



Training Material

## Business Valuation

- Overview, Approaches & Methodologies

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**Introduction to Valuation**

**Types of Valuation**

**Valuation Approaches and Methodologies**

**Selecting Right One**

**Some additional factors influencing M&A transactions**



*It's better to buy a wonderful company at fair price than a fair company at wonderful price*

*- Warren Buffett*

## Introduction to Valuation

*What you pay v/s what you get*



*Non-Accurate and discretionary*



*Multiple ways to reach an end*



*Research and analysis*



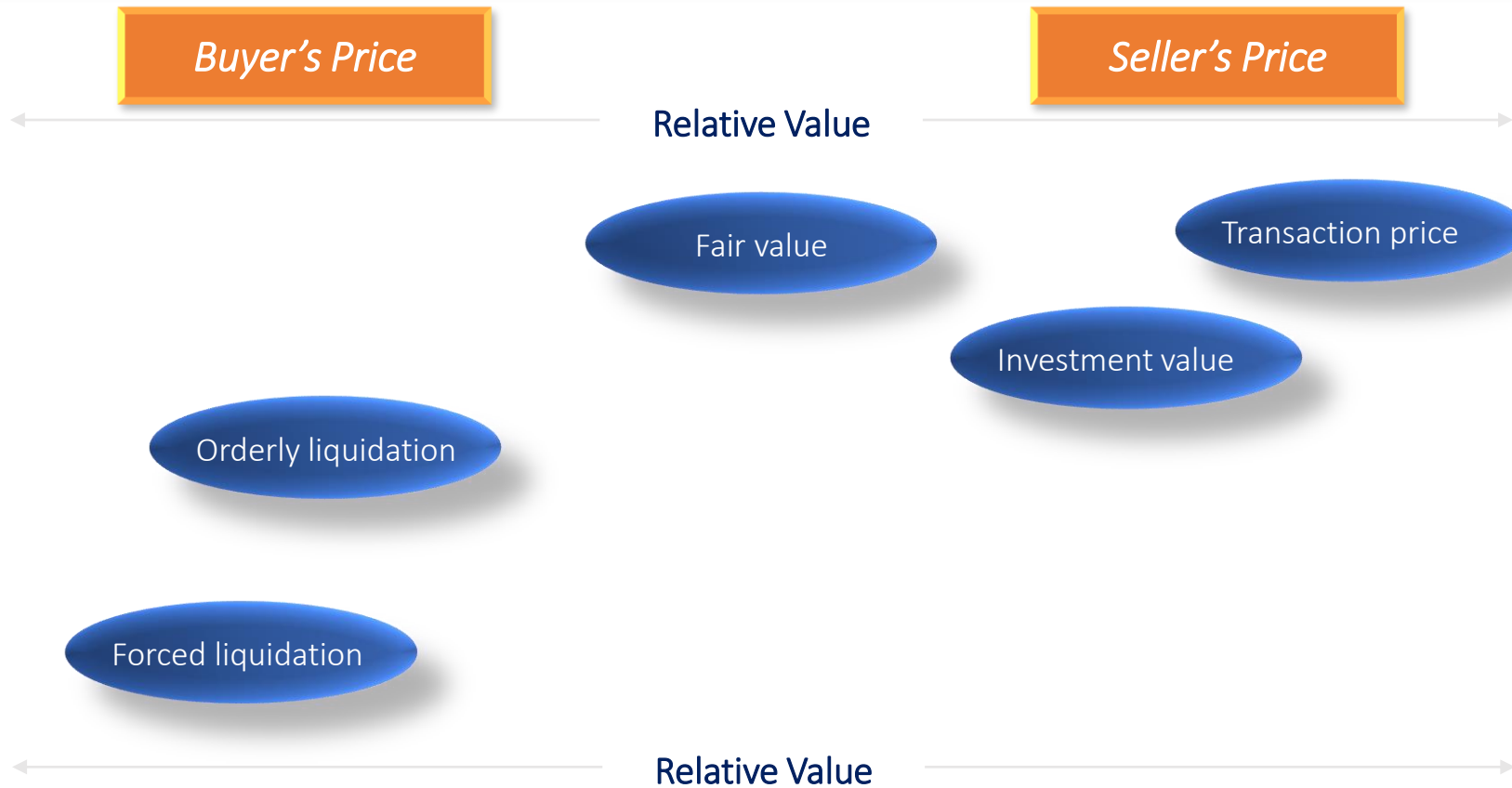
*Are you Inquisitive?*



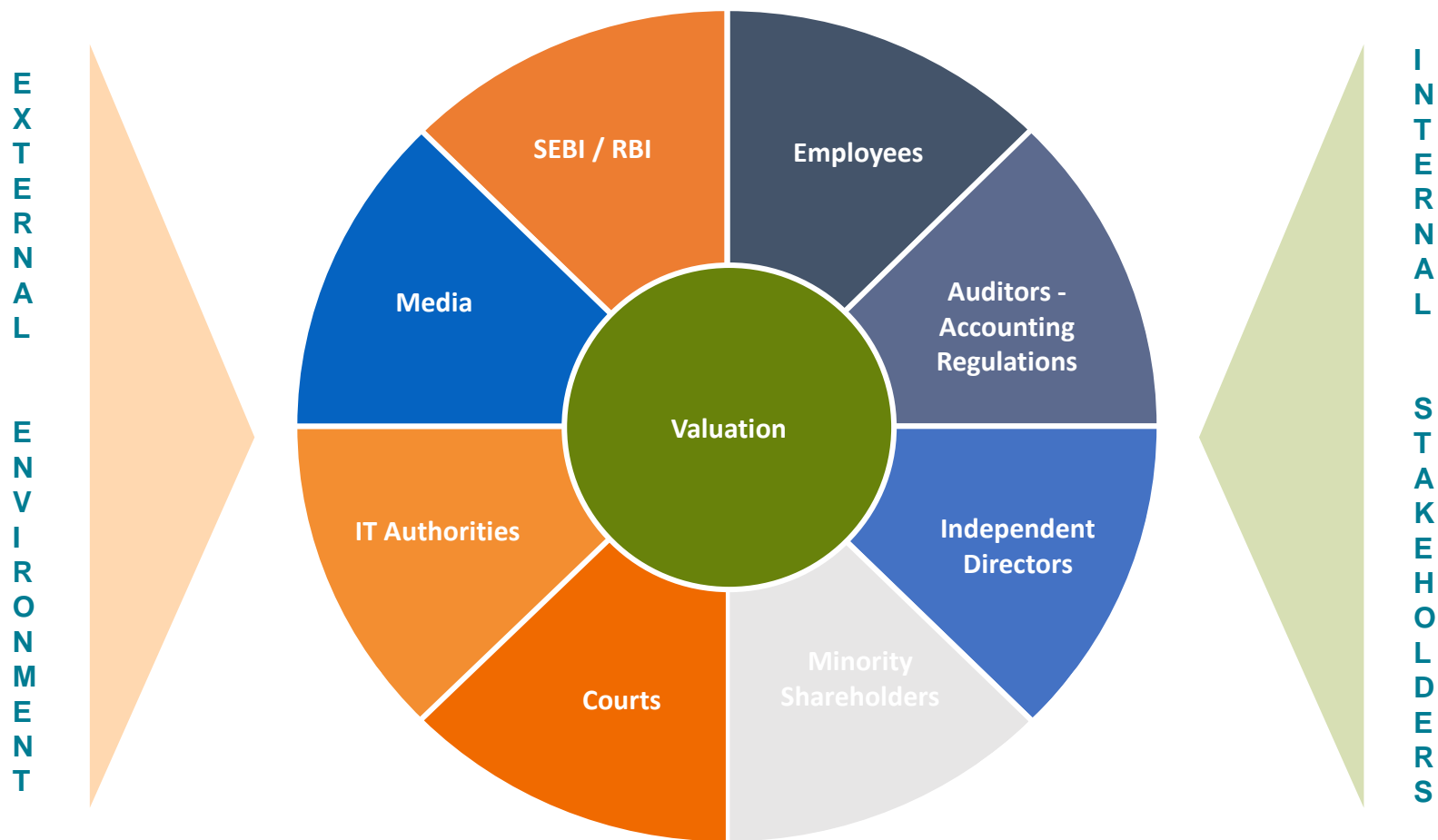
*Experienced and Common Sense*



*The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.*

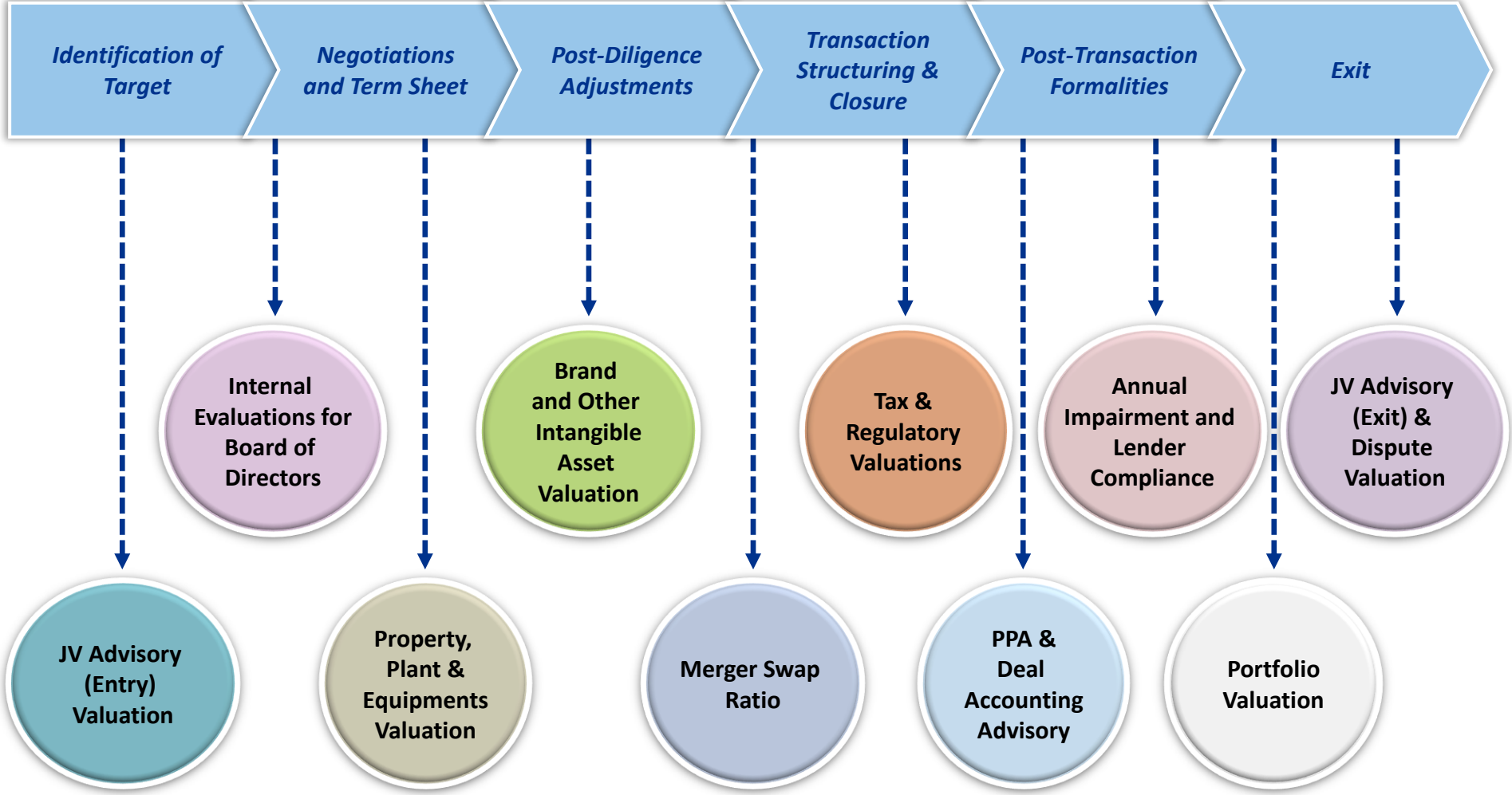


# Stakeholders depending on purpose of Valuation



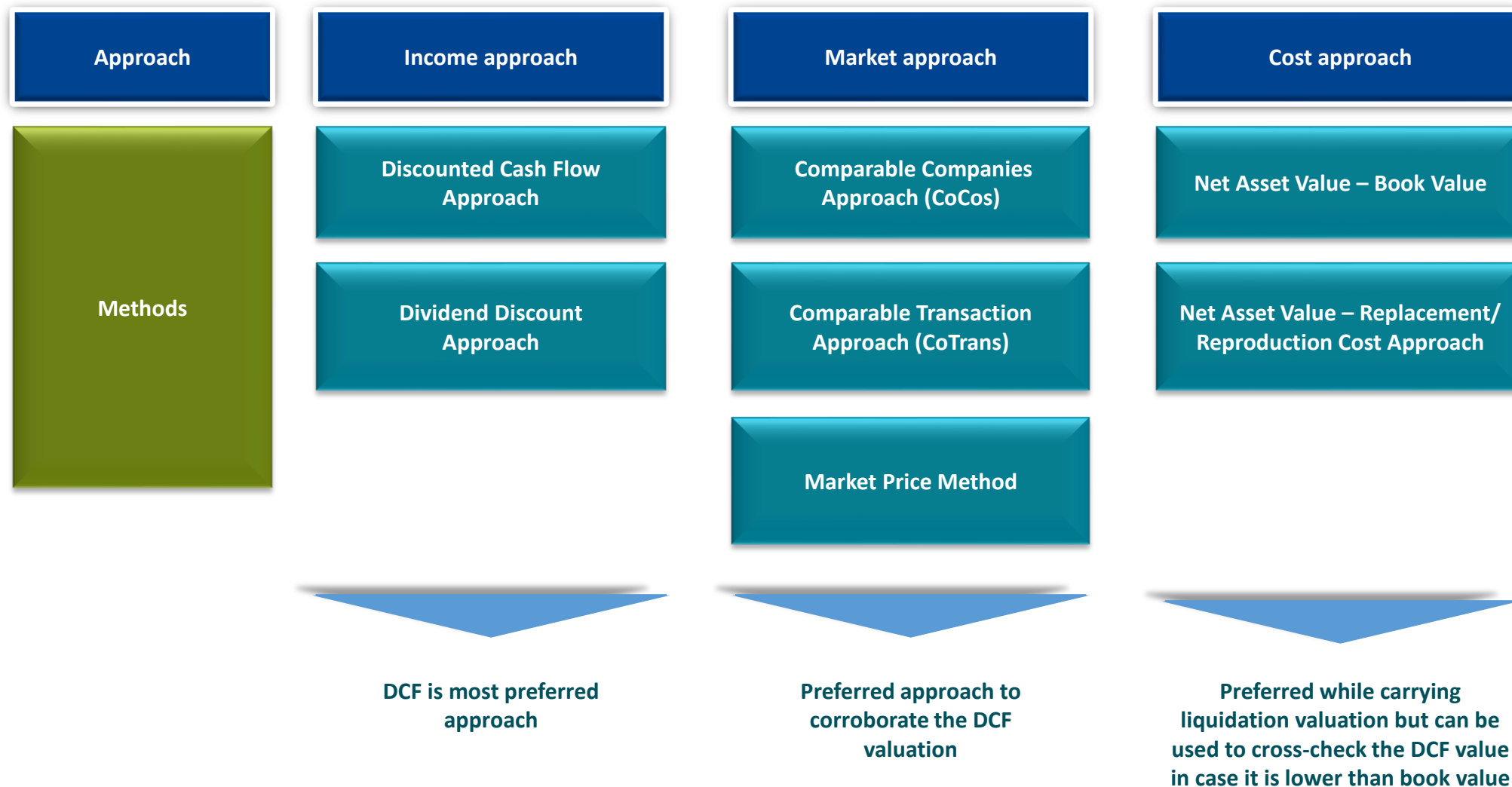
## Types of Valuation

# Types of valuation



## Valuation Approaches and Methodologies

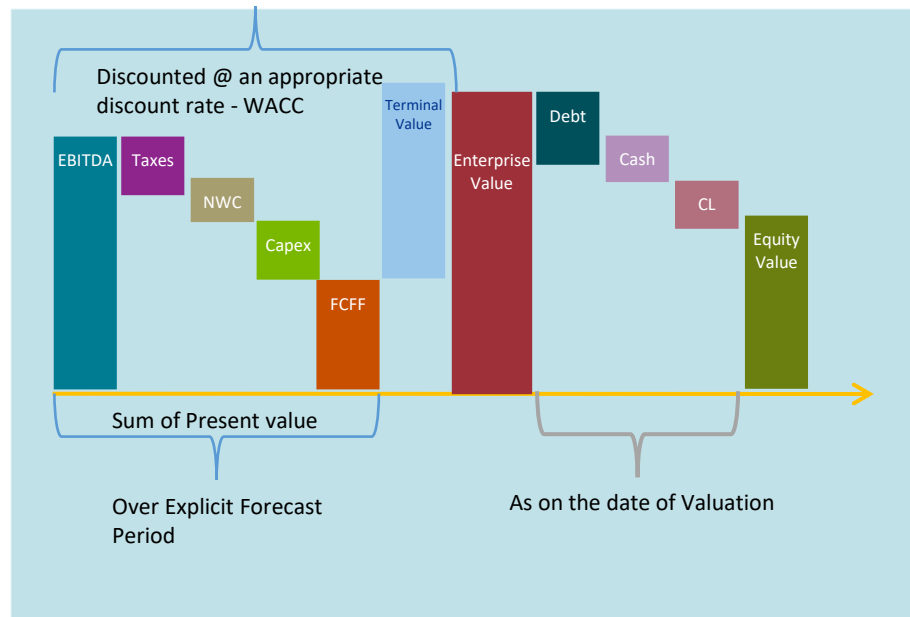
# Valuation Approaches and Methodologies



# Discounted Cash Flow Method – FCFF Vs FCFE

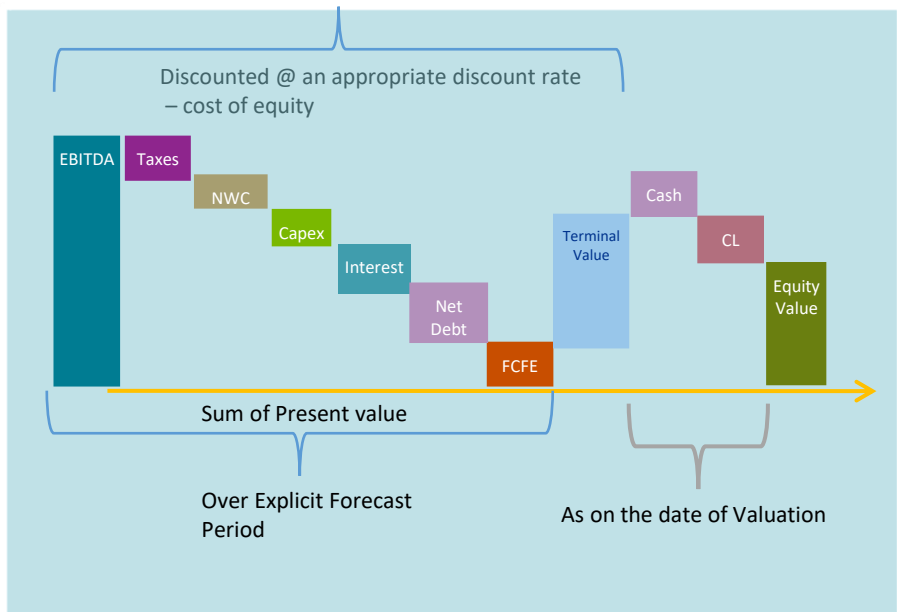


## Discounted Cash Flow Method – FCFF Method



- Companies expected to stabilize at industry levels
- Discount rate – Weighted Average Cost of Capital.

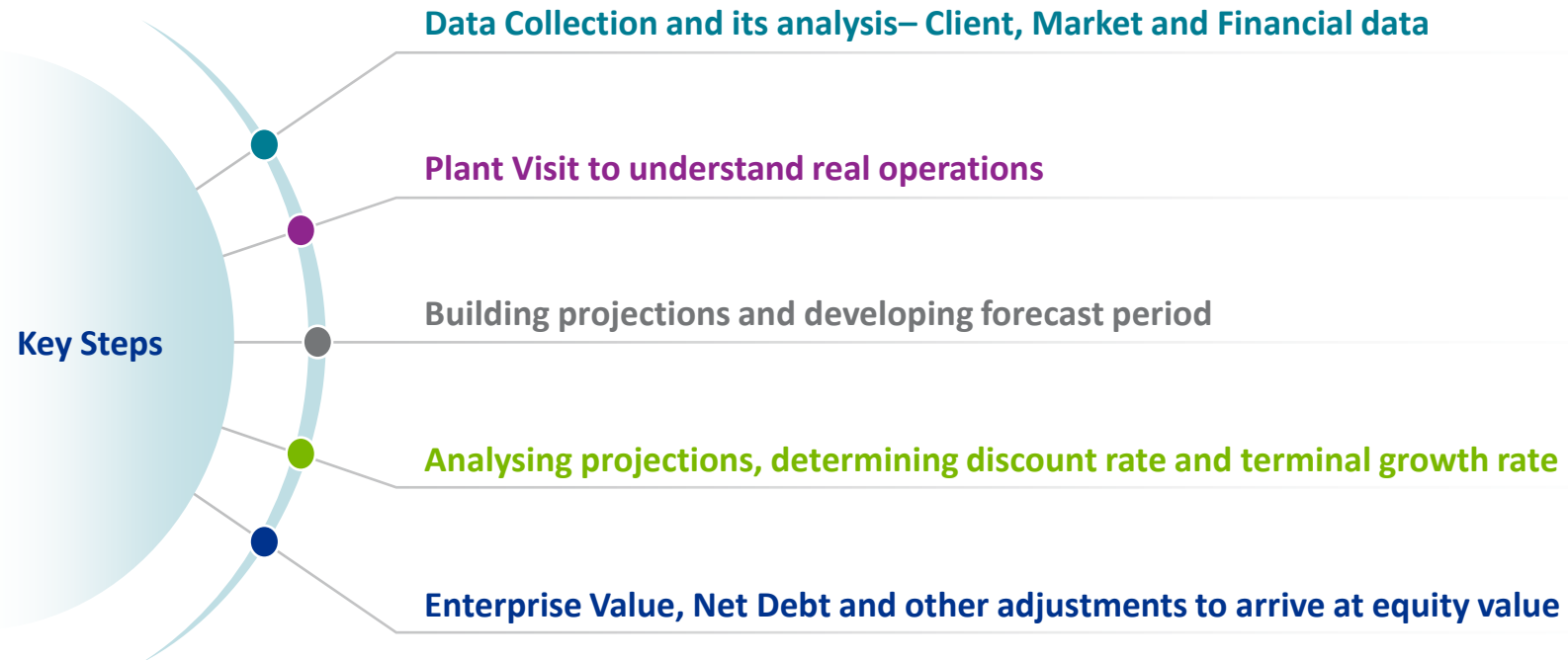
## Discounted Cash Flow Method – FCFE Method



- Project driven cash flows
- Fixed borrowing and tenure of repayments
- Discount rate – Cost of Equity

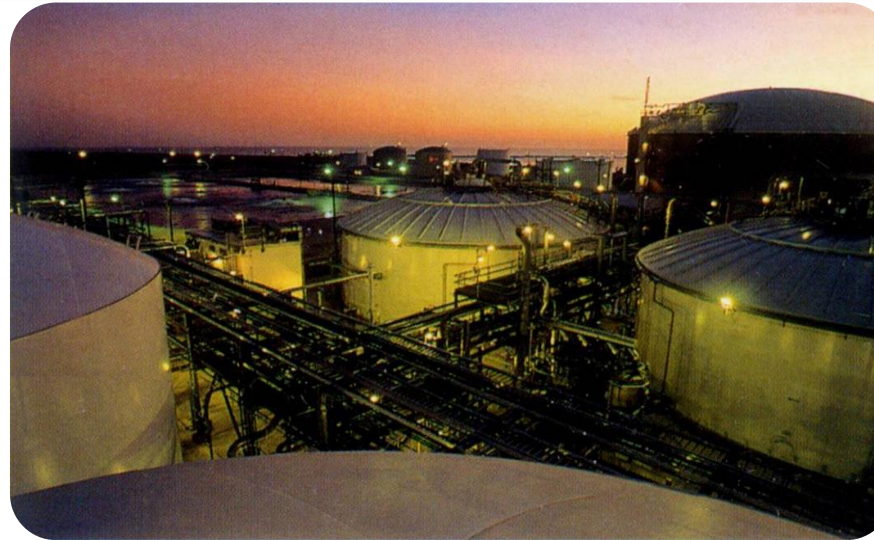


## Key Considerations - DCF





- Market Related data
  - To understand competitive landscape and industry data
- Client Related data
  - To have basic understanding of the client
- Financial Data
  - Financial strength and positioning of the business



- Post preliminary discussions with the Management, the Valuer should propose to carry out a plant / site visit to
  - Understand the status of operations
  - Meeting with management personnel at site
  - Understanding the manufacturing process
  - Meeting key operating staff
  - Market understanding
  - Other soft factors

## Which way is the tide going?

- A rising tide lifts all boats
- But, a falling tide strands them

## Overall state of the economy

- e.g. Purchasing cycles: will customers purchase today?



If a business does well, the stock eventually follows – Warren Buffett

Key business  
drivers

Market size  
and position

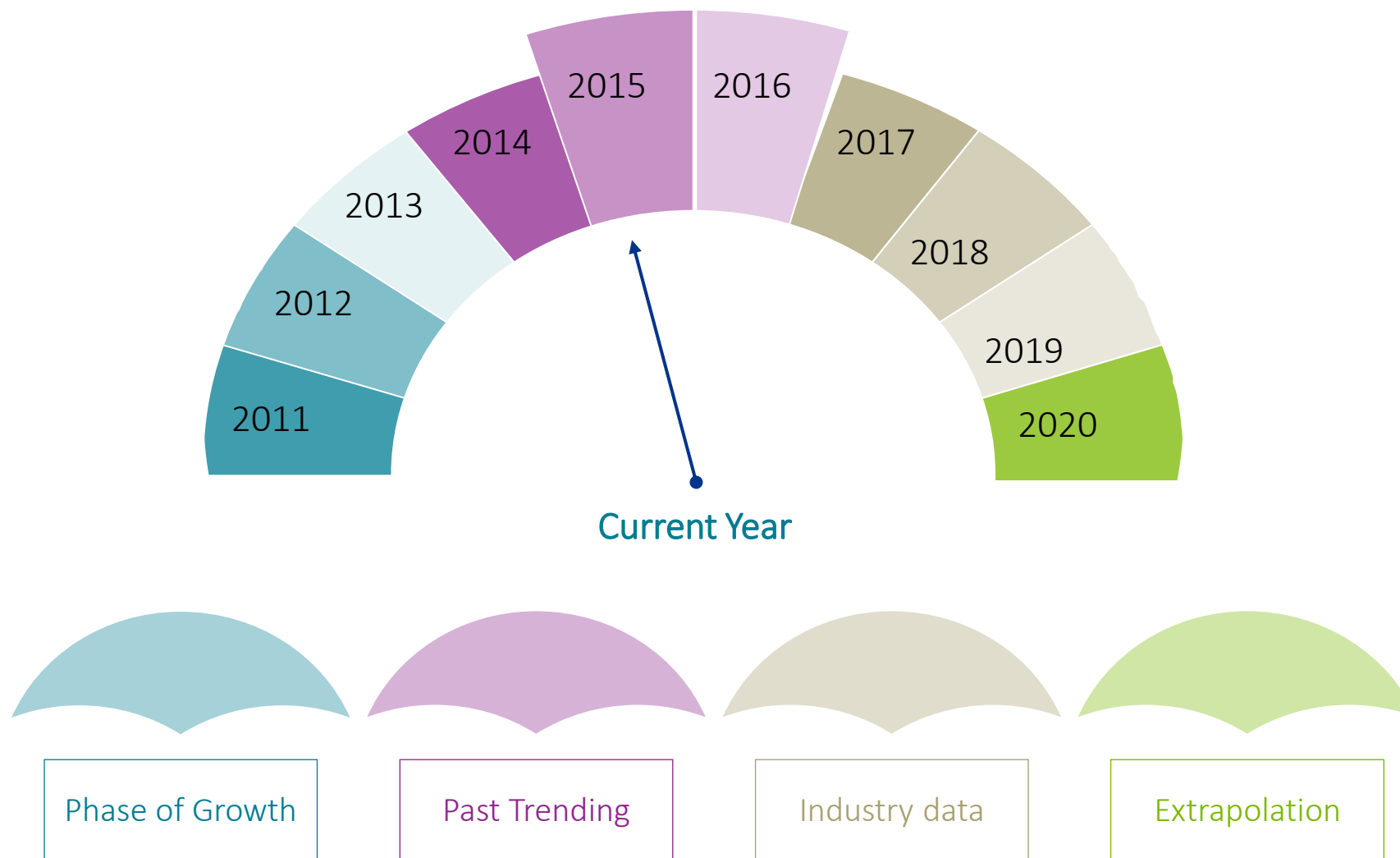
Track  
record

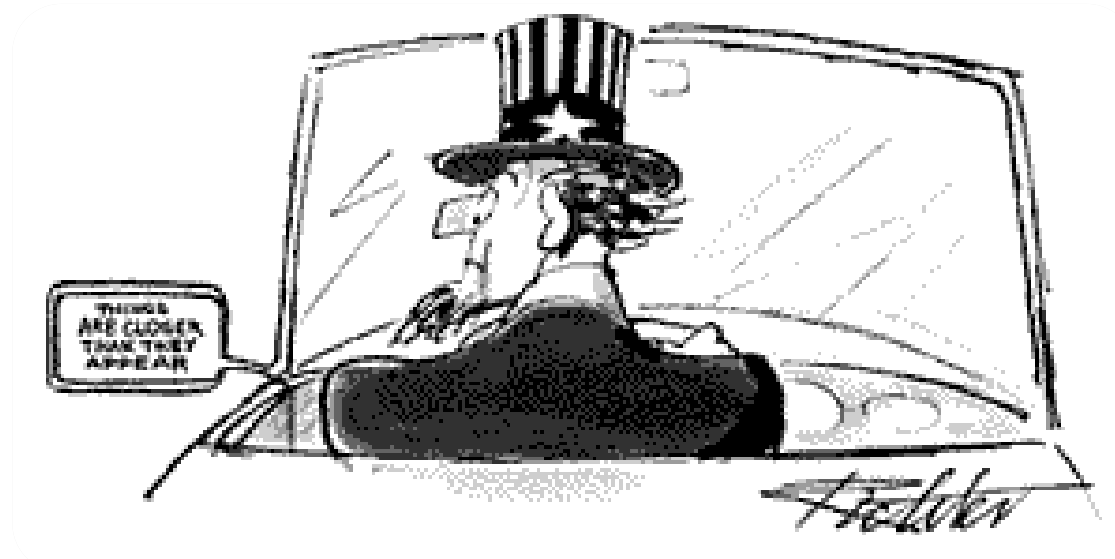
Products and  
services

Management  
Capabilities

Business  
model

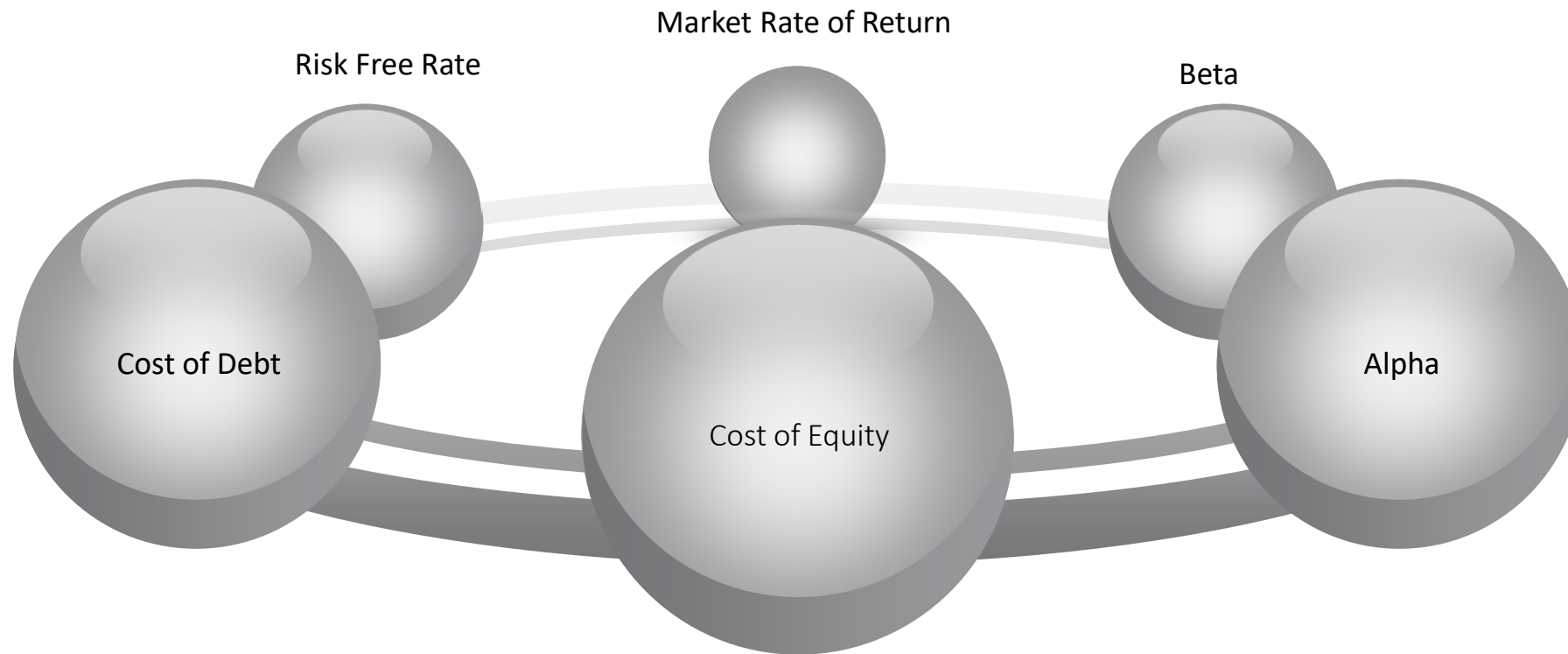
# Explicit forecast period: one complete business cycle



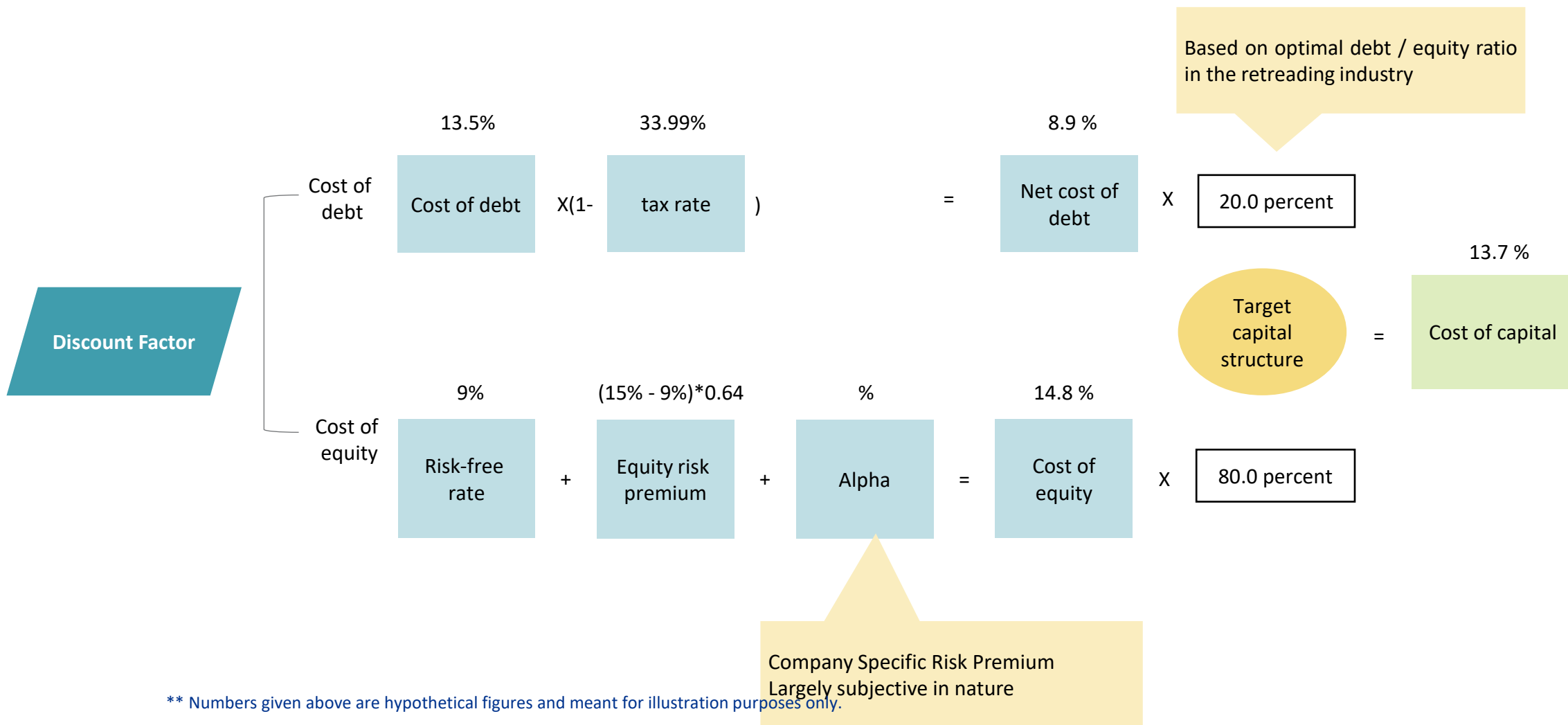


*“TELLING THE FUTURE BY LOOKING AT THE PAST ASSUMES THAT CONDITIONS REMAIN CONSTANT. THIS IS LIKE DRIVING A CAR BY LOOKING IN THE REAR VIEW MIRROR”*

# Discount rate – Components of discount rates



# Construct of Discount rate based on CAPM



Discount rate that one uses on a cash flow will reflect the risk of that cash flow, but the overall level is affected by macro economic variables. There are two key macro components to discount rates that have little to do with the asset that you are valuing and are set by the market.

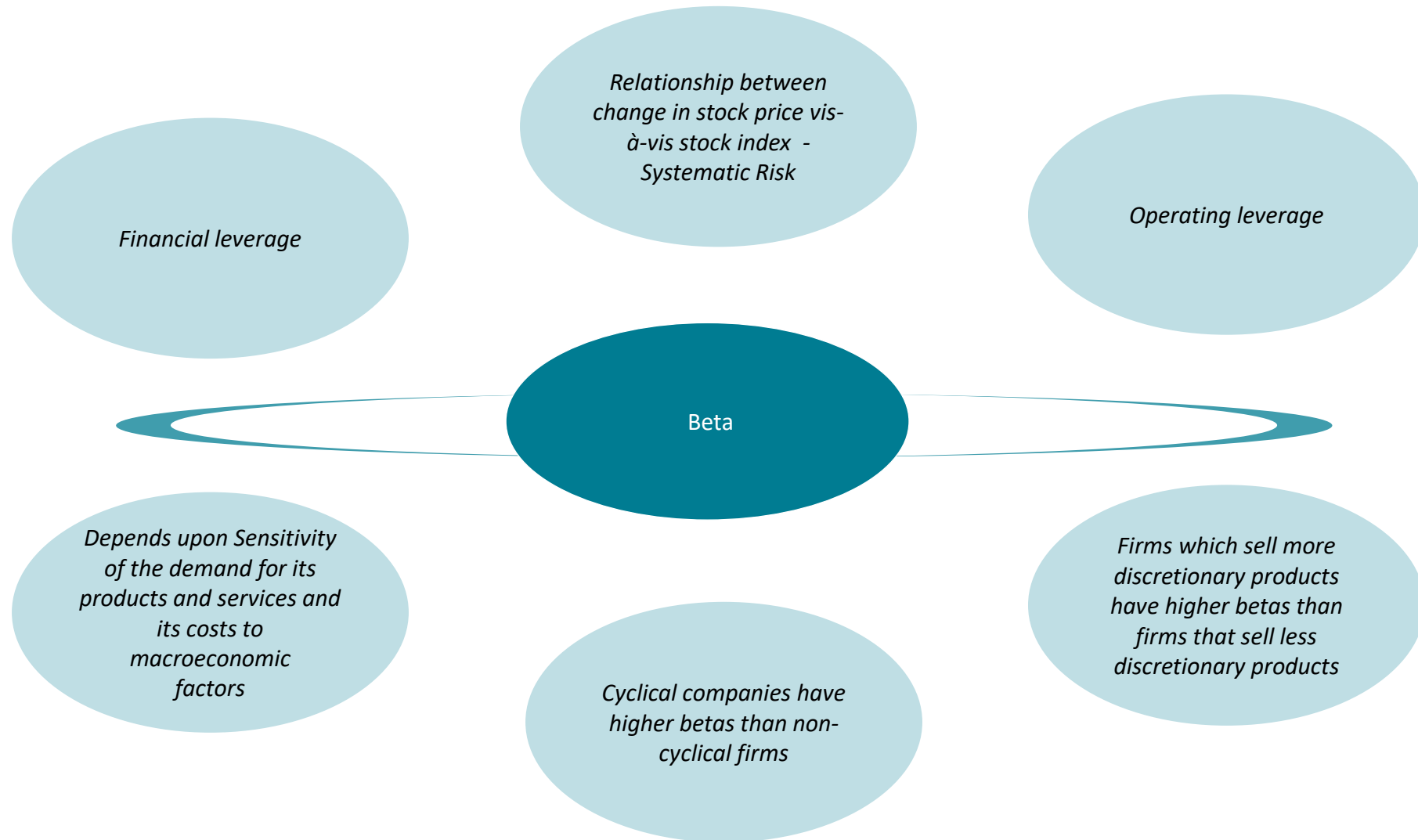
## Risk Free Rate

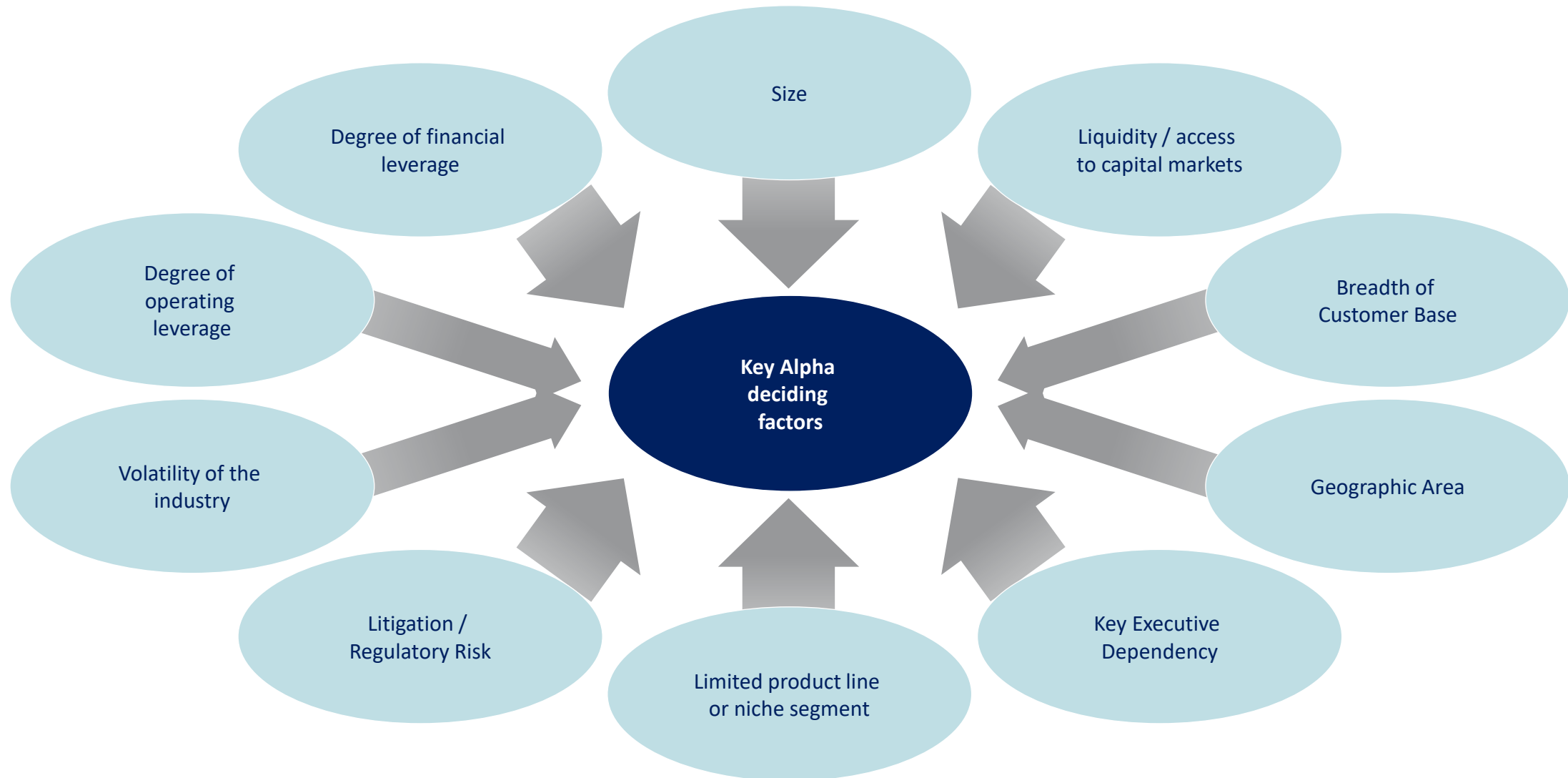
- Risk free rate = Expected Inflation + Expected Real Interest Rate.
- The risk free rate will vary across currencies.
- Some governments face default risk and the rates on bonds issued by them will not be risk free.
- Depends upon when the cash flow is expected to occur and will vary across time.

**Risk assessment has to factor in where a company operates and not where it is incorporated.**

## Risk Premium

- Equity Risk Premium is the premium that investors charge for investing in equity markets.
- Increases with the risk in the overall economy.
- It is a function of long-term expected rate of return and risk-free rate.
- Question remains on computation of ERP – No standard formula.





- Measures the value of a business after the projected cash flow period i.e., cash flows in perpetuity
- Longer the forecast period the lesser the weight of the terminal value in the total value of the entity



- Estimation of the growth rate is critical - it is a valuation call
- Longer forecast horizon vis-à-vis short forecast horizon/ companies currently achieving high growth (e.g., technology companies)



- Ratio of primary to total value and terminal to total value should be undertaken to ascertain reasonableness of the same

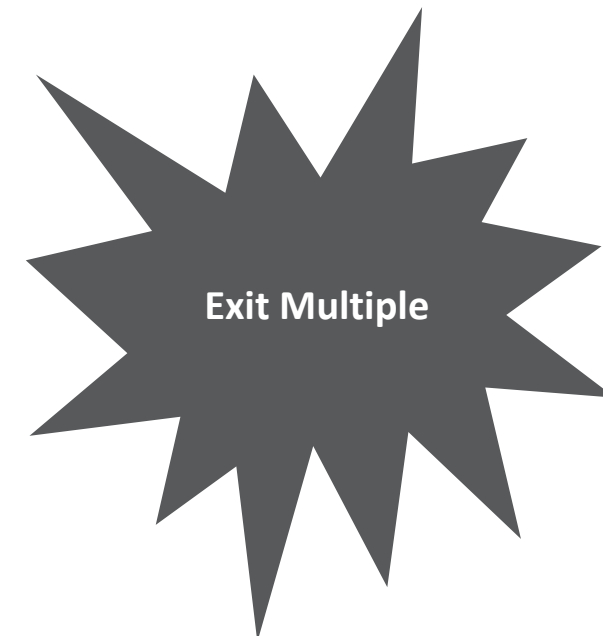


- Should the capital expenditures in the last year be equal to the depreciation expense ??
- 



- Assumption that growth equals inflation means world economy would stop
  - Law of large numbers - Should you grow from a company that is already earning a high ROIC (is the ROIC sustainable?)
  - Time period before which one reaches stable growth is impossible to estimate
- 

- If exit multiple is used then should the multiples be adjusted for prospective growth or returns??
- 



# DCF - Illustration



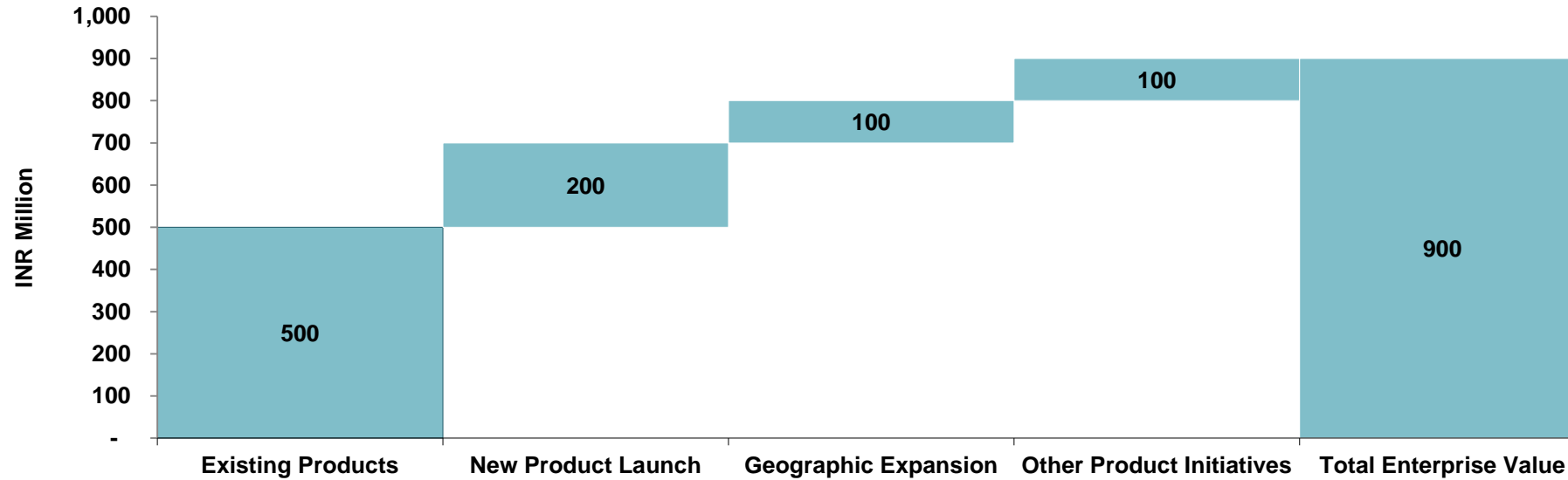
INR Million						
FYE 30 March	2015	2016	2017	2018	2019	Terminal Value
Revenue	296	330	869	1,014	1,186	1,210
<i>y-o-y growth</i>	110.2%	11.5%	163.2%	16.7%	16.9%	2.0%
EBITDA	44	52	237	296	369	376
<i>EBITDA Margin (%)</i>	14.9%	15.7%	27.2%	29.2%	31.1%	31.1%
Less: Taxes on EBIT	1	-	37	49	64	92
Less: Increase/(Decrease) in Net working capital	35	9	75	18	20	4
Less: Capital expenditure	1	275	20	20	20	62
<b>Free Cash Flow to the Firm</b>	<b>7</b>	<b>(231)</b>	<b>105</b>	<b>209</b>	<b>264</b>	<b>217</b>
Period factor	0.5	1.5	2.5	3.5	4.5	5.0
Discount factor	0.93	0.80	0.69	0.60	0.51	0.48
<b>Present value of Free Cash Flow to the Firm</b>	<b>7</b>	<b>(185)</b>	<b>72</b>	<b>124</b>	<b>136</b>	<b>104</b>

INR Million	
Primary value	154
Terminal value	746
<b>Enterprise Value</b>	<b>900</b>

Enterprise Value Sensitivity Analysis - INR Million						
		Terminal Growth				
		1.0%	1.5%	2.0%	2.5%	3.0%
WACC	14.9%	940	970	1,002	1,036	1,073
	15.4%	893	<b>920</b>	949	<b>980</b>	1,014
	<b>15.9%</b>	849	874	<b>900</b>	928	959
	16.4%	808	<b>831</b>	855	<b>881</b>	908
	16.9%	770	791	813	836	862

\*\* Numbers given above are hypothetical figures and meant for illustration purposes only.

# DCF – Value Contributors

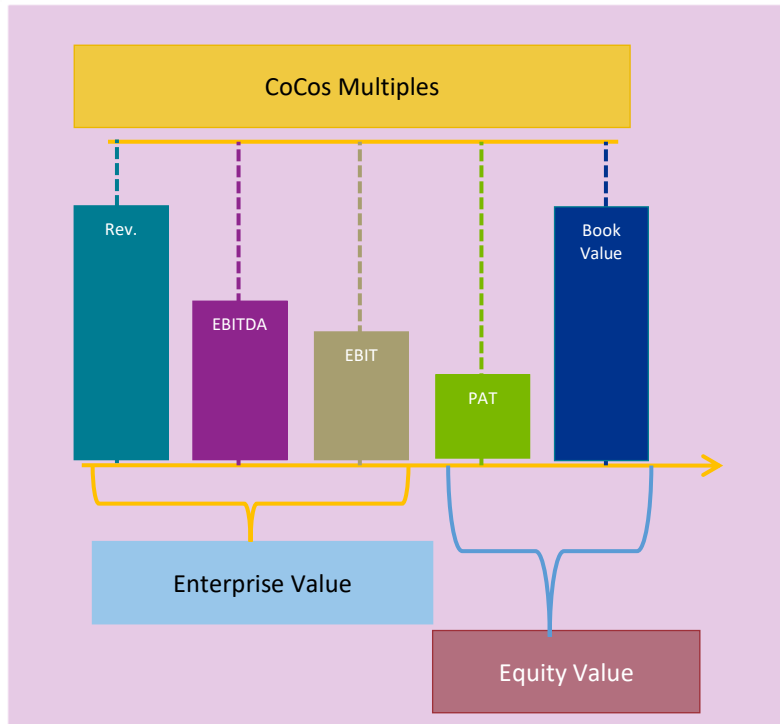


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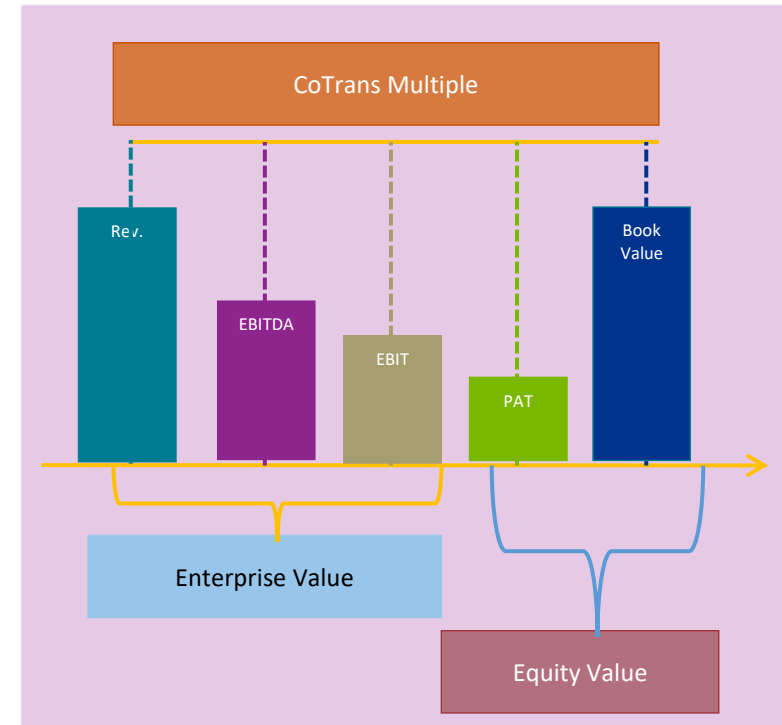
# Market Approach framework - CoCos and CoTrans Methods



## Market Approach - Comparable Companies



## Market Approach – Comparable Transactions



# Market Approach – Comparable Companies Method



Value is determined by applying derived market earnings multiples – based on the market quotations (the Revenue, EBITDA, EBIT, PE multiples, etc.) of Comparable public / listed companies.

*Choice of multiple depends on the maturity levels of the industry and stage of development of the firm*

**Comparable Companies Approach – Multiples**

	Information Technology (Commercial IT Services)	Auto & Auto Components
EV / sales	1.1x - 1.6x	0.7x - 1.0x
EV / EBITDA	8.3x - 9.1x	6.2x - 7.2x
Price / Earnings	12.1x - 13.7x	11.0x - 12.0x

\*\* Numbers given above are hypothetical figures and meant for illustration purposes only.

# Market Approach – Comparable Transaction Method



Value is determined by applying derived transaction multiples (the EBITDA, the PE multiple, etc.) of comparable transactions.

*Normally data relating to discounts and premiums in the transactions is not available hence usage needs to be assessed*

Comparable Companies Approach – Multiples

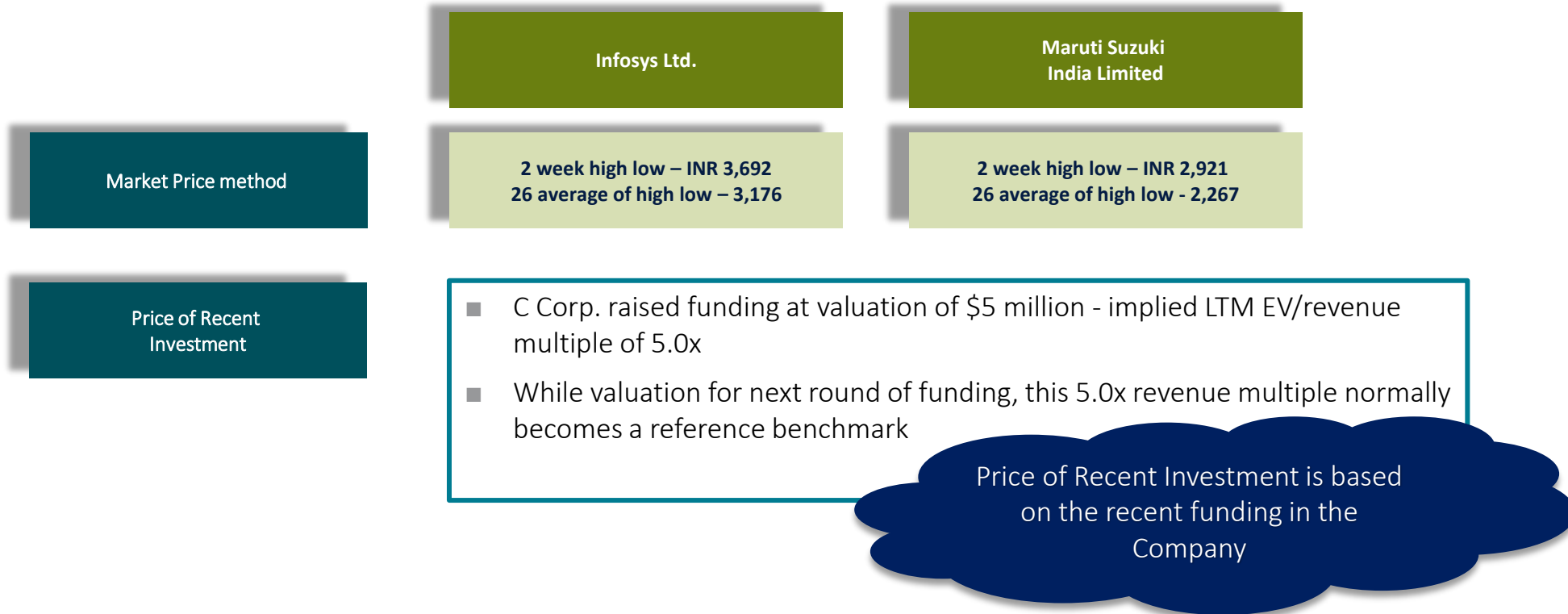
EV / sales
EV / EBITDA
Price / Earnings

Information Technology (Commercial IT Services)
1.0x – 2.4x
6.0x - 10.9x
12.5x - 29.0x

Auto & Auto Components
1.0x - 1.5x
6.9x - 18.2x
20.5x - 27.5x

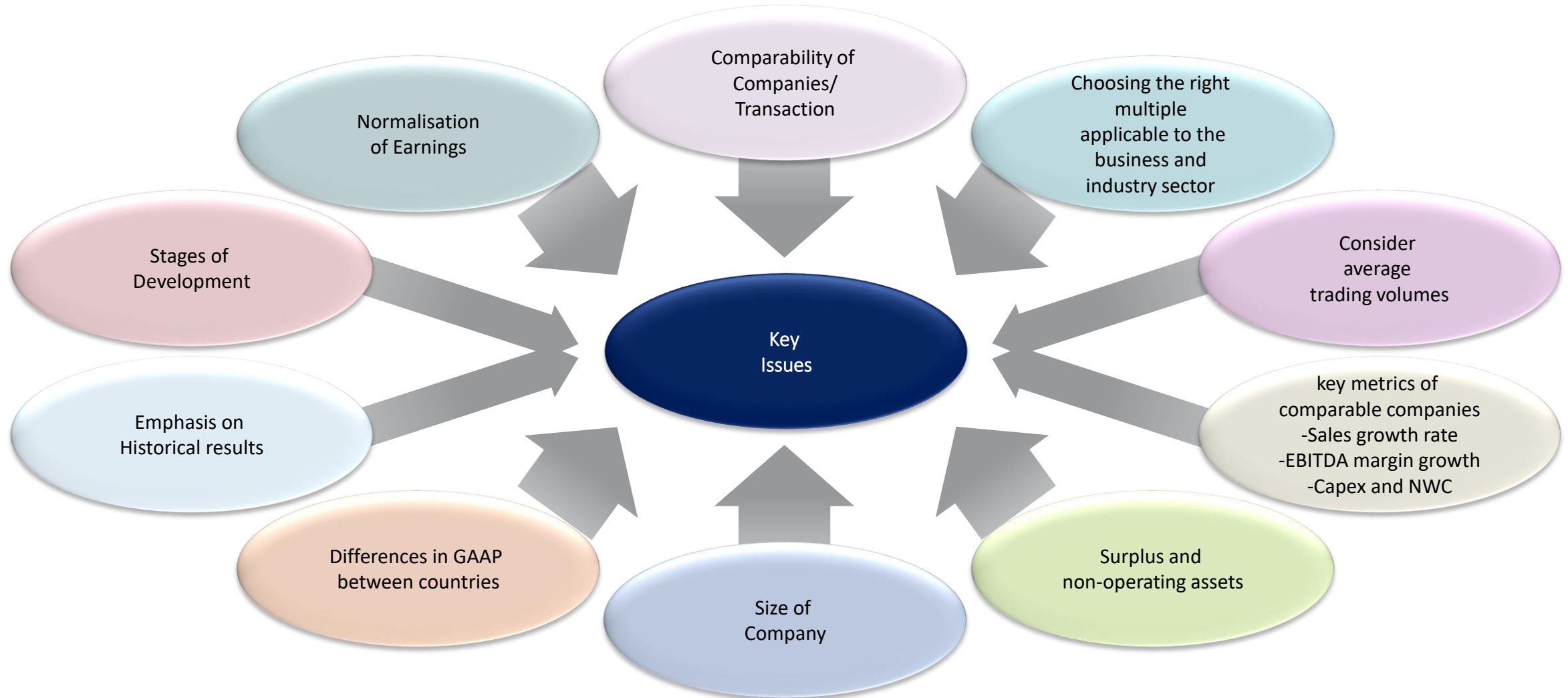
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# Market Approach – Market Price & Price of Recent Investment



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# Market Approach – Key Challenges



## Book Value

INR Million	
<b>Sources of funds</b>	
Equity	100
Add: Reserves and surplus	200
<b>Networth</b>	<b>300</b>
<b>Represented by</b>	
Net Fixed Assets	180
Add: Net Current Assets	200
Less: Borrowings	80
<b>Networth</b>	<b>300</b>

## Replacement Cost

- Cost of acquiring similar assets employed in the business and/or reaching a similar level of development
- Cost of building a new asset of similar condition and utility
- Sales comparison method (Market approach)
- Depreciated replacement cost method

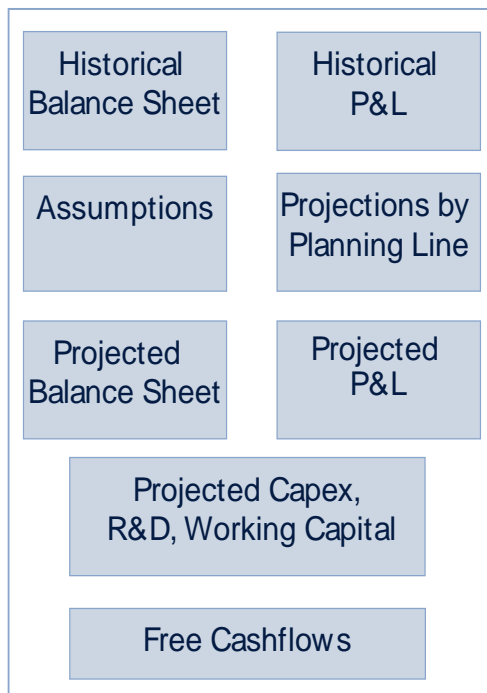
## Reproduction Cost

- Costs involved with identically reproducing an asset or property with same materials and specifications based on current prices
- Cost of creating an exact replica, compared to replacement cost, which looks at the cost of replacing an insured property with one of similar functionality

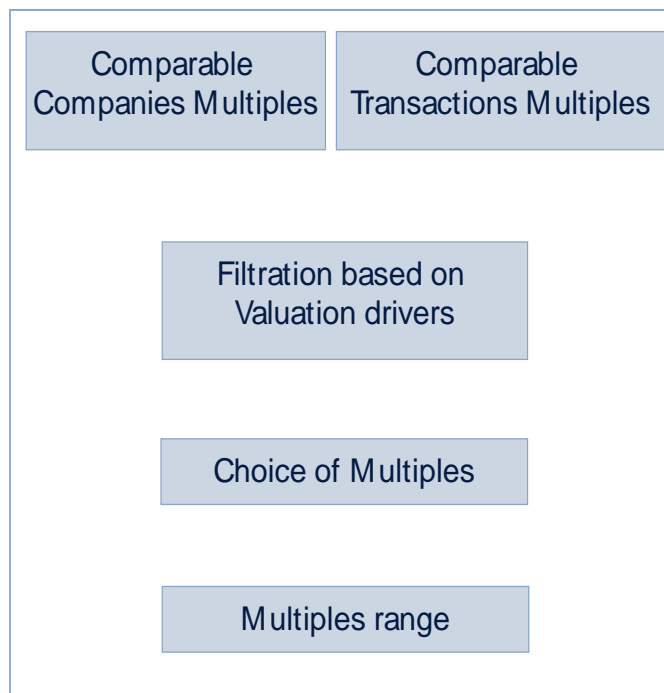
# Summary of Methodologies normally used



## Discounted Cash Flow [DCF]



## Public Market Comparables



## Net Assets Value



DCF Valuation

Sensitivity Analysis

Valuation based on CoCos

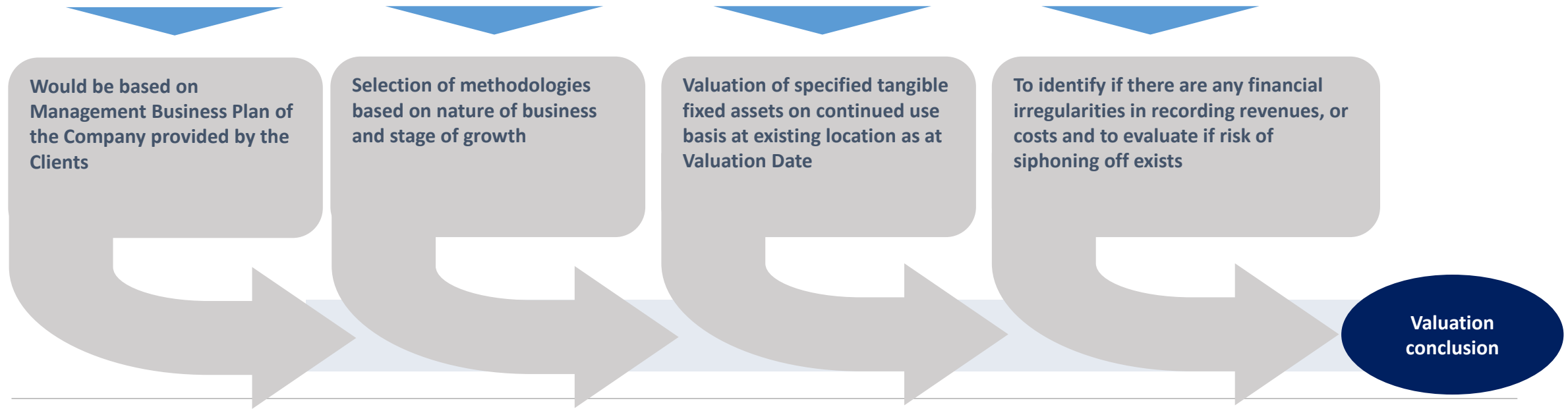
Valuation based on CoTrans

Valuation based on CoTrans

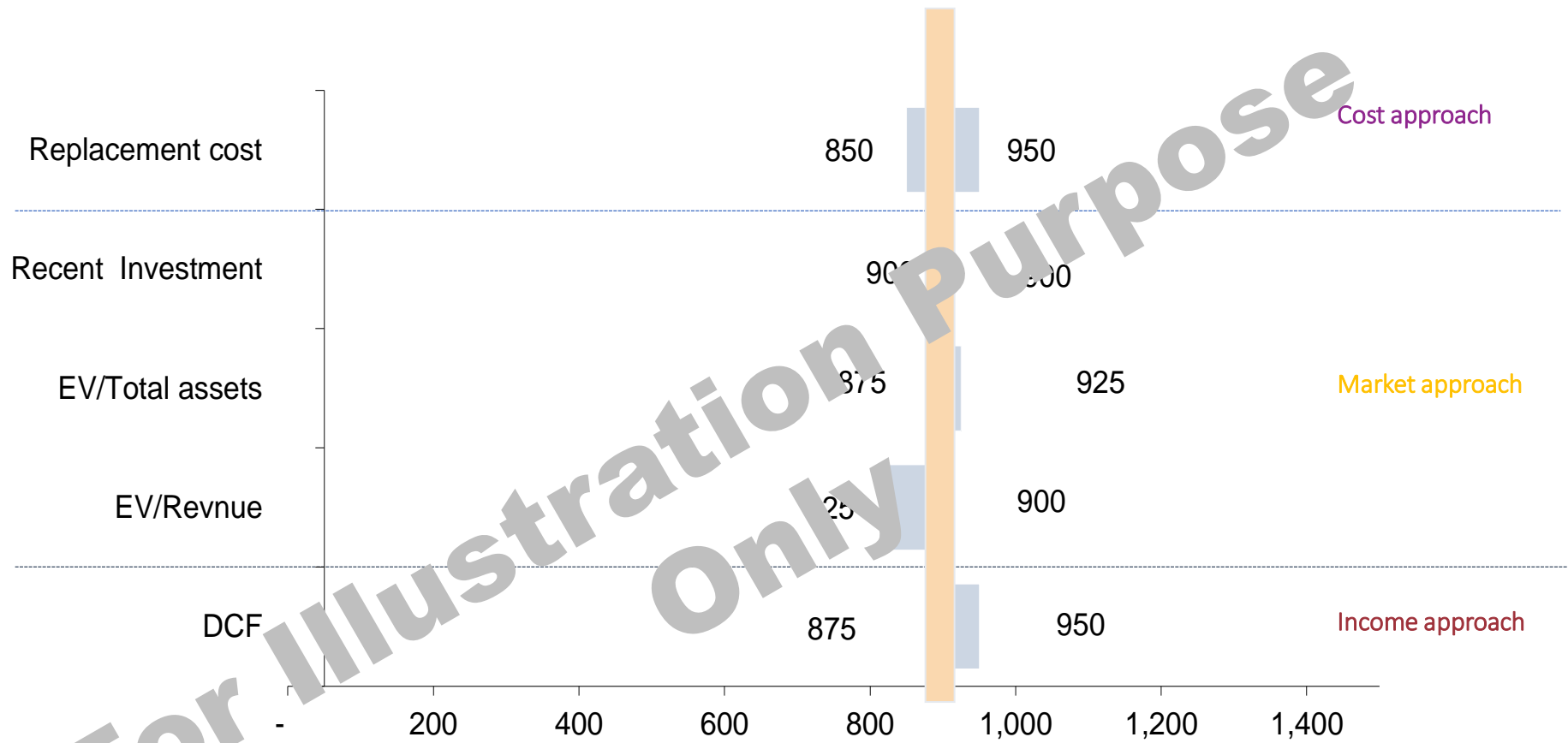
# Proposed Approach to the Engagement



Management Business Plan	Business Valuation	Tangible Asset Valuation	Historical analysis
Projected Income Statement	Income Approach	Land and Building	Project investment
Projected Balance Sheet	Market Approach	Plant and equipment	Sales, purchases, finance and accounts
Projected Free Cashflows	Cost Approach	Furniture fixtures & others	Other support analysis
Key assumptions underlying Management Business Plan			



# Valuation Conclusion

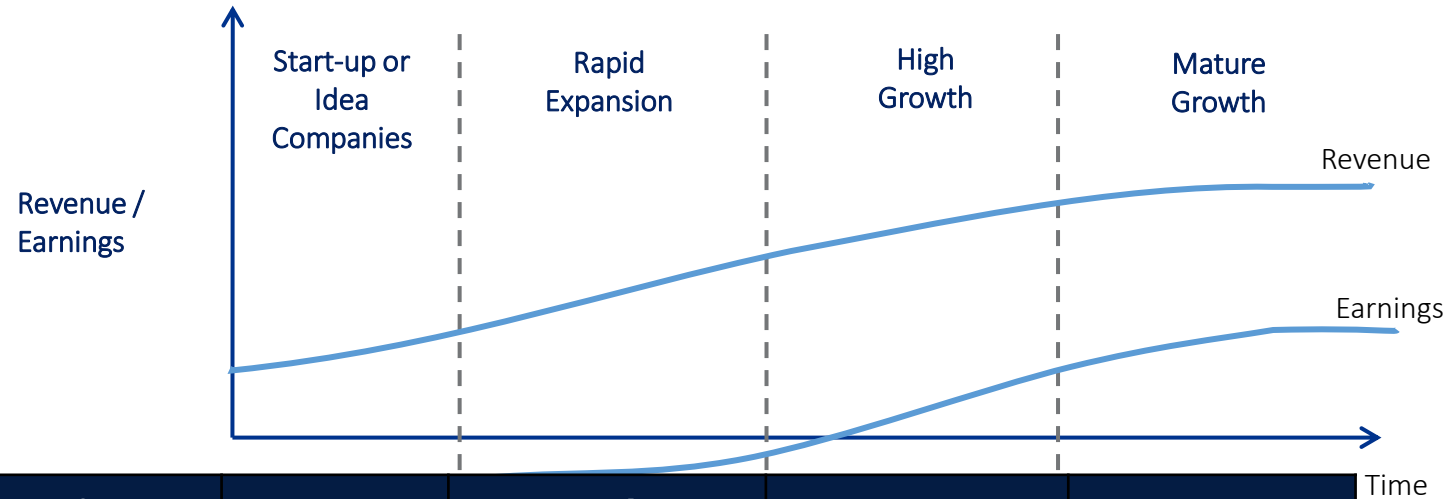


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Selecting the right one

# Selecting right one: analyzing life-cycle of company



Cost Approach

Income Approach

Market Approach

Stages of development	Start-up	Rapid Expansion	High Growth	Mature Growth
Cost to date	• • •	•	N.A.	N.A.
Replacement cost	• • • •	• •	N.A.	N.A.
Net Asset Approach	• • • •	•	• •	• •
DCF	• • •	• • • •	• • • •	• • • •
Sales Multiple	•	• • • •	• • •	• •
EBITDA / PE	•	• • •	• • •	• • • •

• Suitability

**Surplus assets / non-operating assets**

**Pre-money & Post-money**

**Transaction Premiums / Discounts**

**Payback of Capital Expenditure**

**Value creation – Own Versus Lease**

**Restructuring situations**

**Synergies in transactions**

# Key differentiators in valuation process



Many times selection of a right valuation team can make a difference....

In theory, there is no difference between theory and practice. In practice there is... 😊

**In my personal view, Valuation is not an  
"Art" or a "Science" but more of an "Applied  
Science" .....**



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**CIN: U74990KA2018PTC119002**

**GST: 29AACCU3424D1ZK**