Valuation for Mergers & Acquisitions

31st August 2016
Business Valuation
Master class, New Delhi
- M&A – Overview & Industry Trends
- M&A – Situations and Valuation
- Snapshot of Indian Laws impacting M&A
- Valuation in M&A
- Control Premium
- Case Study – M&A Valuation and Swap Ratio
M&A - Overview

M&A is primarily driven with motive of achieving Inorganic growth and Synergy i.e. the potential additional value gain from combining two firms, either from operational or financial sources.

However, certain studies have shown that most – but not all – M&A fail to deliver value and bridge the price-value gap.

One of the reasons is that the aggressive acquirers in consultation with eager advisors result in pushing up the acquisition price; Resultantly, the value often get transferred from acquirer’s shareholders to target company’s shareholders;
M&A - 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
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” decides to close operations in nine cities-Jan 2016

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

M&A - Recent Investment Trends
M&A - Recent Investment Trends

As per latest research reports –

1. Overall Deal Value and Volume is on downside in 2016. In first 7 months Deal value was reported as 7546 Mn $ compared to 14624 Mn $ in 2015. No of deals also reduced to 774 from 959 in this period

2. Buyouts are gaining ground
   - In 2016, Buyout Deal Value has reached 1753 Mn $ i.e. 30.7% of the Total PE Deal Value of 5707 Mn $ in first 4 months of calendar year 2016.
   - 2015 saw highest ever buyout of 3.7 Bn $ constituting 16% of Total PE Deal Value of 23.16 Bn $.

3. M&A’s has emerged as the preferred exit route for PE exits in 2016

4. Deal values continue to slip across early-stage rounds. Cautious investors are writing smaller cheques, indicating a measured flow of "cautious money" available.
M&A - Situations & Valuation

M&A

Mergers
- COURT PROCESS
  - 391-394 of Companies Act, 1956

Acquisitions
- NON-COURT PROCESS
  - 230-236 of Companies Act, 2013 #

Stock Purchase
  - Listed Company
    SEBI [TAKEOVER CODE]
  - Unlisted Company
    - Slump Sale
    - Itemized Sale

# yet to be enforced
Snapshot of Indian Laws impacting Valuation

- Companies Act
- Competition Commission of India
- Takeover Regulations
- Income Tax
- Stamp Duty
- FEMA
- Indirect Tax
- SEBI and Stock Exchanges
- Accounting Standards (AS / IND-AS)
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
Fair Value is “The price at which an entity would change hands between a willing buyer and willing seller, neither being under compulsion to buy or sell and both having reasonable knowledge of all relevant facts.”

M&A VALUATIONS MAY HOWEVER DEPART FROM THEIR FAIR VALUES ON ACCOUNT OF:

- Valuing Acquisition Targets on Standalone basis and Valuing them with Synergy
- Distress Sale Vs. Desperate Buy
- Empirical Evidence
  - Control Premiums and Minority Discounts
- Comparable Transaction Multiples (CTM) and Price of Recent Investments (PORI)
- Competitive Positioning and Risk in Corporate Acquisitions
- Valuation of Intangible Assets and Purchase Price Allocation (PPA)
WHETHER VALUATION IS REQUIRED FOR MERGER?

In the matter of *Shreya’s India (P) Ltd. v. Samrat Industries (P) Ltd.* the Regional Director (RD) raised an objection that no valuation report has been filed and that the exchange ratio for amalgamation has not been worked out by an independent valuer.

“The Hon’ble High Court of Rajasthan overruled this objection and sanctioned the scheme of amalgamation by holding that there was no legal or factual impediment to grant sanction to the scheme of amalgamation.”

Same ratio in Advance Plastics (P) Ltd vs Dynamic Plastics (P) Ltd - Bombay High Court

WHETHER ANY VALUATION METHODOLOGY IS REQUIRED FOR MERGER?

Though there are no specific methodology prescribed for valuation under Merger, however in *Hindustan Lever Employees Union v. Hindustan Lever Ltd and Others*, Bombay High Court -

“accepted the ratio of 2:2:1 as Income, Market and Asset Approach on which the valuation was based.”

VALUATION OF INFREQUENTLY TRADED SHARES

In *G.L. Sulatnia and another* the parameters expressly laid down therein must be considered by the valuer since they are basic and essential. If the valuation report discloses non consideration of any of the enumerated parameters, the report shall stand vitiated for that reason. That however does not prevent the valuer from considering other relevant factors according to accepted principles of valuation of shares.”
Valuation for Acquisition of Shares of Listed Company

SEBI (Substantial Acquisition of Shares & Takeovers) Regulations, 2011

**FREQUENTLY TRADED SHARES**

Traded Turnover of Shares ≥ 10%

[In the Last Twelve Calendar Months preceding the Month of Public Announcement (P.A.)]

**Method of Valuation**

1. Highest Negotiated Price Per Share under agreement attracting the obligation to make P.A.
2. The volume weighted avg. price paid or payable by acquirer or PAC during the 52 Weeks;
3. The Highest Price paid or payable by acquirer or PAC in last 26 Weeks;
4. Volume weighted average Market Price of Shares for a period of 60 trading days

HIGHEST PRICE AMONG ALL IS THE VALUE PER SHARE FOR P.A.

**INFREQUENTLY TRADED SHARES**

Traded Turnover of Shares < 10%

[In the Last Twelve Calendar Months preceding the Month of Public Announcement]

**Method of Valuation**

1. Book value,
2. Comparable Trading Multiples;

Such other Parameters as are customary for valuation of shares of such companies
Valuation for Mergers

“Valuation is generally the Starting Point of the M&A process”

APPLICABLE LAW FOR VALUATION FOR MERGERS:
1. Companies Act, 1956 [Section 391-394];
2. Fairness Opinion [Regulation 37 of the LODR];
3. SEBI Notification [CIR/CFD/CMD/16/2015], dated 30th November, 2015

Under SEBI Notification, Valuation by independent chartered account mandatory other than those specifically exempted. "Valuation Report from an Independent Chartered Accountant" is not required in cases where there is no change in the shareholding pattern of the listed company / resultant company.

None of the aforesaid laws provide for specific valuation approaches under Mergers - Valuation Standards under Registered Valuation provisions are proposed under Companies Act, 2013;
In case of a merger valuation, the emphasis is on arriving at the relative values of the shares of the merging companies to facilitate determination of the swap ratio.
- Hence, the purpose is not to arrive at absolute values of the shares of the companies.

The key issue to be addressed is that of fairness to all shareholders.
- This is particularly important where the shareholding pattern and shareholders vary between the two companies.

There are established legal precedence for merger valuation methodologies.
- Valuer’s role is to incorporate case specific factors and use appropriate methodologies so as to determine a fair ratio.
- Usually, best to give weight ages to valuation by all methods.
- Market price method and Earnings methods dominate.
• **If the exchange ratio is set too high**, there will be a transfer of wealth from the bidding firm’s stockholders to the target firm’s stockholders.

• **If the exchange ratio is set too low**, there will be transfer of wealth from the target firm to the bidding firm’s stockholders.
“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%.

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**Recent Transactions (2016)**

<table>
<thead>
<tr>
<th>Company Acquisitions</th>
<th>Control Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>Microsoft acquires LinkedIn</td>
<td>50%</td>
</tr>
<tr>
<td>Oracle acquires NetSuite</td>
<td>19%</td>
</tr>
<tr>
<td>Verizon acquires Fleetmatics Group</td>
<td>40%</td>
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</table>
CASE STUDY
Calculation of Exchange Ratio in M&A and Independent Buyer-Seller perspective
Merger of a Unlisted Power Company into Listed Steel Manufacturing Company

**Features of Steel Company**
- Frequently Traded Listed Company
- Low Profit Margin, due to high Power Cost
- Running in Low Capacity Utilization due to poor supply of Power

**Features of Power Company**
- Unlisted Company
- Company is implementing the Power Plant of 9.5 MW, The Production is expected to start within Year

**Acquisition Rationale**
- Location Advantage, both companies have their unit in same Location
- Synergistic benefits- (Captive Power Plant will reduce the Operating cost, because Steel Industry is energy consuming)
- Tax benefit from the unabsorbed losses of Power Company
- Up the value chain
- Capacity utilization will increase in existing steel business, due easy availability of Power

*Common Promoter Group*
**Merger of a Unlisted Power Company into Listed Steel Manufacturing Company**

**EXCHANGE RATIO & VALUATION – MERGER**

- **Valuation on Steel Company**

<table>
<thead>
<tr>
<th>Valuation Method Rs Crores</th>
<th>Weights</th>
<th>Value of Company</th>
<th>Weighted Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market Cap</td>
<td>2</td>
<td>100</td>
<td>200</td>
</tr>
<tr>
<td>Income Method</td>
<td>2</td>
<td>95</td>
<td>190</td>
</tr>
<tr>
<td>NAV</td>
<td>1</td>
<td>150</td>
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<td><strong>Fair Value of Company</strong></td>
<td></td>
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<td>90</td>
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<tr>
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<tr>
<td><strong>Fair Value of Company</strong></td>
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^ considering 3 years forward earnings and 80-90% Capacity utilization basis
### Pre and Post Shareholding

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### Independent Buyer-Seller Perspective

**Valuation of Power business on as is basis – Rs.55 crores (approx.)**
- Assets Method
- Earnings Method (Includes premium for the license)

**Valuation of Power business taking into account synergies – Rs. 70 crores (approx.)**

An independent Buyer would bid an amount in excess of valuation on standalone basis (Rs. 55 crores) and below Synergy valuation (Rs.70 crores).

**Acquisition Price would finally depend on negotiations.**
Chander Sawhney
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