Mergers, Acquisitions and Corporate Restructuring

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Lecture: 23
Alternative Exit and Restructuring Strategies - 1

Hello friends welcome to one more session on mergers acquisition corporate structuring in these days if you look at the corporate market where so many days are taking place we find that lot of companies are now being acquired which are actually in startup in nature. They are new ventures new companies formed by a small group of people some technocrats some practitioners. So they have also, become now attractive target for the existing companies.

So instead of starting the idea on its own a company a legacy company which has been there for several years they look at a startup a new venture which has been set up by some investors and a finance also by some investors and they acquire them. Because that way possibly they will be able to reduce the gestation period so instead of trying the, new ideas on their own so they go for acquiring company which has those new ideas or products or services offered by those companies.

So in this particular session we will be focusing on startups its financing pattern stages financing stages we also talk about the valuation of startup what are the different approaches that one can use and also we will talk about some other special cases. So we will, continue the discussion in this session also the next session.

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So the concept that we have in this session is startups as an acquisition target startup stage and financing cycle how to value a startup or new venture what are the different challenges in valuing startup then free money and post money value these are the terms which use in case of startup valuation and also this score card approach, which could be used for valuing a startup.

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They are the keywords you have startups, startup finance cycle valuation, pre money post money value valuation multiples and scorecard approaches.

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Now coming to the definition what is meant by startup if you go by the oxford dictionary it is simply it is a newly established business. So somebody has started the new business with a new idea product service that is, called the startup. But in India we have got a initiative by the government of India where startups are encouraged so they have also defined this startup as per notification in 2019 so they say that startup in India to get the advantage of the government policies regarding startup these are the criteria to be taken care.

Otherwise generally one can say startup is nothing but a new idea but if you want, to take advantage of the government policies incentives schemes etcetera then the company has to meet these 5 criteria. First is that this company must be 10 years old or lesser it should not be company which is established 10 years before then company type as a set of type ownership type it has to be a private limited company registered or a registered partnership firm or a limited liability partnership.

That means it is something likely privately managed company business it is not a public limited company where several shareholders are there. The turnover in the last financial years since inception should not be more than 100 crore on any of the year and it should be original entity it should not be coming out of an existing business by restructuring or splitting the company that is, not the idea as us to get the advantage.

Otherwise if you look at companies established companies also have their own startups they set up new companies as a part of that subsidiary and grieve the management the people there who are working in that particular thing if freedom to try with new ideas. So they are not covered here because they are part of a existing company so here it should be not, coming out of a existing business rather it is set of new.

And the final criteria that is the most important that in that way it should be innovative and scalable so it should be working towards development or improvement of product or service and also should have a scalable business model. It is not that you just have a new idea but there is no commercial viability you cannot scale it you cannot take it to greater heights it has no high potential so it should have a potential for creation of wealth as well as creation of employment opportunities.

See this thing is considered these things are considered these are 5 things which are considered to recognize a company a startup or not as per government of India guidelines which is under the ministry of commerce industry department promotion, industrial internal trade has given these guidelines.

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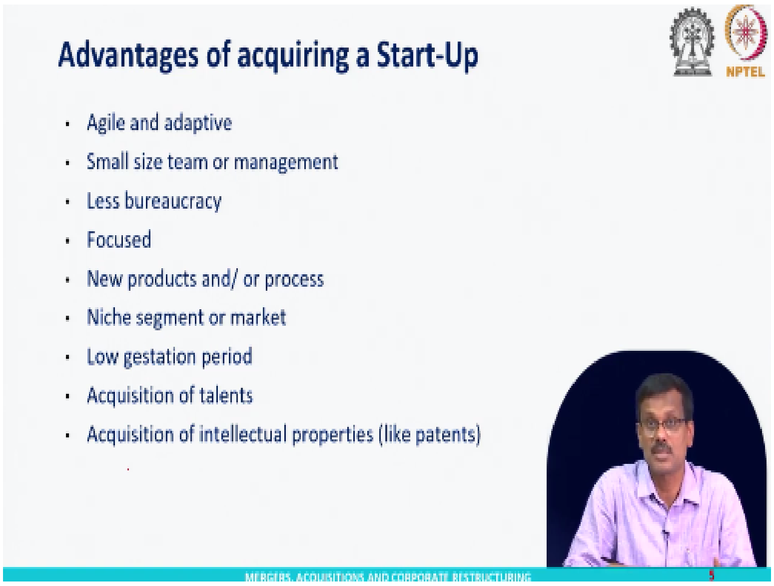

Now why a company an existing business will like to acquire a startup? First of all is that the startup being a small company closely held they are more agile more adaptive because if you are a bigger organization you are burdened by the bureaucracy and layers of management. So in this case these owners are actually the operating managers they take decision they look for funding they also are very agile to what is happening in the market in terms of technology market etcetera.

And they can adapt to new things quickly because the organization is small and may be more flexible. It is also small size team or management so when you are going to acquire a startup you are going to deal with a small group of people so the, negotiation can be little easier for us. Since it is a small company so bureaucracy is obviously very less and the company startup is focused it is into a particular technology product or market they are not into very diversified businesses.

They are also having new products or processes they develop so for that acquiring company which we could not have lowest technology or product we can add to, our kitty because that is the new product the startup has they may be in some niche segment or market where the operator is very high and profitability could be very high if the market is actually accessed. They may be having marked having presence in those market.

And if you company also can on its own go for it develop the new technology and adapt it but it will take time so the registration will, be there so if you are going to acquire a company with that new technology it is going to be less time consuming for them. And startup can be acquired for talents is not necessary that their only product they may be having good pool of talent good people working there skilled people are working there so they that also can be considered as a acquisition of as a startup criteria.

To whether choose the, startup one because this company has good talents also possible the acquisition is that particular startup is being done with the startup has got a lot of intellectual properties maybe like some patterns copyrights they have developed for doing something. So these are the things that is possibly could be attributed to start up which makes the start up attractive for a existing for an existing company.

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Then if you look at recently as per a particular report we have 210 deals in a M and A which took place 2021 this steel user startup companies acquisition actually now it has become in the last year 2022 there are 240 M and A deals involving startup acquisition. So that shows that companies are going for such acquisition they are becoming startups are becoming popular targets by the, established companies for the purpose of acquisition.

So just an example we have cited here certain examples here how different conglomerates business conglomerates in India have gone for acquisition how many the acquisition they have used the targets which are actually they have taken with the targets which are active startups. So for example Tata group is a conglomerate which has acquired big basket which is online in grocery supermarket. So Tata group wanted to end the business so they acquired that and this company big basket was formed in 2011.

And Tata group has acquired that in 2021 similarly now we look at the market online medicine so one can order a medicine online with a uploading a prescription and all those things the companies look at those genuineness of the customers needs and they supply the medicine at the doorstep with the courier or something like that. So that has become a new market so now Tata group has also acquired one company like the 1mg which is into online medicine market.

And that company was formed in 2015 and Tata group was acquired in 2021. Similarly reliance group also certain select acquisitions are there in the Tata group also they are, select acquisitions they have acquired several other companies but we have cited only 2 of those.

Netmeds is another online medicine market company which is a competitor of 1 mg it was found in 2015 and round reliance group has now acquired their company 2020.

There is online fashion segment in that find is one company which is founded 2013 and this company has been acquired 2020, Saavn is a music play music company where you can access to popular musics is a little quite little old company in that way 2007 it was established but later it has been acquired by reliance in 2018 another in the logistics company Grab holds acquired by reliance industries which was set up in 2013 reliance industries in the period 2019 - 2021 this phase they have slowly taken over the state in the company.

Another is online furniture retail business Urban ladder is a very popular brand for that matter which has been also acquired by 2020 by reliance industries reliance group and this company was set up 2012. So these are all select cases that is just to show that startup acquisition is a very common phenomena now. So companies can look for acquiring startups as targets.

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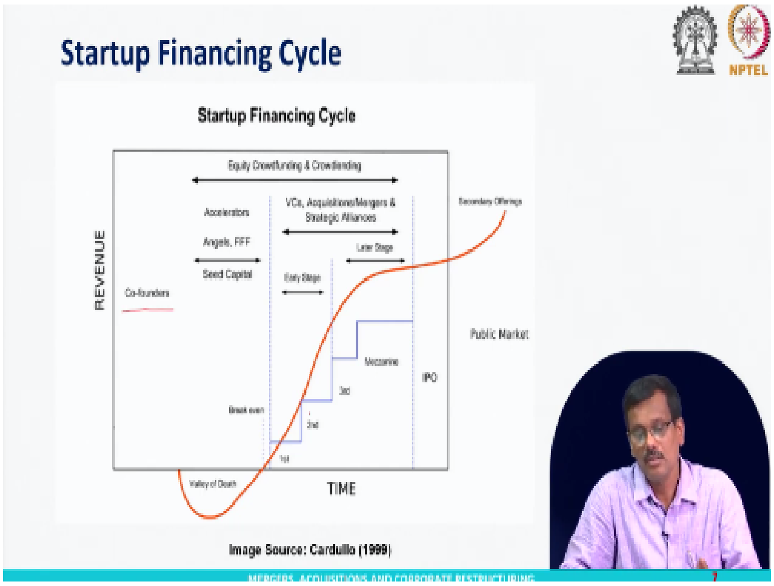

Then if you look at the startup why they go for acquisition also because at certain point of time the present management may not have that ability to raise more money so they may like to exit so in that case M and A can take place. But before that they must have lot funding to set up the business and grow also so this particular graph talks about startup financing cycle. So what happens this red line, is talking about the revenue of the company.

That is how this company is growing and alongside we have got this in time and there you have got what type of financing is done. What happens in a startup first of all some few friends relatives come together bring their own savings. And that is the first seed capital is called pre seed capital to set up the company so there could be taken from, the co-founders they get the money and start a business start an idea.

Then looking at this if found that there is some spark some light in the tunnel they could see that then they like to scale it up try certain new things and they will approach now the start of financing companies they could be venture capitalist angel investors private equity players they will approach. So then they go for the state capital angels other companies can give that they are also known as accelerators.

Then looking at that yes there is something happening there is a opportunity that is the product is going to be successful commercially possible going to be viable something is viable is done then you go for further exp they need more money for expansion so then they go for venture capital is the private equity, players or angel investors in that. So then they have got something called early stage. So in each in this stage they have a multiple financing rounds the first round then first round has shown some result.

Company has done something good so then second round then third round then they have got another round where the measurement financing is there measurement financing nothing but a like is a mix of, debt a convertible date so it is a mix of data and equity can be taken some extra before they go for IPO or they need some more money so the mezzanine phone can be taken also it is possible even go going without going for IPO as an exit where owners will exit some of them exit to some extent.

They can also go for a acquisitions opportunity somebody can acquire the silicon look for the companies, which can acquire this company. So at this stage a M and A can mean exit option for the startup company or startup company can further expand they can go for initial public up they can get. So if you look at essentially the startups need money and over a period of time as they prove themselves they will able to attract more and more funding in different, different rounds.

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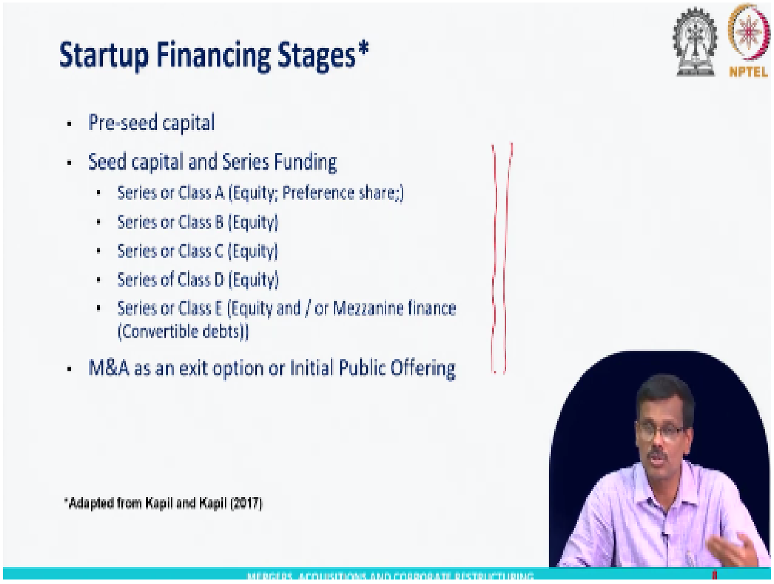

So further you can explain them these are different financing stages for a startup as given in the previous chart firstly pre seed capital that is given by the promoters the friends, relatives who start the business they take bring their own money. Then they go for seed capital and the seed capital will reference series or series also known series as well as class so class A they will go for some investor then may go for equity some preference shares.

Such type things can be there and if once they take this money they will go for trying new products they try to develop the product or the process something find nobility and prove that to proof of concept will be there they will try to prove to the market yes this is something interesting that can be developed further then they go for class B next series of transaction again, they find is a market is there good growth possible.

Then go for C class C or series C all this class B C and then a class D also will be in terms of normal typical normal equity this; whatever talking about this particular framework they are suggested framework there could little changes in terms of how these startups are actually financed. It is not necessary always liquid it could be convertible, date converted preference shares those things are the possible.

Then they go for another series class E that means previously in class B C D whatever is objective that was mentioned by the company when they go for when for this particular series those objects are taken care then only they go for next series also. So then that time they can go for further equity or Mezzanine finance may be, convertible date you can go and once that is done that means at this point in time is scalable come product is commercial viable.

People are there people are buying, people are showing interest, sales have taken place may be company has started making operating profit also then they are known in the market so there will be some other companies like to acquire as a target or they can also go for, initial public offering so the promoters can exit or with an acquisition opportunity or some of the promoters can exit or the earlier investor like in index foreign series A B C D they may exit promoters may continue.

Either through M&A or through initial public offering so then initial public offer takes place means finally it is scalable model but they need money for further expansion and the privately equity players angel investor now do not find that much attractive. Because now the growth in their investment is not good that substantial so they may exit at this point of time with the help of when the company is going for IPO that time the investors can also offload the their shares and exit from the investment.

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So now coming to that how to value a startup valuation of startup may be, required at the time of acquiring valuing a startup can also be required when a new inverse is coming and trying to invest in the existing startup. So all those things are there where valuation can be required as what is challenge and valence startup is unlike a established listed company or public companies that because they are information is more or less available in public because of regular requirements.

So that is little easier to get them so that is one because it is a privately head and they might be following the normal accounting principle or practitioner that which can make them comparable with other state finance statements other companies. So that case they are this challenge for to get the information right information. But they are young company so there is no history and they have unique business ideas products services.

So you cannot apply the model that we have general model valuation models same thing you can do because there could be some product which may give very high growth in initially the lot of growth approaches that where the niche is there. At the same time since there is very unique business a product or idea services there is a risk it is possible this startup will get bossed. That means there is no more commercial viable for the thought of that will be a unique thing to give the market it is no more unique.

Somebody might have come with the same idea or same product some computer might have come or they estimated that there will be customers for the product they can scale it but it is not positive so that risk is also there. So when you are take over the startup so, those things also the company in the occurring company can face the situation. So that way it is risky to get that and that case the valuation has to be has to factor those things.

Then what stability a stage of startup valuation can vary from stage to stage early stage or seed capital stage or early growth stage or expensive stage or a sustainable growth stage depending on that the valuation approach can be different suppose you are going to use a discounted cash flow so maybe the discounting factor is going to higher for the cash flow in the initial years. Because that is at least a lot of risk involved whereas the cash flow which is going to come after stability stage the risk is going to lower so risk counting factor can be lower there.

Because risk and discounting factor are positive related more the risk more the discounting factor as known the cost of capital then you have a startup which is very less revenue at this point of time but may be lot of growth potential. The company may have negative earnings suppose we have to use a multi valuation multiple let us say we as you discussing valuation enterprise value to EBITDA multiple. Suppose you are going to, use this multiple as a relative valuing mechanism for a value startup.

It is possible the EBITDA itself will be negative in that case you cannot use this multiple also so you have to look for something else so negative earnings or the company may have very less profit. So that may not be suitable assessed the company may have also negative operating cash flow. So companies not having enough collection from the customers to take care of the day-to-day expenses.

Then when it will become cash flow positive that has to be seen so these are the things which are typically applicable for startup companies and the final statements that the company is because they are not regulated so much they are not have to comply so many regulating agencies the financial statements may not be having, followed that proper accept accounting principles nor that they are illegal something like that they are not have not legal asses.

But they may not be that robust to compare with other companies we also heard because these companies are not regulated these companies are free to do whatever there are also instances when you hear that they also go for manipulating the fancy statement and manipulating the awnings like they may recognize revenue earlier than when they should recognize. So all those problems are there because they are not subject to so many regulations as so it is also something one the company has to be careful.

When they look at the financial statements of startup and maybe the acquiring company has to readjust the figures based on certain assumptions or policies and, also even if you are going for comparable company after valuation of startup we may not have as many comparable companies to compare so that you can have a benchmark to value. So these are the challenges which are there in start of valuation so honest that is why startup violation little different than a established company valuation.

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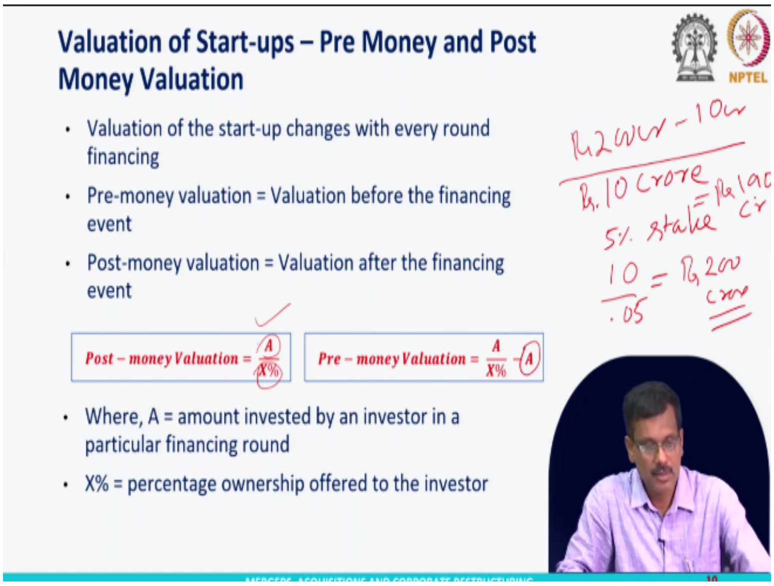

Now one very popularly very one 2 terms are used, in case data valuation is called the pre money and post money valuation very simple pre-money valuation is nothing but valuation before the financing round or financing event post many valuation the valuation after the financing event. So suppose one investor has taken a stake in a company today so what are the valuation before? What is the valuation after?

So very simple formula post money valuation is, how much this investor is giving amount how much stake is going to get because of this particular investment that is the post money valuation. So for example if the investor is giving rupees 10 Crore and with this the company is giving they are going to give 5 percent stake so if for 5 percent stake it is 10 crore then what will be the value post money it is nothing but 10 / 0.05 percent that is called rupees 200 crore.

So this is the valuation of post money valuation of this startup or any company for that matter so pre money will be how much money has been given by the new investor so 200 10 crore and the values is now 200 crores of 200 crore - 10 crore that is the amount given by the investor is called rupees 190 crore. So this is called pre money and post money this is, some normal in stutter balance these terms are actually used quite a quite frequently.

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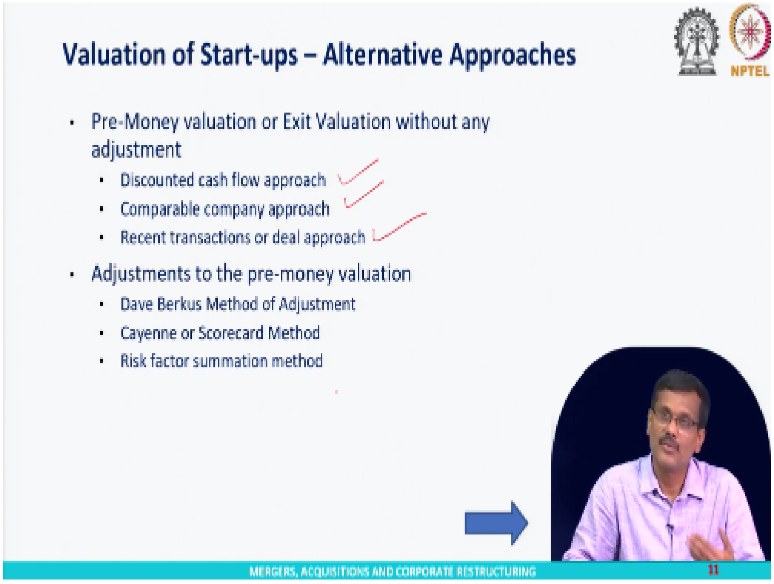

Then we go to different approaches of evaluation of startup first what happens we do a valuation that is called pre money valuation before the financing takes place a pre money violation has to be done or that is called exit valuation also possible that company will the investment exit by giving the stake, that is also possible. So those things are done by using the typical apples as applicable one may apply discounted cash flow one may approach comparable company approach or one may apply recent transactions or deal up approach.

So look at recent deal that has taken place in same type of startup segment then get the multiple or something then relate to that you find the value. So we will have little more, discussion about this cash flow and the adjustments separate lens the next session but suppose having done that valuation is as in like you do in case of normal valuation then because the startup is there because of the nature of the business because the stage of the business.

Because the risk involved possibly some adjustment to be done there and adjustments done there are different approaches in order all they are just to be done one of these approaches may be applicable depending on the investor and that is why this is very subjective approach that means the approach used by one person one investor for a starter valuation can be different than that we followed by another investor for them so honest to be careful about that subjectivity is definitely there.

In any case valuation as such a lot of subjectivity but starter valuation has got more and more subjectivity involved compared to normal valuation process.

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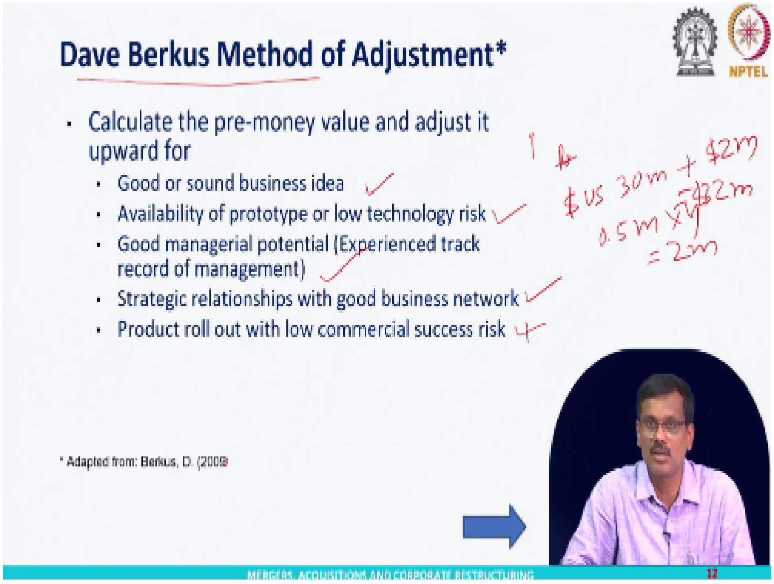

So what type of adjustments can be done the Dave Berkus method that we have so first of all we do a pre money valuation using whatever approach that is convenient for the company for the investor then looking at that suppose you got a pre money valuation and this particular, approach is typically given in the context of American US market somebody berkus in 2009 he gave this particular idea. One can always adapt to it will make some changes so that point what was suggested is that suppose the pre money valuation is let us say 30 million.

So looking at them further criteria whether this as a investor you are looking at does it have a good or sound business idea, yes does it have low technologies means they have already got prototype of the processor product that means it is not that is not there are not looking at the dark and fine fog will be the outcome of this particular venture they have good managerial potential that means they have the people to manage this particular business at this point.

So that as an investor I should not be looking for having management to take care of this business also so the management is there and this business has got very good strategic relationship with suppliers customers technologies have suppliers for that matter so that means strategic network is there and product is also rolled out let us say. But and also there is low commercial success risk that means products are rolled out and the customers have checked it and there is a viable.

That means it is accept the customer so if these things are taken care or some of them are taken care also it is possible that a particular startup or the first 4 things have been taken care that is there you are satisfied but the last one is we do not know as of now berkus then you do not consider that and for everything ticked suppose all the things are taken care except this one then the author suggests you add 0.5 million each.

So in that case if the four things are taken care into 4 it comes to 2 million US dollar extra large so the valuation will be 30 US million plus 2 million extra so the validation is going to 32 million dollar. So let me sounded that this is a subjective method this is this gives an approach idea how to go about it we may not exactly add this particular figure but is an approach can also be looked at and this is also quite old and approach for that matter one can always change the figure.

But these 5 criteria based on that you add the value add something extract to your base valuation or pre money valuation based valuation that is also there that is one method.

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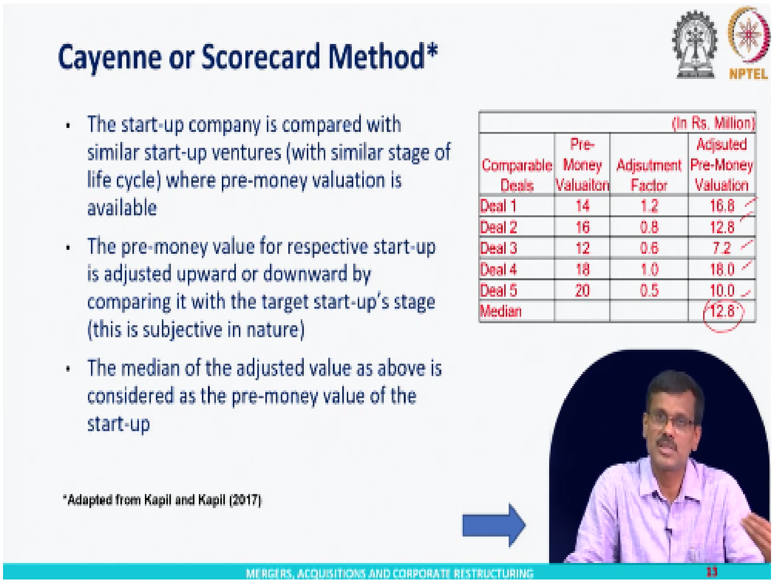

Another approach of adjustment is that the scorecard, method where a startup is compared with similar startup ventures that is which is a difficult task for do they should be in similar stage of life cycle also where the pre money evaluation is available. And looking at that because it is difficult to get an exactly same startup same type of startup as such so you may get something similar but not exactly same.

Then in that case some adjustments can be done and for example the deal 1 we feel we get the deals 5 different deals an example here from the market where this valuation has been done a pre money value is available in that case suppose we got 14 million rupees in the valuation and possibly we feel that company was not same as what you are talking about let similarly so what happens then adjustment is done.

And adjusting factor can be more than one or less than one and once the adjustment factor for 5 different deals then you multiply the adjustment factor or you are comparing your company with another company in similar sector and then you multiply that then once you have the adjusted pre money valuation 5 different figures are there. Then one will have the median of that and the median the median comes to 12.8 or sorry.

Another approach of adjustment in case of start evaluation is that we look at the companies in the similar sector startups are there where deals have taken place acquisition deals have taken place or financing deals have taken place new investors have come and taken the stake in that company. So there we have different deals and do some adjustment because the company that, is deal we have got they are exactly they may be better they may be little worse than the our target.

So we will do the adjustments and adjustments can be less than one or more than one then you multiply that so we have got 5 deals there we have got five adjustment factor by comparing with our startup and on see multiple adjustment factor we got 5 different adjusted values adjusted pre money value then take the median that is 12.8 so we can say 12. 8 is the million rupees is the value of the startup that we are looking at.

So that is another approach we have other approaches of adjustments and which you will discuss in the next session.

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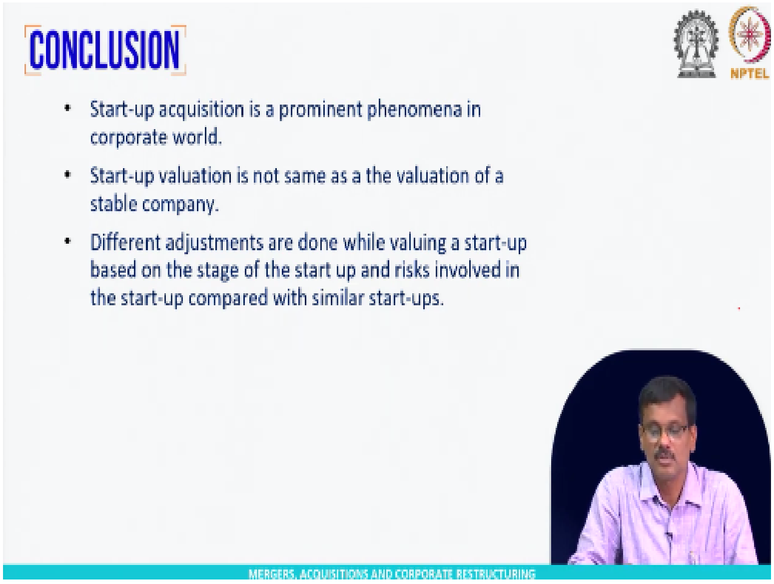

So to conclude startup acquisition is a very prominent phenomenon in the corporate world these days startup valuation is not same as the valuation of a stable company and some adjustment have to be done while valuing the startup based on the stage of the startup based on the risk involved in the startup compared with similar startups. So that has to be taken care and the valuation can be done.

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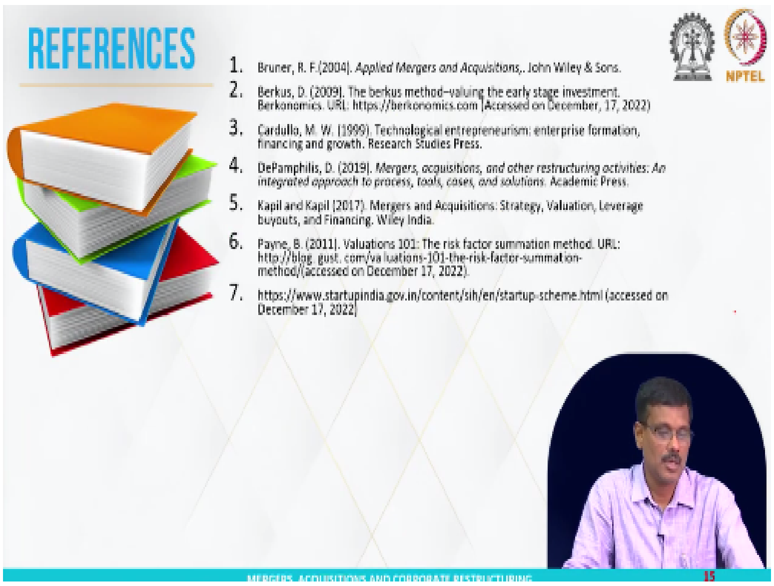

So thank you and happy learning