Losses

(-) Not a preferred method as such, other than for Mature Companies

- Book Value is the Investment (Net Worth) that equity shareholders have put in & earned in Company
- Not much relevant as Earnings not factored in (other than mature cos)

Multiples can be Misleading

To use a multiple you must:

- **Know what are the <u>fundamentals</u> that determine the multiple and how <u>changes in these fundamentals</u> change the multiple**
- **Know what the distribution of the multiple looks like (Mean/Median/Outliers)**
- **Ensure that both the denominator and numerator represent same group**
  - ➢ **PE, Book Value, Mcap/Sales Multiples result in Equity Value**
  - ➢ **EBIT, EBITDA, EV / Sales Multiple result in Enterprise Value**
- **<u>Ensure that firms are comparable</u> (Business Model, Product Profile, Geography, Stage & Size of Business, Profitability margins, Borrowings etc. play a crucial role in finding "Comps"**

Discounted Free Cash Flow Valuation

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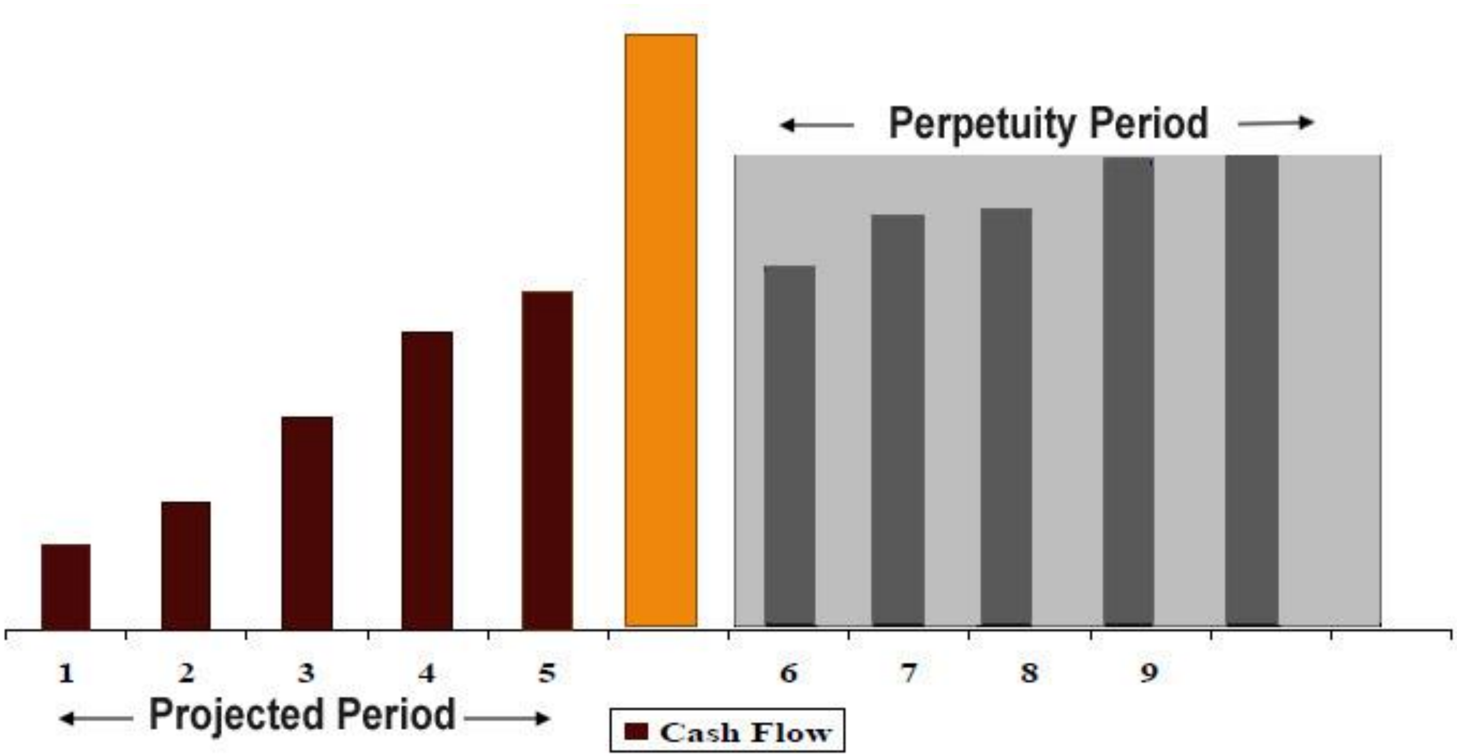
Discounted Free Cash Flow Method (DFCF)

DFCF expresses the present value of the business as a function of its future cash earnings capacity. In this method, the appraiser estimates the cash flows of any business after all operating expenses, taxes, and necessary investments in working capital and capital expenditure is being met. Valuing equity using the free cash flow to stockholders requires estimating only free cash flow to equity holders, after debt holders have been paid off.

DFCF Valuation Process

- ❑ Understand Business Model
- ❑ Identify Business Cycle
- ❑ Analyze Historical Financial Performance
- ❑ Review Industry and Regulatory Trends
- ❑ Understand Future Growth Plans (including Capex needs)
- ❑ Segregate Business and Other Cash Generating Assets
- ❑ Identify Surplus Assets (assets not utilized for Business say Land/Investments)
- ❑ Create Business Projections (Profitability statement and Balance Sheets)
- ❑ Discount Business Projections to Present (Explicit Period and Perpetuity)
- ❑ Add Value of Surplus Assets and Subtract Value of Contingent Liabilities

Free Cash Flows – Value Trend



Terminal Value is calculated for the Perpetuity period based on the Adjusted last year cash flows of the Projected period.

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Free Cash Flows Calculation

FREE CASH FLOWS

Free cash flows to firm (FCFF) is calculated as

EBITDA	−	Taxes Change in Non Cash Working capital Capital Expenditure	=	Free Cash Flow to Firm

Note that **an alternate to above is following (FCFE) method in which the value of Equity is directly valued in lieu of the value of Firm**. Under this approach, the Interest and Finance charges is also deducted to arrive at the Free Cash Flows. Adjustment is also made for Debt (Inflows and Outflows) over the definite period of Cash Flows and also in Perpetuity workings.

Theoretically, the value conclusion should remain same irrespective of the method followed (FCFF or FCFE), (Provided, assumptions are consistent).

Cost of Capital Calculation

DISCOUNT RATE – WEIGHTED AVERAGE COST OF CAPITAL

$$\textbf{WACC} = \frac{(K_d \times D) + (K_e \times E)}{(D + E)}$$

Where:
D = Debt part of capital structure
E = Equity part of capital structure
K_d = Cost of Debt (Post tax)
K_e = Cost of Equity

In case of following FCFE, Discount Rate is Ke and Not WACC

Cost of Equity Calculation

DISCOUNT RATE - COST OF EQUITY

The Cost of Equity (Ke) is computed by using Modified Capital Asset Pricing Model (Mod. CAPM)

Mod. CAPM Model

ke = Rf + B (Rm-Rf) + SCRP + CSRP

Where:

Rf = Risk free rate of return (Generally taken as 10-year Government Bond Yield)

B = Beta Value (Sensitivity of the stock returns to market returns)

K_e = Cost of Equity

Rm= Market Rate of Return (Generally taken as Long Term average return of Stock Market)

SCRP = Small Company Risk Premium

CSRP= Company specific Risk premium

Terminal Value Calculation

PERPETUITY FORMULA

- Usually comprises a Large part of Total Value and is sensitive to small changes
- Capitalizes FCF after definite forecast period as a growing perpetuity;
- Estimate Terminal Value using Terminal Value Multiplier applied on last year cash flows
- Gordon Formula is often used to derive the Terminal Cash Flows by applying the last year cash flows as a multiple of the growth rate and discounting factor

$$\frac{(1 + g)}{(WACC - g)}$$

- Estimated Terminal Value is then discounted to present day at company's cost of capital based on the discounting factor of last year projected cash flows

IMPORTANT TIP- It is advised to do Sanity check by applying Relative Valuation Multiples to the Terminal Year Financials and also doing Scenario Analysis.

Rule of Thumb

A rule of thumb or benchmark indicator is used as a reasonableness check against the values determined by the use of other valuation approaches.

Industry	Valuation Parameters
Hospital	EV/Room
Engineering	Mcap/Order Book
Mutual Fund	Asset under management
OIL	EV/ Barrel of equivalent
Print Media	EV/Subscriber
Power	EV/MW, EBITDA/Per Unit
Entertainment & Media	EV/Per screen
Metals	EBITDA/Ton, EV/Metric ton
Textiles	EBITDA depend upon capacity utilization Percentage & per spindle value
Pharma Bulk Drugs	New Drug Approvals , Patents
Airlines	EV/Plane or EV/passenger
Shipping	EV/Order Book, Mcap/Order Book
Cement	EV/Per ton & EBITDA/Per ton
Banks	Non performing Assets , Current Account & Saving Account per Branch

However, Exclusive use of Rule of Thumb is not recommended

Startup Valuation - Recent Investment Trends

Internet based businesses globally have seen unprecedented growth and now with India taking a center stage in global markets because of high growth & reform expectations, demographic dividend and large market, many Indian startups have come out, especially in the last couple of years, building scalable businesses (substantially Tech-enabled) to solve a multitude of problems we face in our daily life.

Till 2015, Indian digital retail and e-Commerce companies and their valuations were being closely linked to the soaring valuation of US tech start-ups and investors are under the fear of missing out. The online retail companies were relying on a different metric of valuations – "GMV" gross merchandise value which is defined to indicate total sales value for merchandise sold through a marketplace over a period. However, it must be noted that GMV is not reflected on their financial statements and their actual revenues are just a fraction of GMV. The GMV or sales (as per financial statement) was then multiplied by a multiple (x times) to get the Valuation of the entity.

Interestingly the trend of Investments has remained difficult and different in 2016. Many e-tailers have reported decline in number of orders significantly as they cut discounts leading to drop in their GMV raising eyebrows on their fresh funding rounds and valuations

Startup Valuation - Recent Investment Trends

While we fully appreciate the way startup revolution has taken in India but we recall how the best and most innovative companies in the world like Apple, Microsoft etc. were formed. Yes, they were bootstrapped !

But in recent times, we have seen mad rush for Investor Funding and focus is much more on Valuation than Value and Scale then having a biz model with stable profitability.

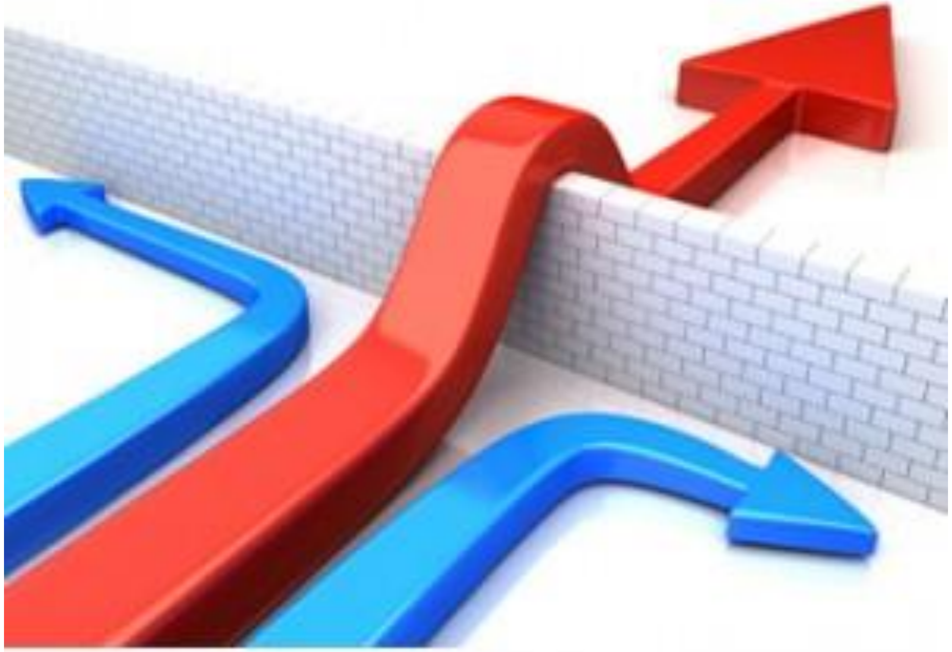
“Topline is vanity, Bottomline is Sanity, Cashflow is reality”

Start-up Funding has dried Up with Investors looking when and if ventures would turn Profitable? This is also driving more M&A as consolidation is taking place, striving for consistency -

- Jabong sold to Flipcart for just $70M in July 2016; Got Valued at approx. 0.5 times of its reported 2015 Topline
- Jabong parent raises $339M; valuation plunges by 68% - April 2016
- Morgan Stanley marks down “Flipkart” valuation by 27% - Feb 2016
- Hyperlocal delivery start-up – “PepperTap” shuts operations in six large cities – Feb 2016
- “Grofers” decids to close operations in nine cities-Jan 2016

There are others like Yebhi, Bestylish and many others who are half dead…….

Tricky Issues



Tricky issues in DFCF

- **Pre Money or Post Money:** If the effect of the money coming in Company is taken in Projections, the Expanded capital base should be considered or else the Equity Value should be reduced by the inflow amount to reconcile with the existing capital base.
- **Terminal growth rate:** Since it is tough to estimate the perpetual growth rate of a company, it is preferred to take the perpetuity growth rate factoring in long term estimated GDP of the Country and Historical/Projection Inflation of the Country.
- **Projection Validation via-a-vis Industry:** Need to have Sanity check of the projections with the trend of the industry.
- **Beta of Unlisted Company:** It is calculated on relative basis by adjusting the average beta of its comparable companies for differences in Capital Structure of the unlisted company with the listed peers.
- **Risk Free Rate:** Yield of a Zero Coupon Bond or Long Term government Bond yield should be taken as the risk free rate since it does not have any reinvestment risk .

Tricky issues in DFCF (Cont.)

- **Adjustment of Company Specific Risk Premium or Small Company Risk Premium:** Small Companies are generally more risky than big companies. CAPM model does not take into consideration the size risk and specific company risk as Beta measures only systematic risk and Market Risk Premium (generally pertaining to Sensex Companies). These risks should also be taken into account while computing the cost of equity.
- **Length of Projections:** The Projected Cash Flows should factor in the entire Business Cycle of a Company.
- **Notional/Actual Tax:** Actual Tax Liability may be worked out and replaced for the Notional Tax Liability
- **Investments:** Investments should be valued separately based on their Independent Cash Flows
- **Surplus Assets:** The Value of Surplus Assets (not being utilized for Business purposes) should be added separately and their cash flows should be ignored while computing the Free Cash Flows.

Discounts

Discounts & Premiums come into picture when there exist difference between the subject being valued and the Methodologies applied. As this can translate control value to non-control and vise versa , so these should be judiciously applied.

- **Discount for Entity Level** – Impact on entity as a whole
  - Key Person Discount
  - Discount for Contingent Liability
  - Discount for diversified company
  - Discount for Holding Company
  - Tax Payout

Global Studies over the years on diversified companies and holding companies has shown that companies trade at a discount in the range of 20%. to 40% each.

- **Discount for Shareholders Level** – Impact on specific ownership interest
  - Discount Lack of Control (DLOC)
  - Discount Lack of Marketability (DLOM)

DLOM: As per CCI Guidelines, 15% discount has been prescribed; however practically DLOM and DLOC depends upon following factors:

- % stake & special rights
- Size of distribution or dividends
- Dispute
- Revenue / Earning – Growth / Stability
- Private Company
- Shareholders Agreement caveats

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Excess Cash and Non Operating Assets

Excess cash is defined as 'total cash (in balance sheet) **–** operating cash (i.e. minimum required cash) to sustain operations (working capital) and manage contingencies

Key Issue: Estimation of Excess Cash ?

One of the solutions is to estimate average cash/sales or total balance sheet size of the company's relevant Industry and then estimate if the company being valued has cash in excess of the industry's average.

Non operating Assets are the Surplus assets which are not used in operations of the business and does not reflect its value in the operating earnings of the company. Therefore the fair market value of such Assets should be separately added to the value derived through valuation methodologies to arrive at the value of the company.

What is an asset is not yielding adequate returns ?

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Cross Holding and Investments

Holdings in other firms can be categorized into:

Types of Cross Holding	Meaning
Minority, Passive Investments	**If the securities or assets owned in another firm represent less than 20% of the overall ownership of that firm**
Minority, Active Investments	**If the securities or assets owned in another firm represent between 20% and 50% of the overall ownership of that firm**
Majority, Active Investments	**If the securities or assets owned in another firm represent more than 50% of the overall ownership of that firm**

Ways to value Cross Holding and Investments:

- **Investment Value**
- **Dividend Yield Capitalization or DCF based on expected dividends**
- **Separate Valuation (Preferred)**

By way of Shareholders Agreement even less % holding may command control value

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Accounting Practices and Tax issues

Most of the information that is used in valuation comes from financial statements. which in turn are made on certain Accounting practices considered appropriate.

- **Cash Accounting v/s Accrual Accounting**
- **Operating Lease v/s Financial Lease**
- **Capitalization of Expenses**
- **Notional Tax vs. Actual Tax**
- **Treatment of Intangible Assets**
- **Companies Paying MAT**
- **Treatment of Tax benefits and Losses**

Control Premium and Takeover Bid

"Beauty lies in the eyes of the beholder; valuation in those of the buyer"

- An investor seeking to acquire control of a company is typically willing to pay more than the current market price of the company. **Control premium** is an amount that a buyer is usually willing to pay over the fair market value of a publicly traded company to acquire controlling stake in a company.
- Control can be direct (shareholding or Authority to appoint Board) or indirect (veto power, casting vote etc)
- Research has shown that the control premium in India has widely ranged from 30-50% in the past few years having median of 40%.

Recent Transactions (2016)	Control Premium
Microsoft acquires LinkedIn	50%
Oracle acquires NetSuite	19%
Verizon acquires Fleetmatics Group	40%

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Valuation Methodologies and Value Impact

Major Valuation Methodologies	Ideal for	Result
Net Asset Value		
Net Asset Value (Book Value)	Minority Value	Equity Value
Net Asset Value (Fair Value)	Control Value	

Comparable Companies Multiples (CCM) Method		
Price to Earning , Book Value Multiple	Minority Value	Equity Value
EBIT , EBITDA Multiple		Enterprise Value

Comparable Transaction Multiples (CTM) Method		
Price to Earning , Book Value Multiple	Control Value	Equity Value
EBIT , EBITDA Multiple		Enterprise Value

Discounted Cash Flow (DCF)		
Equity	Control Value	Equity Value
Firm		Enterprise Value

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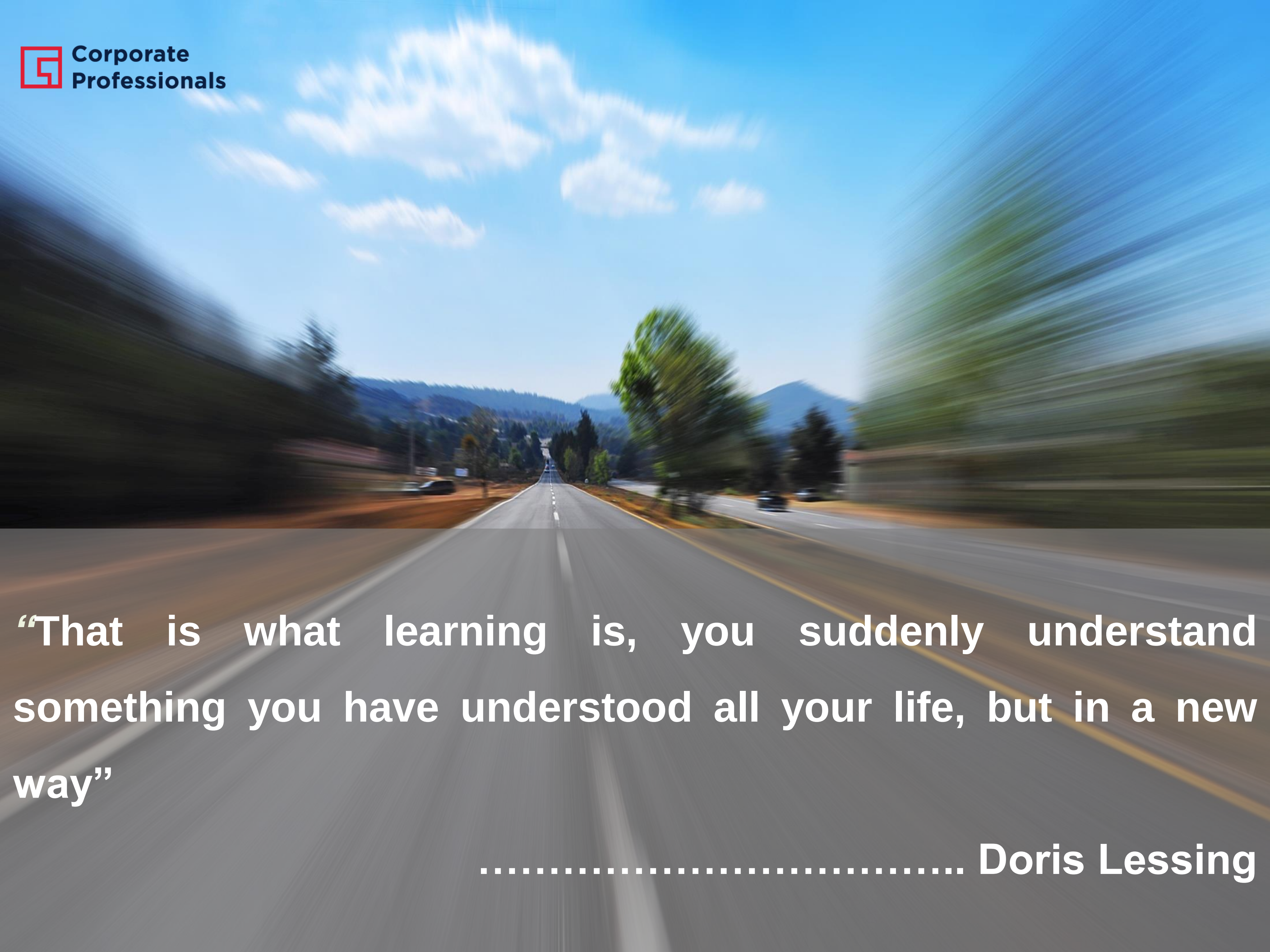
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“That is what learning is, you suddenly understand something you have understood all your life, but in a new way”
………………………………….. Doris Lessing

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