Relative Valuation

Corporate Professionals
WHERE EXCELLENCE IS LAW
SEBI REGISTERED MERCHANT BANKER - CAT I (INM000011435)

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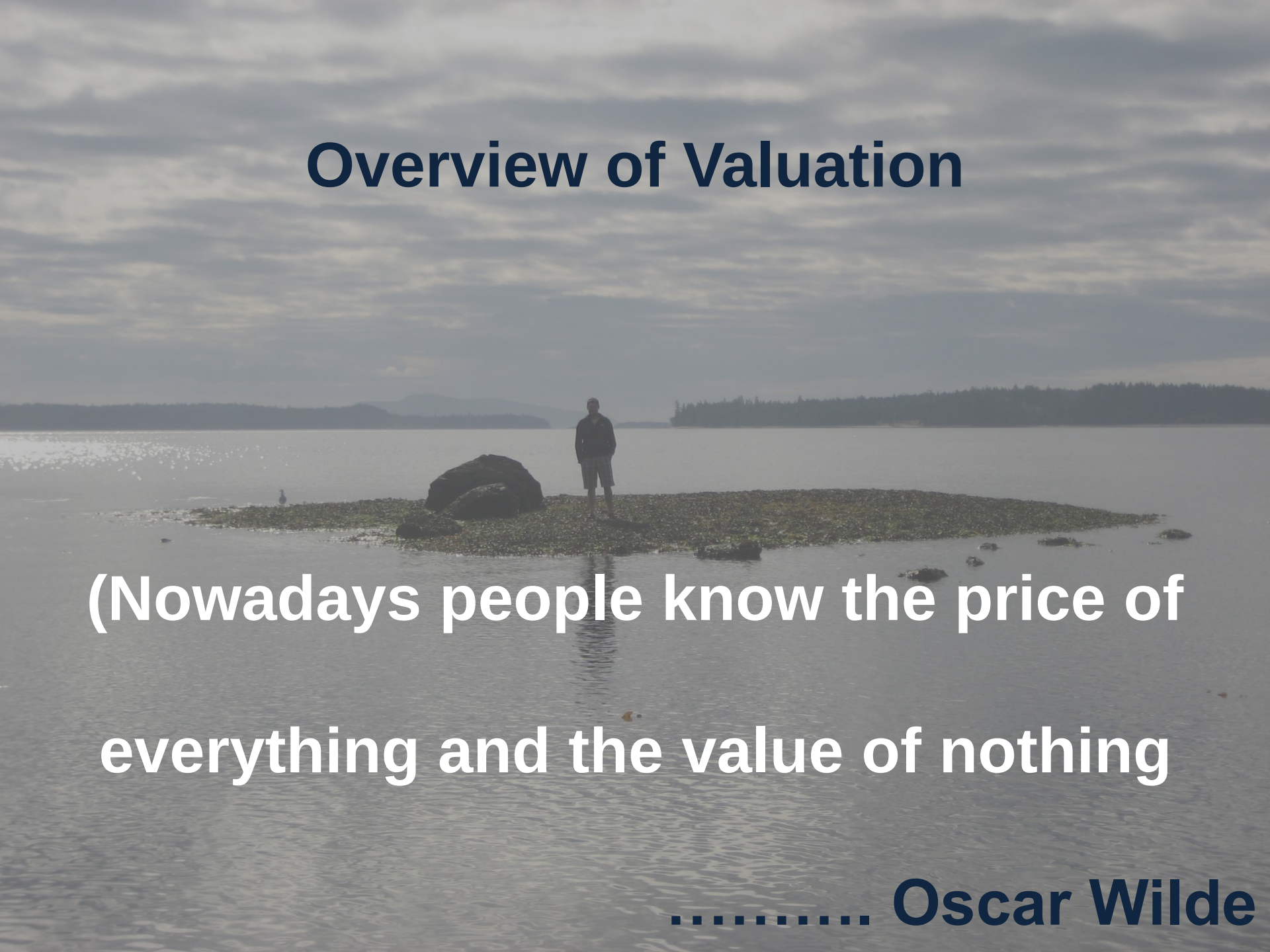
31st August 2016
Business Valuation
Master class, New Delhi

Agenda

- Overview of Valuation
- Principles of Relative Valuation
- Why Relative Valuation is more favoured in Application
- Industry Specific Applications of Relative Valuation
- Techniques of Relative Valuation

Overview of Valuation



(Nowadays people know the price of everything and the value of nothing

…….. Oscar Wilde

Value & 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*

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

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

S Standard of Valuation

T Thesis of Valuation

E Economics of Valuation

M Methodologies of Valuation

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

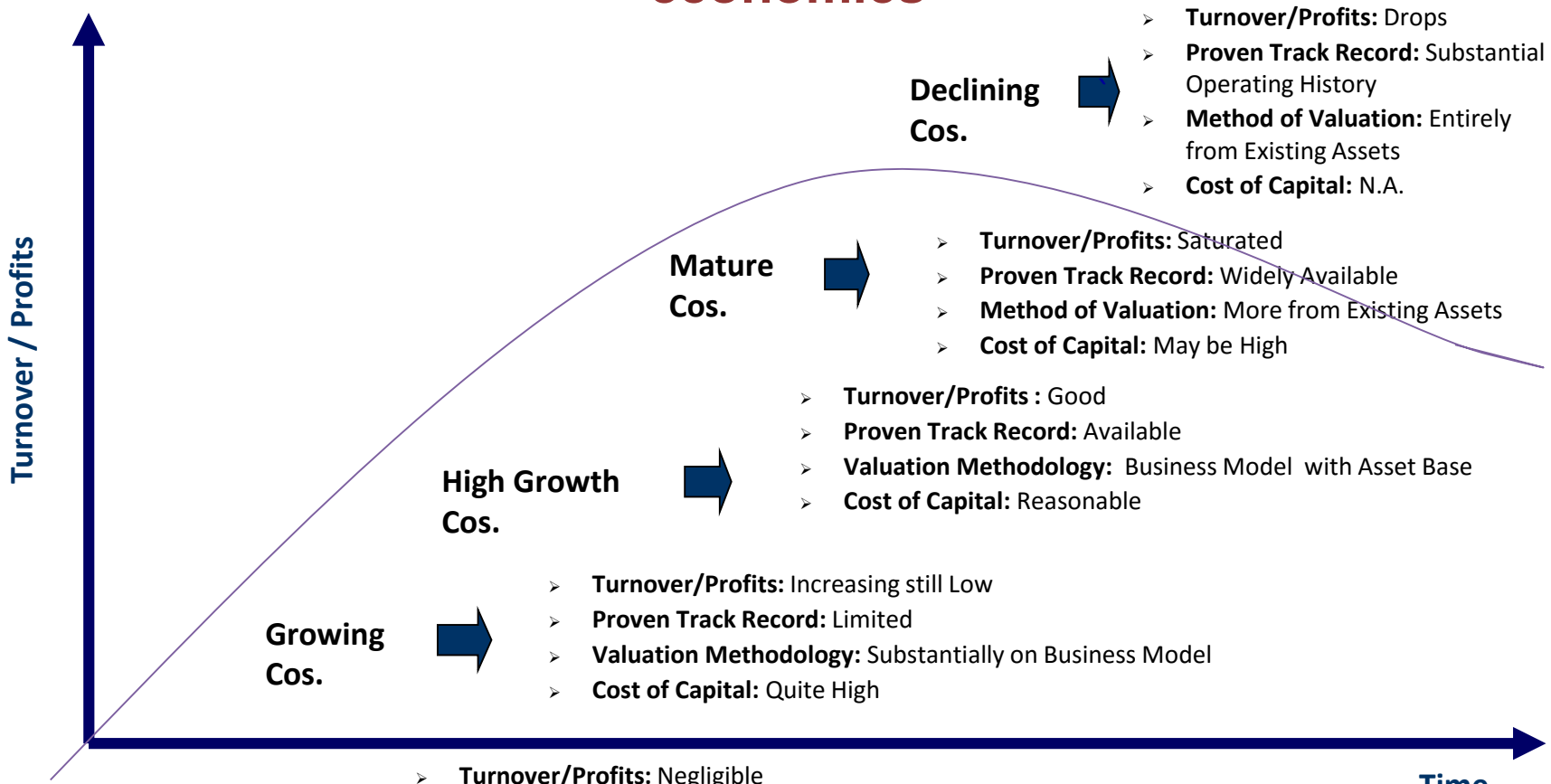
FAIR VALUE

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



Declining Cos.

- **Turnover/Profits:** Drops
- **Proven Track Record:** Substantial Operating History
- **Method of Valuation:** Entirely from Existing Assets
- **Cost of Capital:** N.A.

Mature Cos.

- **Turnover/Profits:** Saturated
- **Proven Track Record:** Widely Available
- **Method of Valuation:** More from Existing Assets
- **Cost of Capital:** May be High

High Growth Cos.

- **Turnover/Profits :** Good
- **Proven Track Record:** Available
- **Valuation Methodology:** Business Model with Asset Base
- **Cost of Capital:** Reasonable

Growing Cos.

- **Turnover/Profits:** Increasing still Low
- **Proven Track Record:** Limited
- **Valuation Methodology:** Substantially on Business Model
- **Cost of Capital:** Quite High

Start Up Cos.

- **Turnover/Profits:** Negligible
- **Proven Track Record:** None
- **Valuation Methodology:** Entirely on Business Model
- **Cost of Capital:** Very High

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

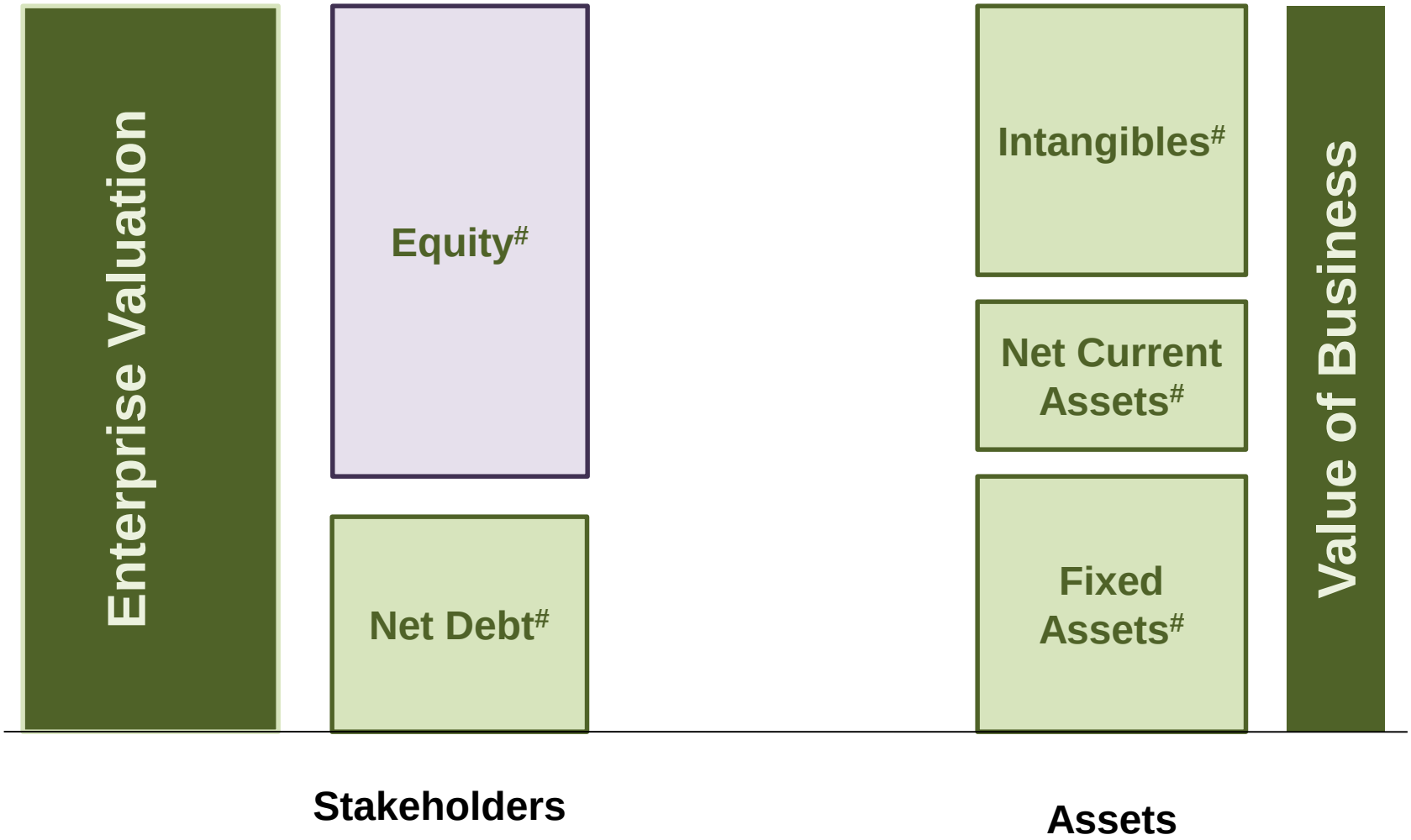
Market Based Method

- 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

Enterprise / Business Valuation



Based on Market Values

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 – M&A

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).

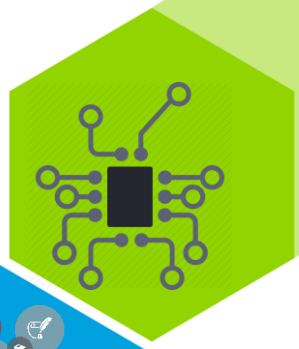
- **However, Asset Approach is preferred in case of Asset heavy companies and on liquidation;**
- **Market Approach is preferred in case of listed entity and to evaluate the value of unlisted company by comparing it with its listed peers;**

RELATIVE VALUATION

What is Relative Valuation

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

IDENTIFY
Comparable Assets and obtain Market Values



CONVERT Market Values into Standardized Values

Relative Valuation is Pervasive

Most Valuations in Capital Markets are done using Relative Valuation approach

Relative Valuation is preferred as it arrives at the Value as on the date of Transaction reflecting the market positioning of the Industry & Peers at that time

Relative Valuations can be done using latest Financials and do not require much information and assumptions

While Discounted Cash Flow (DCF) method is applied for arriving at Fundamental Valuation, most M&A transaction are based on Relative Valuation multiples (mostly Earnings based)

Many DCF Valuations are done for Sanity Check of the Multiples being used in Relative Valuation

Terminal Value in DCF is also derived using Multiples in a large no of cases

Standardizing Value

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

- PE
- EV / EBITDA

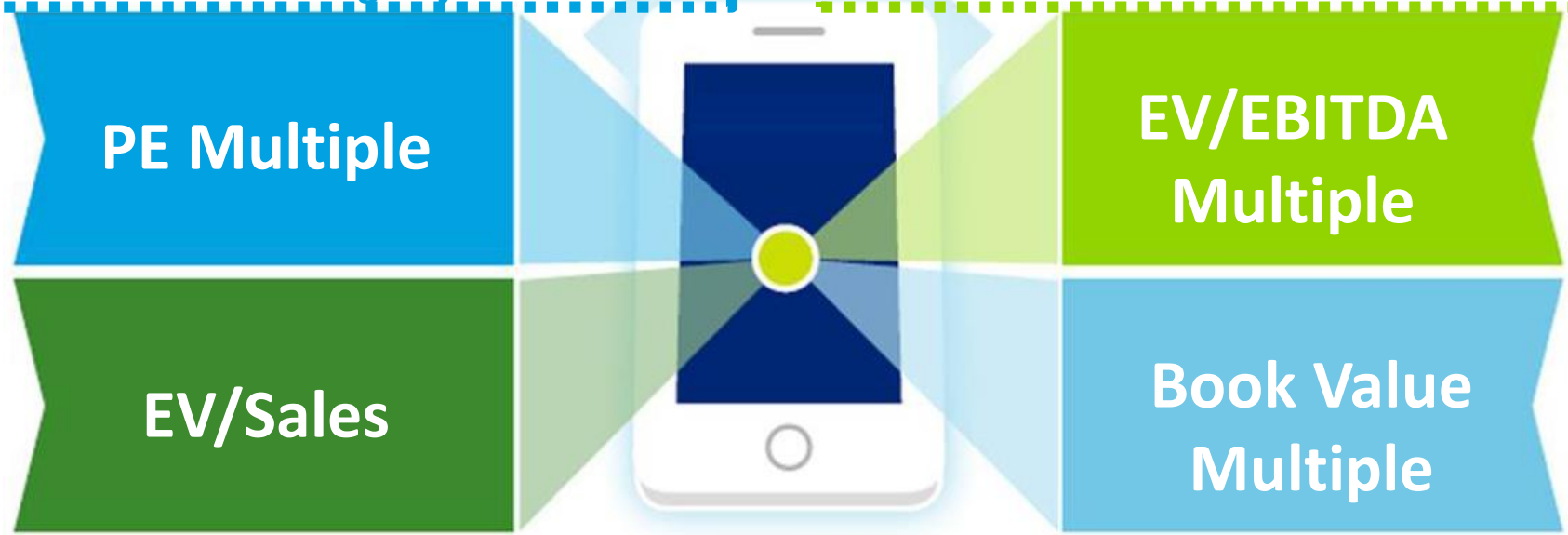
- EV / Sales

Price/Book Value

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)

Industry Specific Variables

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
Mutual Fund	Asset under management
OIL	EV/ Barrel of equivalent
Print Media	EV/Subscriber
Power	EV/MW
Entertainment & Media	EV/Per screen
Metals	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
Cement	EV/Per ton

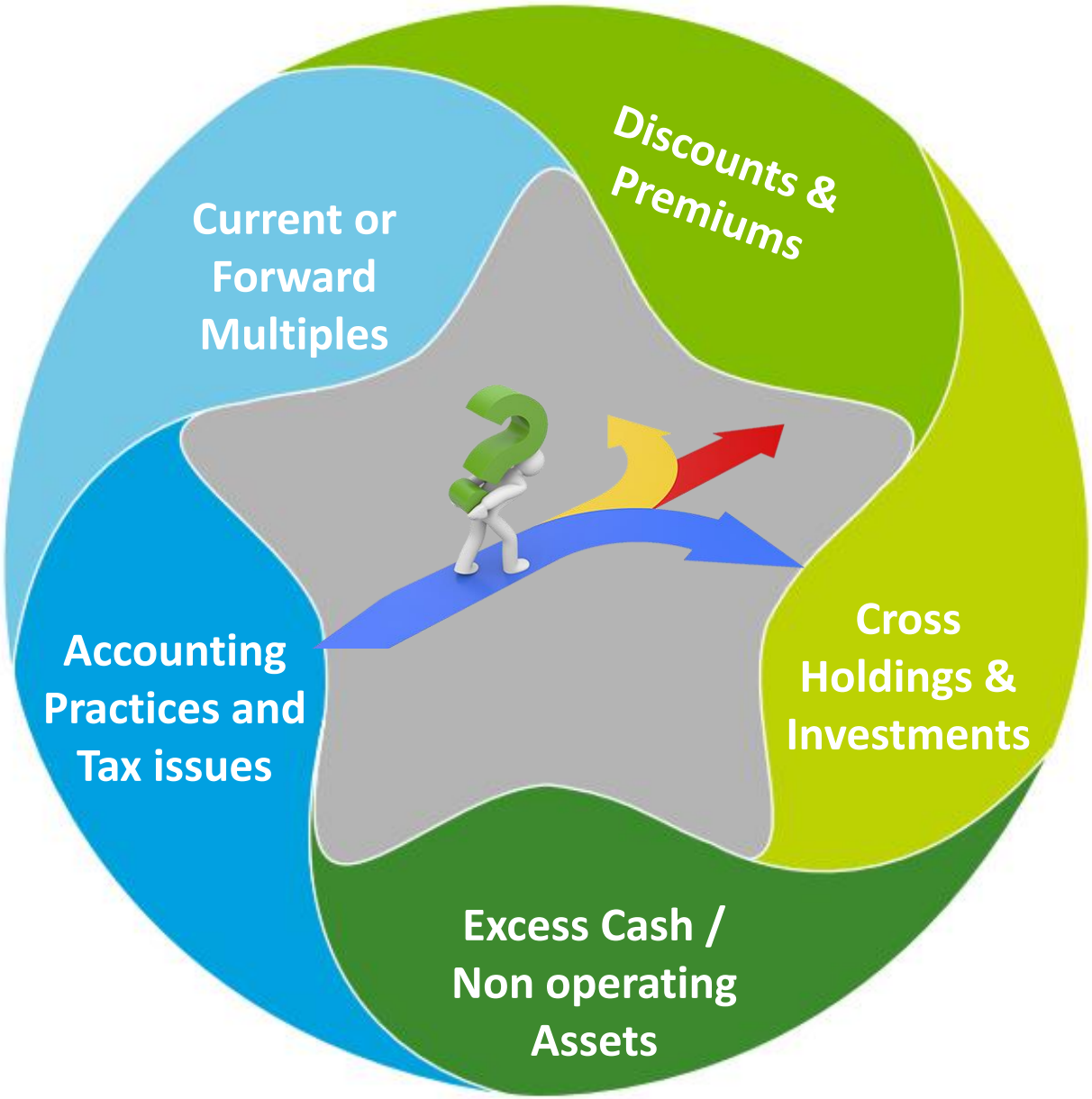
However, Exclusive use of Rule of Thumb is not recommended

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"**

Where Things can go Wrong



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 erstwhile 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

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

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 ?

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**

Current or Forward Multiples

Generally prevailing market multiple of the comparable companies is applied

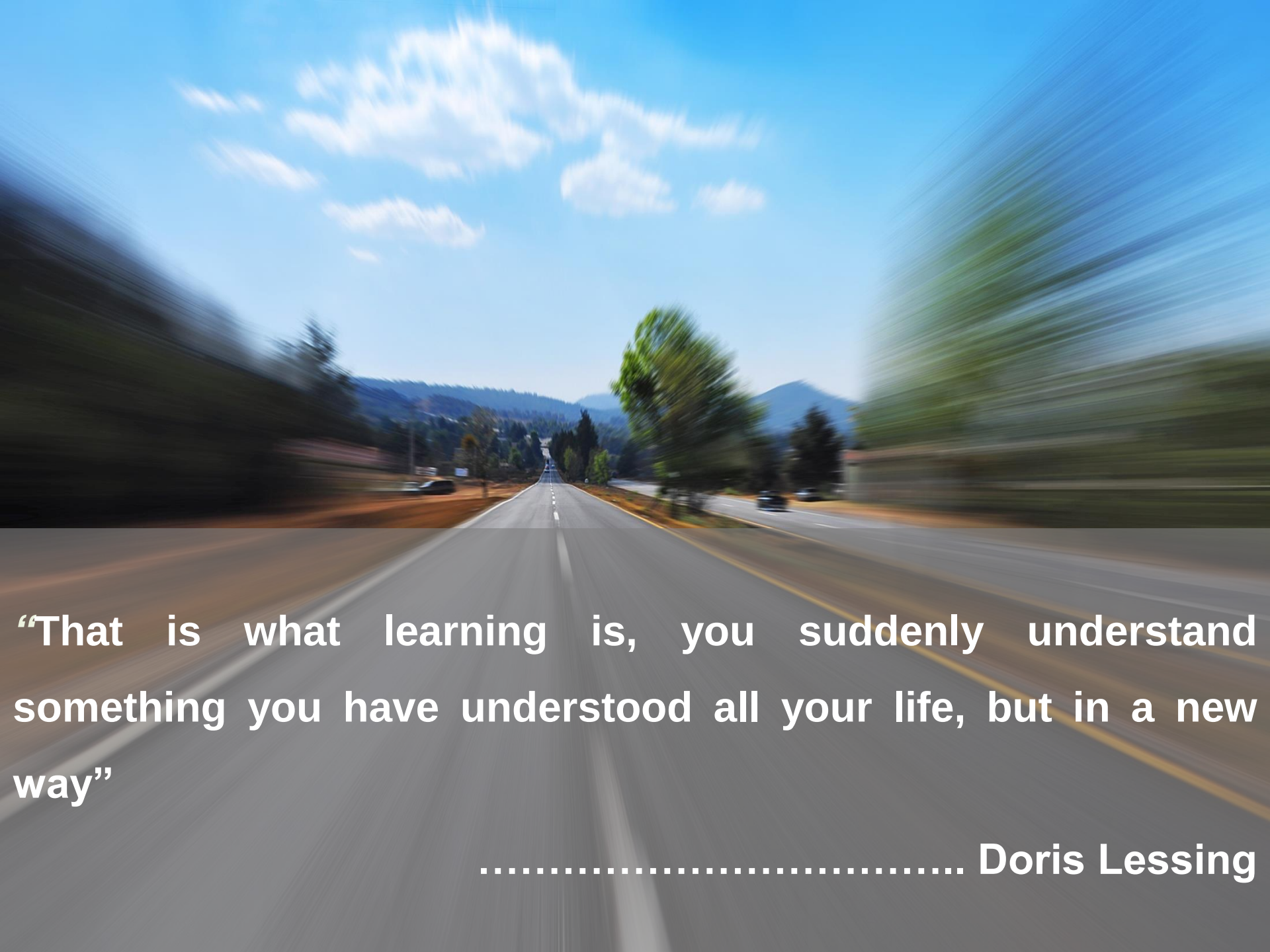
However while valuing early stage companies whose value of financials in future years provide a much better picture of the true value potential of the firm, forward multiples of comparable companies may also be applied

In case forward multiples of comparable companies are not available, their prevailing valuation multiple may be applied to the forward stabilized financials of the company being valued. The same will then be discounted back to date to arrive at the present value of company.

(Discounting can be done using the cost of capital/equity of the company)

To Conclude, Relative Valuation Steps to understand Multiples

- **Define the multiple**
  - Check for consistency
  - Make sure that they are estimated uniformly
- **Describe the multiple**
  - Multiples have skewed distributions: The averages are seldom good indicators of typical multiples
  - Check for bias, if the multiple cannot be estimated
- **Analyze the multiple**
  - Identify the companion variable that drives the multiple
  - Examine the nature of the relationship
- **Apply the multiple**
- **Do Sanity Check through use of other Valuation methods like DCF.**



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

…….. Doris Lessing

Chander Sawhney

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