THE CHAMBER OF TAX CONSULTANTS

Valuation Application

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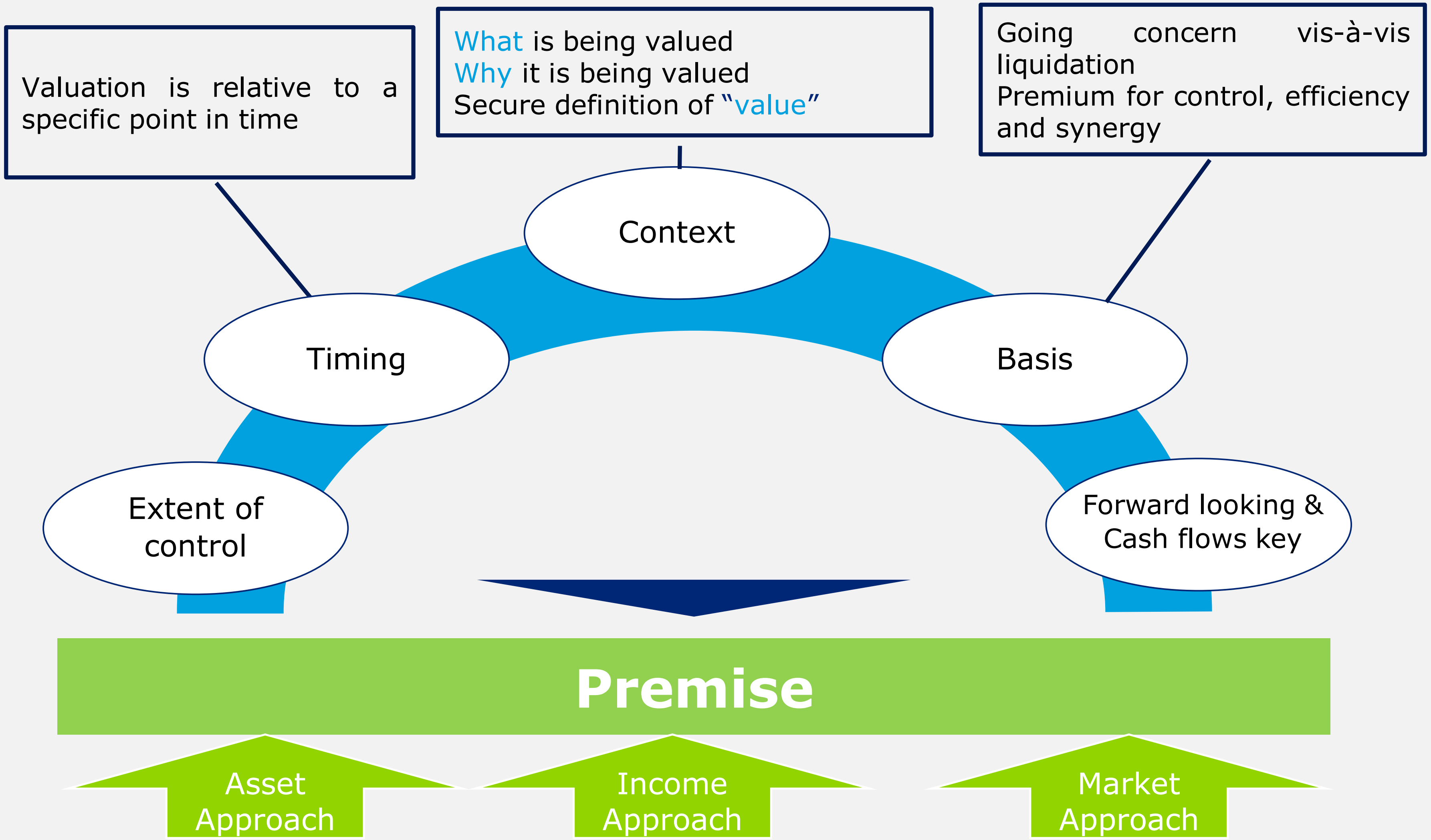
Topics covered:

- Valuation for Mergers and Demergers
- Valuation of Small and Medium Enterprises
- Valuation of Investment Entities
- Distressed Asset Valuation
- Start-Up Entities Valuation

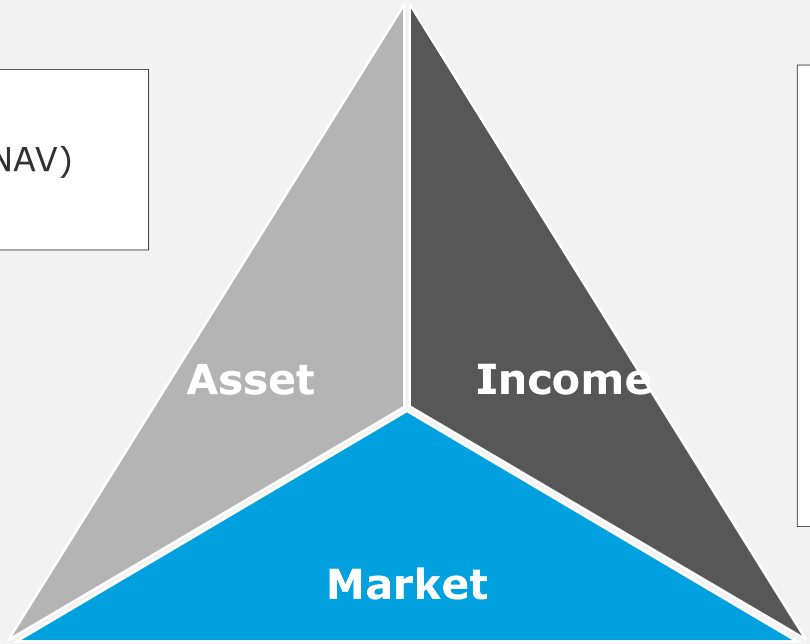
Valuation – A Perspective



Valuation analysis and results are specific to the purpose of the valuation and the valuation date.

Valuation Approaches- Business / Intangibles

Asset Approach:
- Net Asset Value (NAV)
- Liquidation Value



Income Approach:
- Discounted Cash Flow Method (DCF)
- Yield Method / Profit Earning Capacity Value Method (PECV)
- Earnings Capitalisation
- Royalty Relief method
- Contribution / Excess earnings method
- Incremental Cashflows method

Market Approach:
- Market Prices Method
- Comparable Companies Multiples Method (CCM)
- Comparable Transactions Multiples Method (CTM) – including past transactions in shares of the subject company.

- ➢ **Generally combination of methods are preferred**
- ➢ **Approaches are not exclusive; but complement each other**
- ➢ **More than one right way to value**

Valuation for Mergers and Demergers

Merger / Demerger / Slump Sale Valuation – General Proposition

- In a merger / demerger valuation, attempt is not to arrive at absolute values of the shares of the companies, but their **relative values** on a **stand alone and as is where is basis** to arrive at the exchange / entitlement ratio.

- A relative valuation is based on various methodologies and various qualitative factors relevant to each of the companies and the business dynamics and growth potential of the businesses of respective companies.

- Values of **operating assets** best captured by the value of income they can generate.

- Values of **non-operating assets** which can be easily disposed off without affecting the business of the companies are based on their estimated net realizable values.

- Evaluation on stand alone basis – **post merger synergies not to be considered**.

- In a demerger wherein the economic and voting interest of the shareholders remains the same **(pre and post demerger), no valuation is required**.

- In a slump sale of an undertaking, attempt is to arrive at **absolute values** of the undertaking and the consideration maybe discharged by cash / shares. E.g.- Bharti Airtel Ltd -Telesonic Networks Ltd

Type Of Mergers

Case 1: Merger of two companies with independent shareholders

(E.g.- IDFC – Capital First)

Company A ↔ Company B

Case 2: Merger of listed company with unlisted company or vice versa

(E.g.- Excel crop care –Sumitomo Chemical)

Company A (Listed/Unlisted) ↔ Company B (Unlisted/Listed)

Case 3: Merger with a foreign entity

Company A (Indian company) ↔ Company B (Foreign company)

Valuation of Shares based on Swap Ratio

Case 4: Merger of a wholly owned subsidiary with its holding Company

(E.g.- Vodafone India Digital Ltd – Vodafone Idea)

Company A (Holding) → Company B (WOS)

No Valuation Required

Types of Demergers

Case 1: A listed company demerging its unlisted subsidiary/division (E.g.- HCL Tech – Geometric Solutions)

Company A (Listed/Unlisted) → Company B (Unlisted/Listed Subsidiary/ Non Subsidiary)

Valuation of shares based on swap ratio

Case 2: A WOS demerging from its holding company (DLF Limited demerging its real estate undertaking DLF Utilities Ltd)

Company A (Holding Company) → Company B (WOS)

Valuation based on Fair Market Value or Agreed Ratio

Fair Market Value or Share swap based on whether consideration is discharged in cash or shares

Valuation in merger and demerger

Key Considerations

- **Relative Valuation on standalone basis** for share swap ratio
- Valuation approaches and methods remain the same
- **Assess weights to be assigned** to each method.
- For listed companies, **consider whether shares are frequently traded or not** while assigning weight to Market Price Method
- **Like to like weights** to valuation methods to determine the share exchange ratio
  - Valuation Judgements :
  - Hindustan Lever Employees Union vs. Hindustan Lever Limited - Assigning weights to values under different methodologies to arrive at a single relative value of the shares and determine the exchange ratio.
  - Miheer H. Mafatlal Vs. Mafatlal Industries – Exchange Ratio not disturbed by Courts unless objected and found grossly unfair.

SEBI-Fair exchange ratio format for listed companies

	XYZ Ltd		PQR Ltd	
Valuation Approach	Value per Share	Weight	Value per Share	Weight
Asset Approach	x	a	y	d
Income Approach	x	b	y	e
Market Approach	x	c	y	f
Relative Value per Share	**x**		**y**	
Exchange Ratio (rounded off)			**xx**	

Key Takeaways

- Relative valuation on standalone basis
- Valuation approach and methods remain same
- Focus on **weights assigned to each method**
- Mode of payment of consideration- **cash or shares**

Valuation of Small and Medium Enterprises

Traits of Small and Medium Enterprises

- **Small size of business** with limited ability to reach new markets.
- **High growth initially due to small base**
- **Limited financial acumen**
- **Challenges in financing working capital requirements**
- **Owner management**- This limits its exposure to expertise.
- **Readiness to cope with changes in technological or regulatory environment**. E.g- Disruption - Introduction of GST, negatively affected the small and medium industries

Valuation of Small and Medium Enterprises

- **Valuation of SMEs do not differ from those for the valuation of larger enterprises**
- Particular attention is paid to –
  - Business being valued
  - Stage of growth
  - Market share and size of enterprise
  - Reliability of sources of information
  - Costs towards managerial remuneration
  - Finance structure
  - Proforma Adjustments
  - Appropriate premiums / discounts to be considered

Key Takeaways

- Valuation approach and methods remain the same.
- Premium/Discount **adjusted for size, growth and finance structure.**

Valuation of Investment Entities

Investment Entities

Investment entities could be:

- Mutual Funds, Hedge Funds, Sovereign Funds, Pension Funds, etc
- **Group Holding Companies**. E.g.-
  - Tata Sons which holds stake in various Tata Group Companies
  - JSW Investments Pvt Ltd which holds stake in JSW Steel, JSW Energy and JSW Infrastructure
  - SoftBank has its own operations and has many strategic investments including ~26% stake in Alibaba.

Valuation of Investment Entities

- Significant value is derived from **fair value of its investments**
- Valuation approaches and methods remains the same for underlying investments
- **Value of Group Holding Companies = Fair Value of its own operations, if any + Fair Value of its investments**

Key Takeaways

- Valuation approach and methods for the investments remain the same
- Focus on **fair vale of underlying investments**
- **Holding Company discount – Concept for Market Price of listed stocks of Holdcos – not Intrinsic Value.**

Valuation of Distressed Assets

Traits of distressed assets

- **Cause of distress** – financial, operational, managerial, outdated/obsolete industry
- **Falling revenue and inability to reverse the fall in revenue**
- **Fall in margins or negative margins** – lose pricing power
- **Tangible assets realization** – as assets are worth more if sold rather than use.
- **Financial leverage** – Cost of borrowing > ROCE.

E.g.- Binani Industries sold its ~ 98.5% stake in Binani Cement to Ultratech Cement to pay off its debtors.

Key risk areas :

Financial Distress

- Condition in which a company or individual cannot generate revenue or income because it is unable to meet or cannot pay its financial obligations
- E.g.- Jet Airways, other companies referred to IBC such Essar Steel, Bhushan Steel and Alok industries.

Operational Distress

- Distress caused due to operational inefficiency and abnormal events.
- E.g.-A fire in the factory of Jensen and Nicholson paints, put the company in distress and limited turnaround scope.

Managerial Distress

- Distress caused by inefficiency and lack of responsibilities at management level.
- E.g.- FireStar Diamond Inc owned and controlled by Nirav Modi.

Obsolete/Outdated Industry

- Distress due to loss of market as a result of redundant/obsolete industry.
- E.g.-Introduction of digital cameras led to the death of traditional Kodak camera industry.

Value Drivers : Purpose for bidding

Company has a scope of turnaround or restructuring

Here valuation can be based on :

Income Approach

E.g.- In 2000, General Motors filed for bankruptcy, but has recovered with years of cost cutting in 2010.

Company has no scope for turnaround

Here Valuation can be based on-

Book Value

Liquidation Valuation

E.g.- Companies under IBC -Alok Industries, Essar Steel, Bhushan Steel

Valuation Methods: When there is scope for turnaround

Income approach: DCF Method

- A **modified discounted cash flow** can be constructed, factoring in restructuring strategy like – additional investment, cost cutting measures, revised managerial costs, restructured debt costs, etc.
- The terminal value computed on going concern basis, since the company has a scope for turnaround.
- **Discount rates and beta adjusted for restructuring or turnaround strategy and assumptions.**

When there is no scope for turnaround

Asset based approach-Net Assets Method or Book Value:

- In case of distressed assets, valuation depends on
  - Potential buyers or investors
  - Buyer pool and their availability of funds
  - Realizable value of the tangible assets
- Valuation can be suitably based on Liquidation Value or Net Assets Value.

Key Takeaways

- Primary Valuation Methods:

  Income Approach (DCF)

  Liquidation Value or Net Assets Value

Or combination of DCF and Asset Values

- Focus on realizable value of **Tangible assets**.
- Jet Airways – focus – Parking spots, International Routes, etc

Startup Entities Valuation

Traits of Startups

- **Limited History**
- **Small or no revenues and operating losses**
- **Focus on Intangibles –** Value of the business idea or a technology under development or an innovation.
- **Success ratio-** Most don't survive the test of commercial success and fail. E.g.- Holachef Founded in 2014, shut down on May 2018 amid a cash crunch.
- **Strategic business model and feasibility study is important**
- **Success depends on management expertise**. E.g.- Zomato recently brought in former Make My Trip COO as CEO.
- **Demands Constant Innovation, Evolving model and Scalability-** E.g.- Zomato went from being a food rating app to introducing services like food delivery and table bookings.
- **Dependent on private equity**-It provides both funding and expertise. E.g.- Alibaba group and CDC group in Big Basket.

Stage of Business and Valuation
Selecting the right model at right stage of business

Early Stage : Pre – Revenue, Concept Market, IP R&D

- Scorecard Method
- Real Options based on market size and market share.

Expansion Stage – High Growth Stage – Maturity Stage

- Discounted Cash Flow Approach
  1. Probability Based
  2. Scenario Based
  3. Venture Capital Return Based
- Comparable Company Multiples
- Comparable Transactions Multiples
- Net Assets Value

Valuation Methods and Challenges

Income Approach- DCF Method:

- **Future cash flow projections** built based on expected growth rate and business strategy.
- Time taken to reach stable growth
- **Higher discounting rate** based on risk undertaken and reliability of the projections
- Terminal Value computation is usually subjective.

Market Approach-Comparable Companies Multiples Method:

- **Challenge in identifying** listed comparable companies - Comparable companies can be Indian or foreign listed companies
- **Multiples adjusted** for size, stage of growth, geography, etc . E.g.-Nykaa an Indian startup, can have international comparable companies like Birchbox (UK), Memebox(US), Ulta beauty(US)
- **Forward looking Earnings or EBITDA** can be considered in valuations.
- Other industry specific multiples are usually used. E.g.- EV/Subscribers (Amazon, Netflix or Facebook) – like organized Retail many years back – was valued based on footfalls, or Subs for Telecom industry
- International Comparables if not available in India – Telecom, Insurance - China

Market Approach- Comparable Transactions Multiples Method

- **Price of a fairly recent investment** could be a scientifically appropriate method. E.g.- In Swiggy's February 2018 Series F transaction, it was valued at $1.1 Bn and in June 2018 Series G transaction, it was valued at $1.3 Bn
- **Comparable transactions** E.g.- Investment by Softbank in Grofers or Unilever Ventures in Milkbasket can be considered for valuation of BigBasket
- **Premiums/Discount** may be applied to recent transactions, to make it more comparable.

Valuation of startup- As per International Private Equity and Venture Capital Valuation Guideline:

- **Scenario Based Method**- A forward looking multiple that considers one or more possible future scenarios. This method includes:

  1. Simplified Scenario Analysis

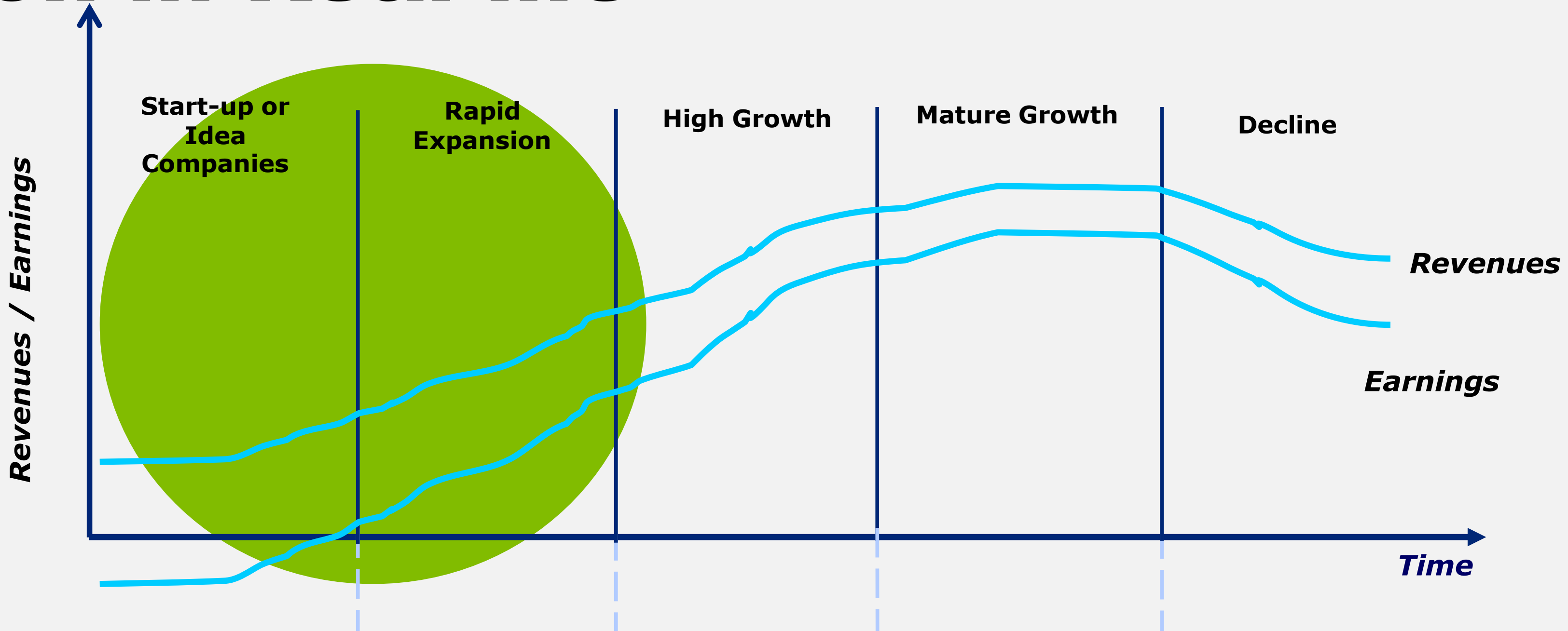
  2. Relative Scenario Analysis

- **Option Pricing Method (OPM),** forward-looking method that considers the current equity value and then allocates that value to the various classes of equity considering a continuous distribution of outcomes, rather than focusing on distinct future scenarios.
- **Current value method (CVM),** which allocates the equity value to the various equity interests in a business as though the business were to be sold on the Measurement Date.
- **Hybrid method-** a hybrid of scenario-based methods and OPM.

Key Takeaways:

- **Commercial** viability and **Scalability** of business model
- Primary Valuation Methods
    - o **Income Approach(DCF)**
    - o **Markets Approach**
- Focus on **Value of Intangibles – eg IP, Technology, Talent**
- **Premiums – large paid – for synergistic benefits that the acquirer may expect – in terms of improving existing products / app or scalability or cost saving.**
- **Not all Acquirers may be able to extract same benefits and hence pay same premiums**

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

Every valuation engagement is unique and the approach, methodologies depend on the facts of each and every case.

Thank you