Valuation Aspect in Merger & Amalgamation

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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

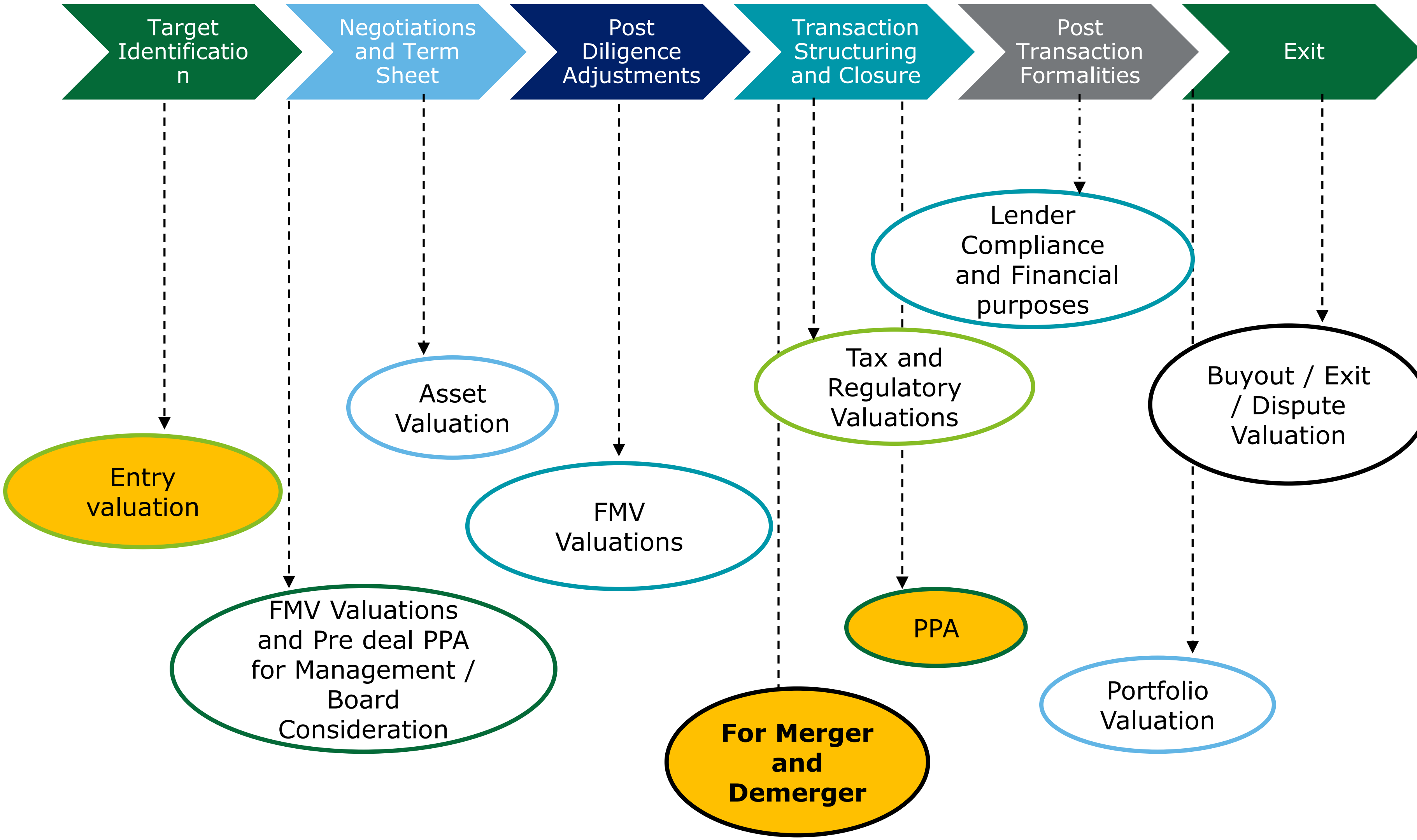
- Growth in terms of new technology, competence, capability, or
- market space through inorganic route
- Diversification by entering into a new segment / geography

Financial Reasons

- Fund Raising
- Utilization of excess cash
- Cost synergies

Importance of Valuation

Valuations and the Deal Cycle



Valuation – an integral part of the deal

M&A – 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.

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

- 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.

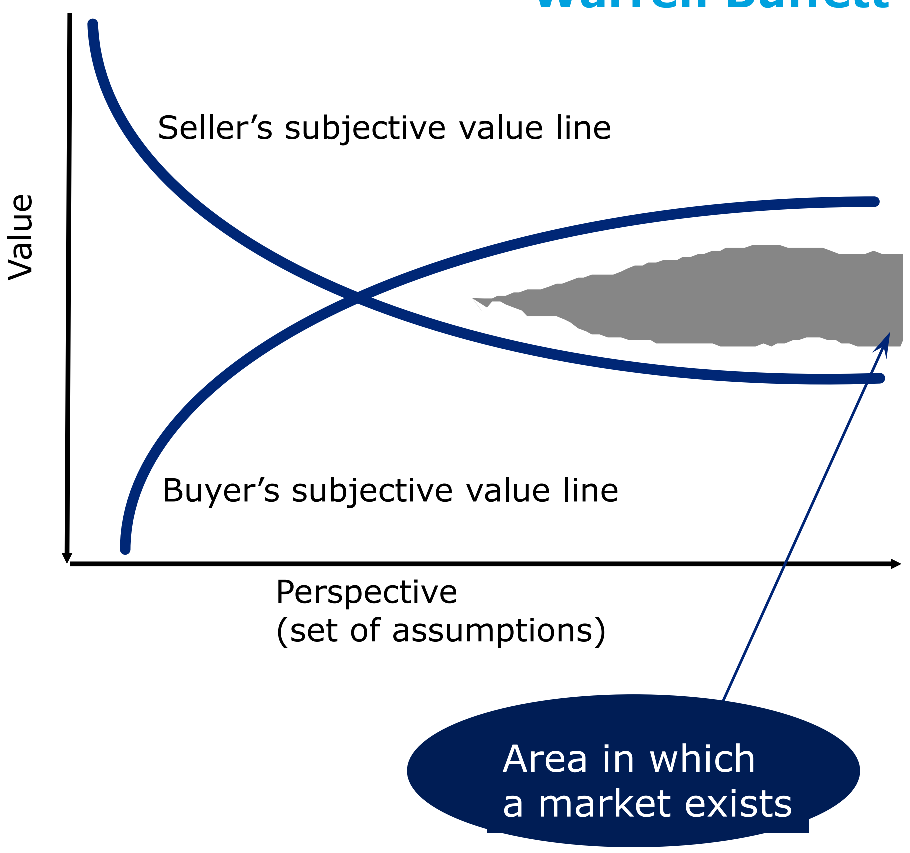
- In a merger and demerger wherein the economic and voting interest of the shareholders remains the same (pre and post demerger), **commercially no valuation is required**.

Valuation

What is a Valuation?

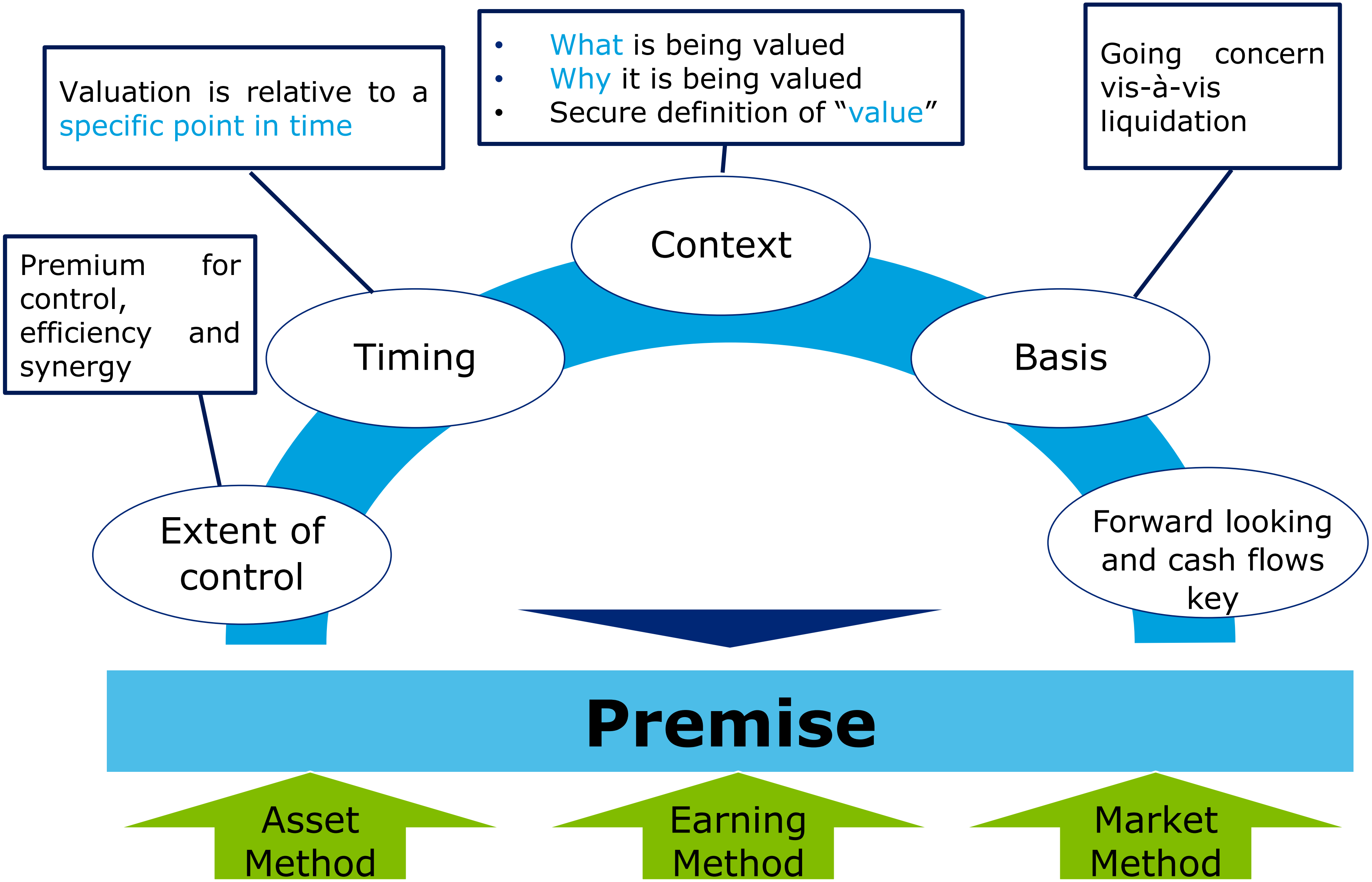
- Principles of valuation
  - Business value vs Asset value
  - Business value more than assets
  - Absolute value vs Relative value
  - Value hovers within a range not a precise number
  - Valuation v/s price

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



- 3 key points to remember:
  - Valuation involves "informed subjectivity"
  - Price is different from value
  - Deal is made at a Negotiated Price

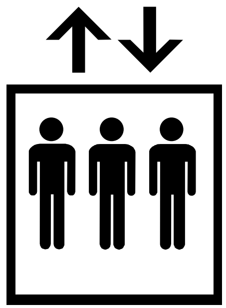
Valuation – A Perspective

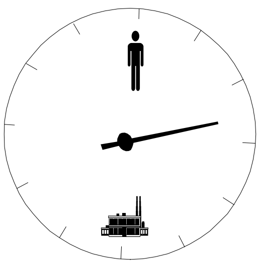


Where is the value

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

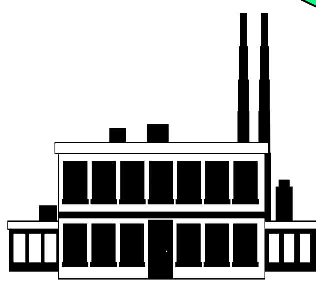
People business





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

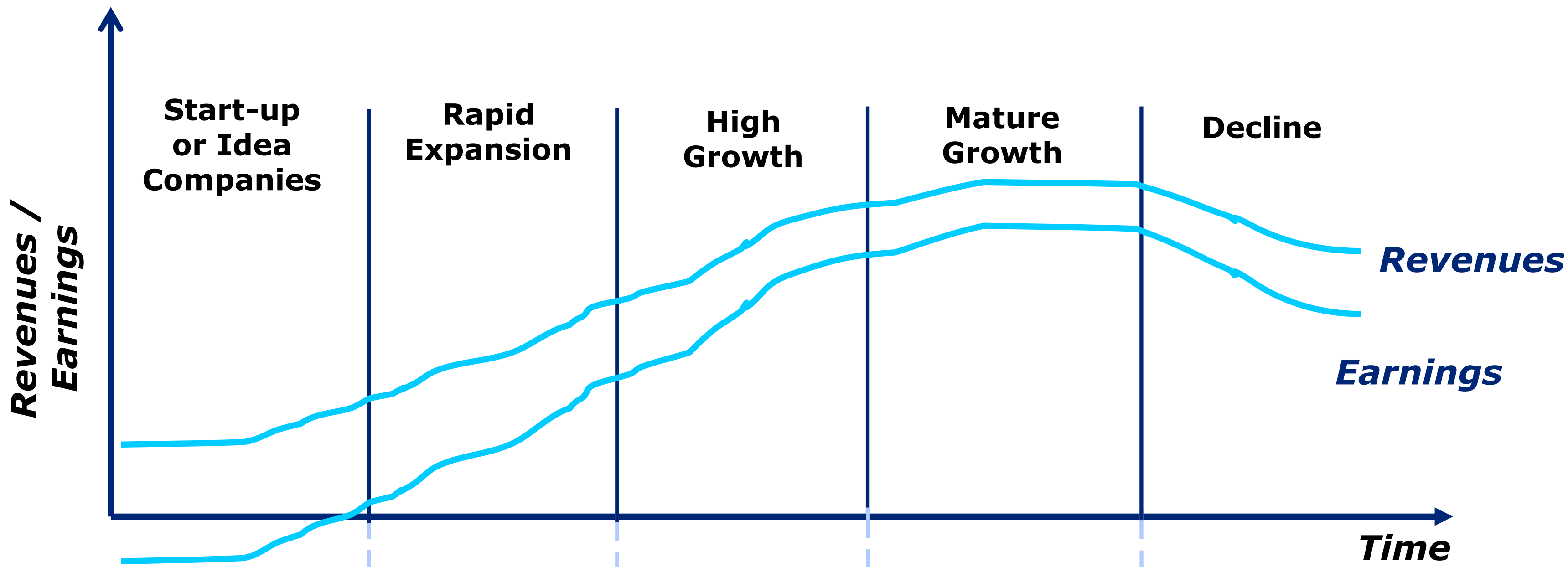
Asset business



Brands

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

Earnings based

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

Market based

- Market Price
- Comparable Companies Multiples
- Comparable Transaction Multiples

Value of Business / Equity / Intangibles

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

Valuation Methodologies

- Methods throw a range of values
- Consider relevance of each methodology & premise of valuation – decide on primary and corroborative methods
- Selecting the final value
  - 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
- Both methods require subjectivity since the weights selected in mathematical

Final Recommendation – common sense and reasonableness

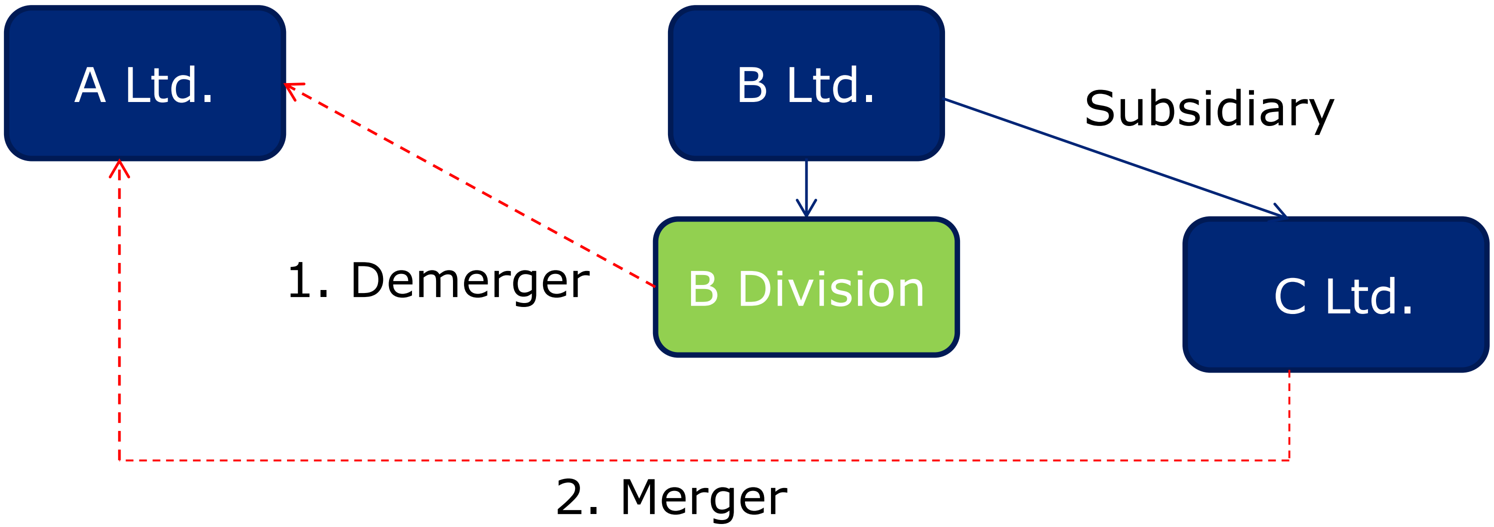
Share Exchange Ratio

- Weightages considered in arriving at the relative fair value of the equity shares are generally

Net Asset Value Methodology	1
Market Methodology	2
Earnings Methodology	2

- Generally predominant weightage given to market and earnings method considering that the proposed merger is on a going concern basis

Scenario



Company	Ownership	Business
A Ltd.	Listed	• Large Conglomerate • Presence in several businesses • Trading, Manufacturing and Marketing
B Ltd.	Listed	• Large Conglomerate • Manufacturing, Retailing
B Division	Segment	• Manufacturing
C Ltd.	100% subsidiary of B Ltd.	• Marketing and Distribution of the products of B Division

Scenario – Valuation Approach

<table>
<tr><th>Valuation Methodologies</th><th>A Ltd.</th><th>B Division</th><th>C Ltd.</th></tr>
<tr><td>Market Price Method</td><td>• Market price reflects revenues and profitability of several businesses</td><td>• Cannot split market capitalisation to reflect the value of the segment.
• If significant segment, one may derive from value of company / multiples.</td><td>Not applicable</td></tr>
<tr><td rowspan="2">Comparable Companies Multiples Method</td><td>• Multiples of companies comparable to each business</td><td>• Multiples of manufacturing companies applied to the division results
• Multiples adjusted to reflect growth, capacity expansion in recent past, newly product launches etc.</td><td>• Multiples of marketing and distribution companies</td></tr>
<tr><td colspan="3">• Relative valuation difficult as each company / division in different segment, different risk reward profiles, governed by different laws</td></tr>
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Scenario – Valuation Approach

Valuation Methodologies	A Ltd.	B Division	C Ltd.
Discounted Free Cash Flow Method	• WACC and TVG to be seen on a relative basis • COE based on several businesses	• Segment profit and loss account and balance sheet • Segment projections • Cost allocations etc. • WACC and TVG to be seen on a relative basis	• WACC and TVG to be seen on a relative basis
Comparable Transaction Method	• 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	• Due Diligence adjustments • Weightages to different methodologies • Focus on resultant shareholding of A Ltd. since listed		

Issues in Valuation

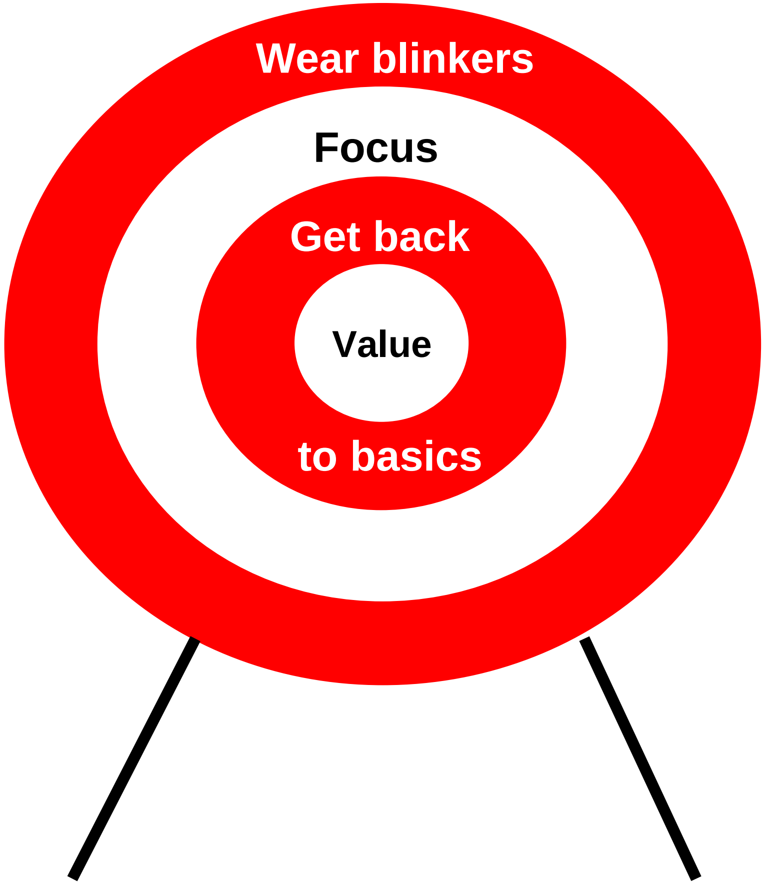
Valuation - Issues & Challenges

- 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
- Synergies
- Premium / Discount

Conclusion

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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