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
-市场 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

- **Target Identification**
- **Negotiations and Term Sheet**
- **Post Due Diligence Adjustments**
- **Transaction Structuring and Closure**
- **Post Transaction Formalities**
- **Exit**

**Entry valuation**

**FMV Valuations**

**Asset Valuation**

**FMV Valuations and Pre deal PPA for Management / Board Consideration**

**Lender Compliance and Financial purposes**

**Tax and Regulatory Valuations**

**For Merger and Demerger**

**PPA**

**Portfolio Valuation**

**Buyout / Exit / Dispute Valuation**

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

• 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
Valuation – A Perspective

Valuation is relative to a specific point in time

• What is being valued
• Why it is being valued
• Secure definition of “value”

Going concern vis-à-vis liquidation

Premium for control, efficiency and synergy

Timing

Extent of control

Context

Forward looking and cash flows key

Premise

Asset Method

Earning Method

Market Method
Where is the value

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

People business

Asset business

Brands

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

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

---

**Graph Description**

- **Axes:**
  - Vertical: Revenues / Earnings
  - Horizontal: Time

- **Stages:**
  - Start-up or Idea Companies
  - Rapid Expansion
  - High Growth
  - Mature Growth
  - Decline

- **Main Curve:**
  - **Revenues**
  - **Earnings**

**Legend:**

- **Start-up or Idea Companies**
  - Non-existent or low revenue/negative operating income
- **Rapid Expansion**
  - Revenue increasing/Income still low or negative
- **High Growth**
  - Revenue in high growth/Operating income also growing
- **Mature Growth**
  - Revenue growth slows/Operating income still growing
- **Decline**
  - Revenue and operating income growth drop

**Notes:**

- **Revenue / Current Operations**
  - None
  - Very limited
  - Some operating history
  - Operating history can be used in valuation
  - Substantial operating history

- **Operating History**
  - Non-existent
  - Limited
  - Some operating history
  - Operating history can be used in valuation
  - Substantial operating history

- **Comparable Firms**
  - None
  - Some, but in the 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

- **Market based**
  - Market Price
  - Comparable Companies Multiples
  - Comparable Transaction Multiples
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

1. Demerger

A Ltd. → B Division → C Ltd.

2. Merger

B Ltd. → Subsidiary → C Ltd.

<table>
<thead>
<tr>
<th>Company</th>
<th>Ownership</th>
<th>Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Ltd.</td>
<td>Listed</td>
<td>• Large Conglomerate&lt;br&gt;• Presence in several businesses&lt;br&gt;• Trading, Manufacturing and Marketing</td>
</tr>
<tr>
<td>B Ltd.</td>
<td>Listed</td>
<td>• Large Conglomerate&lt;br&gt;• Manufacturing, Retailing</td>
</tr>
<tr>
<td>B Division</td>
<td>Segment</td>
<td>• Manufacturing</td>
</tr>
<tr>
<td>C Ltd.</td>
<td>100% subsidiary of B Ltd.</td>
<td>• Marketing and Distribution of the products of B Division</td>
</tr>
</tbody>
</table>
## Scenario – Valuation Approach

<table>
<thead>
<tr>
<th>Valuation Methodologies</th>
<th>A Ltd.</th>
<th>B Division</th>
<th>C Ltd.</th>
</tr>
</thead>
<tbody>
<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.</td>
<td>Not applicable</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• If significant segment, one may derive from value of company / multiples.</td>
<td></td>
</tr>
<tr>
<td>Comparable Companies Multiples</td>
<td>• Multiples of companies comparable to each business</td>
<td>• Multiples of manufacturing companies applied to the division results</td>
<td>• Multiples of marketing and distribution companies</td>
</tr>
<tr>
<td>Method</td>
<td></td>
<td>• Multiples adjusted to reflect growth, capacity expansion in recent past, newly product launches etc.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Relative valuation difficult as each company / division in different segment, different risk reward profiles, governed by different laws</td>
<td></td>
</tr>
</tbody>
</table>
## Scenario – Valuation Approach

<table>
<thead>
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<th>A Ltd.</th>
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<th>C Ltd.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discounted Free Cash Flow Method</td>
<td>• WACC and TVG to be seen on a relative basis</td>
<td>• Segment profit and loss account and balance sheet</td>
<td>• WACC and TVG to be seen on a relative basis</td>
</tr>
<tr>
<td></td>
<td>• COE based on several businesses</td>
<td>• Segment projections</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Cost allocations etc.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• WACC and TVG to be seen on a relative basis</td>
<td></td>
</tr>
<tr>
<td>Comparable Transaction Method</td>
<td>• Not much information available in public domain.</td>
<td>• Transactions - non-control stake, strategic / financial investments, synergies may not reflect in the price paid for the transaction.</td>
<td></td>
</tr>
<tr>
<td>Other Issues</td>
<td>• Due Diligence adjustments</td>
<td></td>
<td>• WACC and TVG to be seen on a relative basis</td>
</tr>
<tr>
<td></td>
<td>• Weightages to different methodologies</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Focus on resultant shareholding of A Ltd. since listed</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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...”
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.

Further, the information contained in this document is intended only to provide a perspective on valuation methods and the process followed in relation to such and related engagements. It should be in no way construed to be an opinion or advise of any character and is in no way represented as such. The information provided herein should not be used and reproduced and should be considered privileged and only for the intended recipients.