Mergers, Acquisitions and Corporate Restructuring
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Module - 6
Lecture - 25
Alternative Exit and Restructuring Strategies - 3

Hello friends, welcome to another session on Mergers, Acquisitions and Corporate Restructuring.

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In the previous session, we talked about the valuation and this is going to be the last session on valuation of companies or valuation targets. In this session, we will talk about certain specific cases or adjustments that one may have to do when doing the valuation as such and particularly in the context of mergers acquisition. So, the concept that we are going to discuss is discount for illiquidity that means their companies where shares may not be that liquid like listed company and the investor may not be able to exit so quickly because there may be readymade market for the investment to be sold.

In that case, the price of the investment is going to be lower, so, the discount is going to be there to the value. Similarly, the merger acquisition takes place. It takes place with the condition that the acquiring company will have the control over the affairs of the target like in decision making process and go for strategy decisions. So, there is a control they have in the affairs of the company.

So, in that case, they may like to pay a premium over the value because they are going to get a control. Secondly what will happen, if the controlling stakeholders get more benefits, so they get a control premium, so, the other investors, other sellers of the company who are minor sellers, their value is going to be discounted. That means, if there is a control premium, there will be also discount for the minority stakeholders.

And we also talked in the free cash flow context, we talked about growth, growth horizon, what is the growth period, so, we will also touch upon those things in the context of free cash flow. And when target's financial statements are there which are using for the valuation purposes, there may be some anomalies, there may be some issues with the financial statement and whatever anomalies could be there and whatever they could look for so that we want to be careful about the target's financial statements. So, we will be talking about these concepts.

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And these are the keywords, liquidity risk, liquidity or illiquidity discount, control premium, minor discount, growth horizon, stable growth rate and accounting anomalies in case of financial statements.

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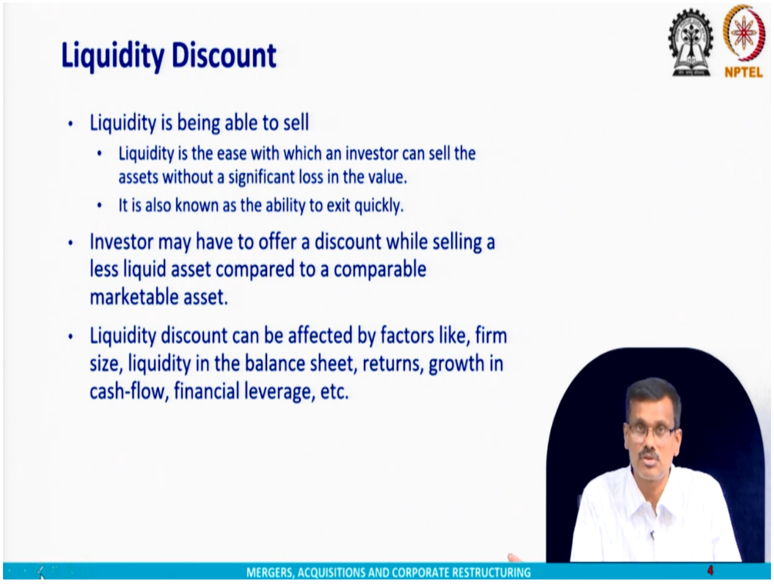

First one we talked about is the liquidity discount. So, liquidity is nothing but that the investor is being able to sell it. That means there is a market, there is a buyer for that asset and at the same time the demand is also there for the share. So, the problem happens in case of unlisted stocks, problem happens in case of start-ups because you do not have readymade market for that, you do not know who is likely to buy from the target point's point of view.

So, that is why target may be valued at a lower rate than the base value if the liquidity problem is there, its stock is more illiquid assets, so, that is why it will be discount. And so, investor may have to offer a discount while selling a share and compared to a comparable company which is listed company possibly. And liquidity discount can be affected by factors like firm size. It is observed that bigger size companies have less liquidity problem, that they will be able to sell the shares more easily compared to small size companies.

Similarly, balance sheet of the company is more liquid, particularly asset side is more liquid that means that is more liquid balance sheet. It is taken as one of the positive sign of the financial statement, good thing about the company. So, those companies with more liquid assets in the balance sheet also are going to have a buyer option; somebody is going to buy them; more number of buyers likely to be there compared to those companies which has got less liquid balance sheet.

Similarly, company having more return on by the company is going to be more liquid compared to companies with less return on by them. And if the growth in cash flow, profit, etcetera is going to be good compared to the other companies which is bad, then good company is going to have better liquidity. In that case, liquidity discount is going to be lower. Another thing is that if the company is more levered finance elements, the company's finance more with the debt, they may have less attraction to get the buyers for that matter.

So, these are the things, certain things which can affect the liquidity of a particular company's share in the market. So, in that case, the liquidity is going to be affected, so, there is a discount going to be there. So, that means whatever value you get by the valuation formula will be possibly they will be getting a value lower than particular that value.

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Then we go to the next aspect called control premium and minority discount. So, what is control? Control is something that yes, you have the ability to direct the affairs of the company, activities of the company. So, we can decide, the acquiring company's management can now decide what to do about these targets. They may close down some operation, they may expand, they may expand new market.

So, they know and they can have their perks, facilities, remuneration. So, they can decide about the activities of the company, so, that is why they have a control because they have a control. Because they are going to get a control and they decide, so, they may be willing to pay a premium for that. And then, in that case, if the control premium is going to be there for the controlling stakeholder, then obviously those people who are not controlling stakeholders, their value is going to be lower. So, if there is a control premium, there is also called a correspondingly is minority discount.

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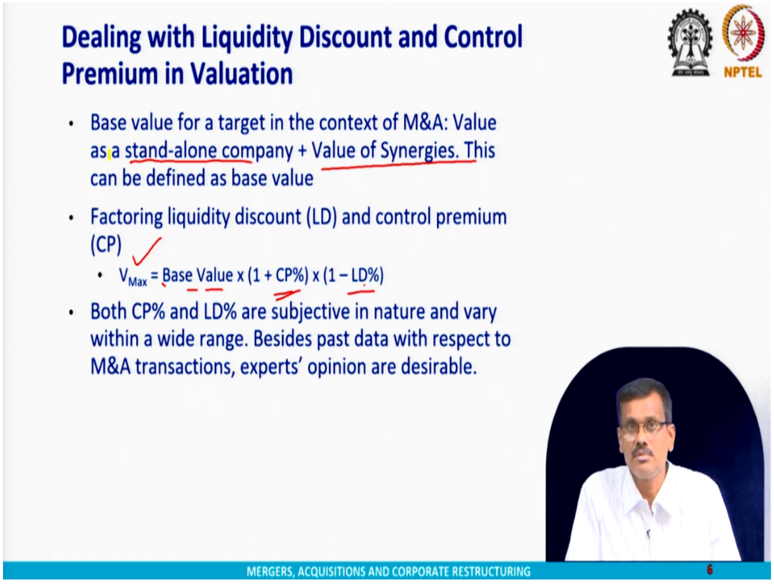

So, how do you factor it in the valuation? The first thing is the base value of a target in the context of M and A is nothing but the value as a standalone company and then you have value as synergies; that is the base value. So, as a standalone company, the value is there, and then there is a synergy possible because they acquired this company. So, those two together gives the base value and then the base value can be more or can be less for the purpose of trading inconsistent margin acquisition.

And when you factor liquidity discount and control premium, what we do, what the valuation is done, the maximum value the company may offer to buy a share could be the base value into 1 plus the control premium percentage, how much extra I would like to give for the, whether I am going to get the control and the 1 minus the liquidity discount. Where the company's stock is less liquid, then in that case, there will be discount with the value or price for that matter, but one thing is that the control premium and liquidity discounts are subjective in nature, they can vary from within a wide range.

So, one has to employ experts, consults, then look at different attributes and accordingly and look at the past cases of similar M and A cases, M and A's. Accordingly, control premium and liquidity discounts can be decided. We do not have a pure black and white formula that what will be exactly control premium, what will be exact liquidity discount for that matter. It is absolutely subjective. So, that way, valuation also becomes subjective in that.

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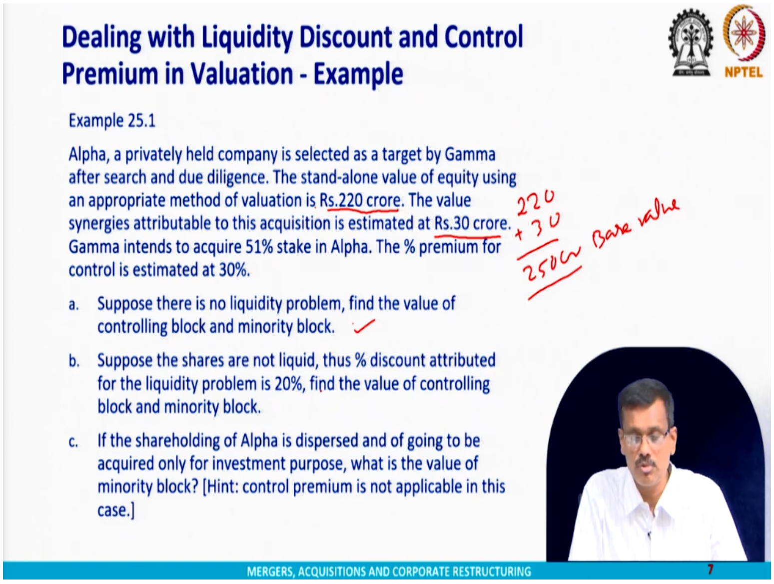

Now, if you look an example here, we have a company Alpha which is a privately held company which selected by Gamma which is the acquiring company. They did a good due diligence and search and got this company and the standalone value of the equity using the certain method maybe useful cash method or the relative valuation method or venture capital method, whatever that may be, so, the valuation has been done as rupees 220 crore; or because the company is being acquired, so there is going to be lot of synergies for this acquiring company and that synergy is separately valuated at rupees 30 crore.

So, that means the value of the base value of this company is nothing but 220 + 30, 250 crore that is your base value. Then, looking at the decision their company can make, the acquiring company management can make, so, they have thought that they can possibly pay an extra 30% premium for the stake extra as a control premium and that is one. So, in that case, what is going to be the value of the controlling block as well as the value of the minority block or minority interest for that matter.

That is one option that you have. That means first option we are not talking about liquidity problems; that means there is no liquidity problem, there is no liquidity discount. In second option, suppose control premium is there as well as liquidity problem is there, then there is discount going to be 20%. Then whatever value you are going to get is going to be less than 20% for the final valuation, then under this, what will happen to those values, controlling block as well as minority block; that is second case.

Third case is that it is not independent of what we are discussing the a and b. Suppose this company is quite dispersed and we are going to acquire shares as an investor possibly, not to control the company's affairs but it is having liquidity problem. In that case what will be the value? That means, first case, only control premium; second case, control premium plus liquidity discount; third case, no control premium, only liquidity discount. So, we will have 3 different scenarios here for one company. One example, then we will see how much value is going to be as per 3 different scenarios.

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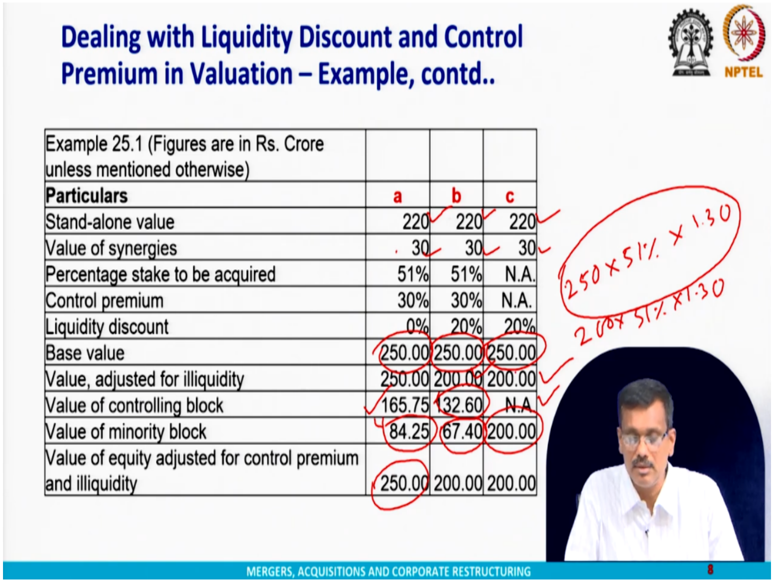

Example 25.1 (Figures are in Rs. Crore unless mentioned otherwise)			
Particulars	a	b	c
Stand-alone value	220	220	220
Value of synergies	30	30	30
Percentage stake to be acquired	51%	51%	N.A.
Control premium	30%	30%	N.A.
Liquidity discount	0%	20%	20%
Base value	250.00	250.00	250.00
Value, adjusted for illiquidity	250.00	200.00	200.00
Value of controlling block	165.75	132.60	N.A.
Value of minority block	84.25	67.40	200.00
Value of equity adjusted for control premium and illiquidity	250.00	200.00	200.00

So, a, b, c, so, standalone value we talked about 220 and the value of synergy 30 and the percentage that the company as we discussed in the example, they are going to acquire 51% stake in this company and the control premium is 30% in both the cases applicable, so, liquidity discount 0. So, finally the value, base value is nothing but 220 + 30 that comes 250 in all the cases and there is no illiquidity in this first case, so, 250 is 250 remains 250 whereas because in the second case there is an illiquidity problem, so, 20% discount to that, that means 250 is 200.

Third case also we have liquidity problem, so, 250 becomes 200. Now, 250, 200, 200 as the case may be, in that we have to find out the controlling block stake and the minority block. So, if you look at the first case which is a control premium to be given, so, 250. In that, one was to have 51% stake and for that 51% stake, whatever control they are going to give 30% premium; so, 1.30 is multiplied.

So, when you multiply that, the value comes to 165.75. So, total value is 250 and 250 - 165.75 is nothing but 84.25. That is the value of the minority block. So, overall value, there is no change. That is 250 only but control stakeholders will have more value in proportion compared to the minority stakeholders; that is the difference here. And finally, those two together gives you 250 valuation.

Same thing we do in the second case where we have liquidity problem, so, that is a value is 200, and in 200, 51% stake is there and you have control premium is there, so, 200 into 51% into 1.30. So, that gives us 132.60. So, then, rest value after 200 is nothing but 67.40. So, that is the valuation breakup; 200 is being split in 2 parts. So, one can observe the base value, is more than the adjusted value because adjusted value is adjusted for the discount, liquidity discount.

Third case, we do not have control premium problem, we have 200 only; that means everybody is taken as like minority stakeholders, minority stake, so, control premium is not there, controlling block is not there, entire value belongs to minority cell. Although the 100%, all together 100%, so, value is 200; but in here, liquidity discount is factored, so, 250 has become 200. So, this is an example where different possible scenarios can be there and the valuation can be taken care.

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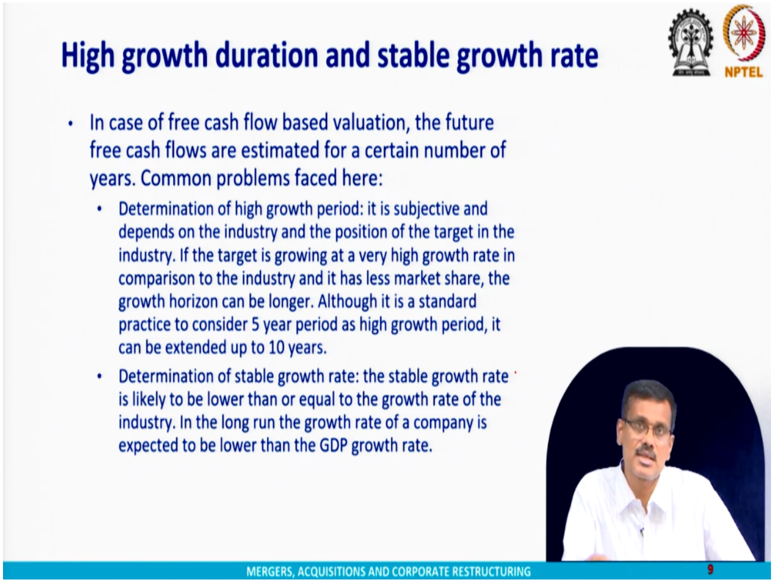

Next what you do discuss when in the context of free cash flow, we have a problem, an issue that what is the growth of the free cash flow amount and what is also the how is the final growth rate after a high growth period and also what is the duration of the high growth period; that also we come across, encounter this problem as such. And these two things are there but that is very subjective and it all depends upon how the target is placed in the industry.

The target is placed in industry; industry is growing at certain percentage but target is doing better, much better; in that case, target's growth rate may be higher than the industry growth rate because of certain unique things about these particular products, facilities and these offerings by the target company. So, they will have high growth rate period, high growth rate of certain years.

So, that case, growth relation can be higher and because they are growing at a rate higher than the industry, so, the growth horizon is going to be higher. It is usually, although there is no black and white rule that how many years to be taken, so, one takes that, popular author, they take like 5 years as a growth, high growth period. After that, the growth stabilised to a constant growth as such.

In that case, if target is going to have more super normal growth, higher growth, possibly that can be, that high growth period can be extended to maybe 10 years as such but not typically more than 10 years. After that, the stable growth; stable growth is likely to be lower than or equal to the growth of the industry. With long run, a company cannot grow more than the industry and the duration can be higher but after certain time, we will be growing with same existing business model, company will be growing at a rate either equal to or less than the industry rate.

And overall, a company will not be able to grow with the same condition, same product, same offerings at a rate higher than the overall economic growth and GDP growth for that matter. So, sometimes we assume that the constant growth that is going to take place after the growth horizon is equal to the GDP growth rate for that much. So, this is the way this problem can be tackled but this is absolutely this is subjective.

It can change from case to case, from industry to industry, company to company and the value or pointables, it can also change because there are certain assumptions the valuer makes and the values and assumptions changes, then these things can always change. So, this is only a suggested approach but it is not the exactly prescriptive approach that how do you take care of the growth relation and the growth rate for that matter.

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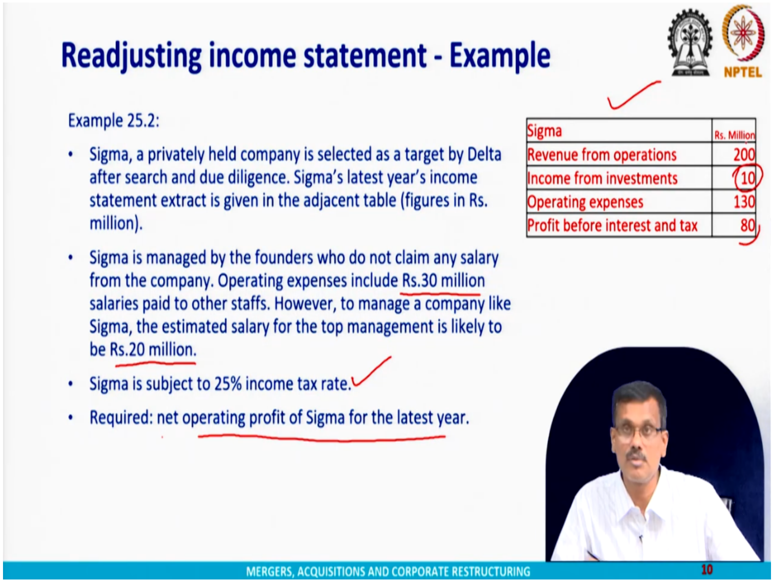

So, another problem that can happen in case of, particularly in case of privately held closed held companies that the income statement may not be in sync with generally accepted accounting principles or the financial statement not prepared with robust accounting principles, there could be some anomalies, there could be some way they have prepared statement which is not a common practice in the rest of the industry, established companies; in that case what to do?

So, we have to actually readjust the financial statement. So, in the context of privately held company, we discussed in the previous session that privately held companies are managed by the founders, the owners, so, they may be having salary and perks a very less amount chart to the company because they are managing but if the company is actually manage their professionals independently, they may have more salaries and perks.

So, the operating cost of the start-up companies or private held companies may not reflect fully the operating cost because they may not be charging their salaries, the perks facility as an employee as such. So, they will be doing something like a free of cost service but if the company is being acquired, we have to have the management and pay salaries for that matter. In that case, we have to book the salary expense, we have to readjust the financial statement.

So, for example, in this particular company Sigma, revenue from operation is let us say 200 and income from other some investment is 10 million and operating expenses come to 130 and then in that case the profit before interest and tax comes to 200 + 10 - 200 comes to 80 million rupees but what they have found out that the founders or men in the company had this company managed by professionals, they would have possibly paid another 20 million salary.

What they are paying presently 30 million salary to the existing staff, they are not the owners or founders of the company, so, they would have paid 20 million salary if they had the professional management. And the company is subject to 25% tax rate, we have to find out what the net operating profit after the tax for the Sigma for the latest year, on this particular year; that you have to find out.

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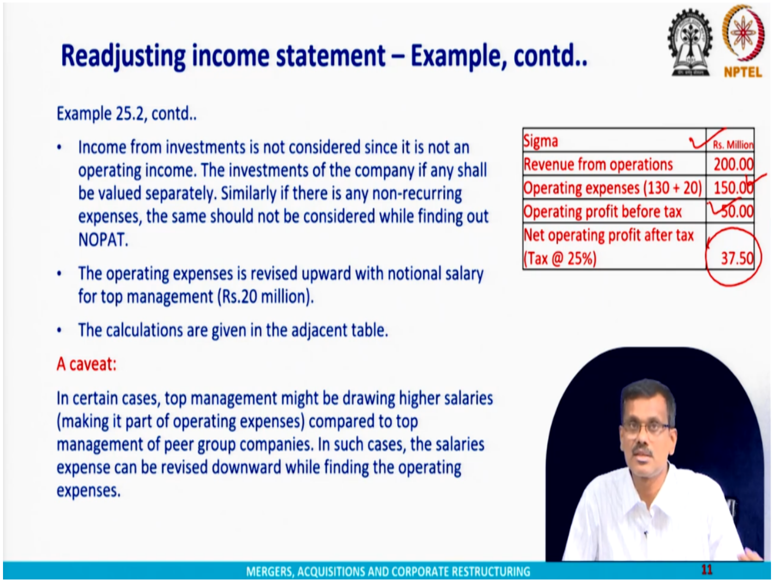

So, the first, what you do here, we have 200 million; the first thing that we do is the operating expense is adjusted for these salaries to be paid plus we say instead of 130 we take 150 now. So, operating profit as 50 and in this you are not considering the income from investments because we are looking at the operating value of the company, so, we are not considering that, so, 50 million rupees is the operating profit before tax and we take 25% tax out, so, net operating profit after tax no part comes 37.50.

As far as the investment income is concerned, the investment itself will be valued separately and that value can be added to the value that we are going to get using this particular profit or cash flow for that matter. So, that type of adjustment will be there. Another problem can be within a caveat could be that I can say, one can alert, in some cases, the top manager may be drawing more salaries than what they should be drawing as a professional manager.

So, they may be booking more as an expense. That is the way they can extract the cash flow from the company in their favour instead of taking as dividends, etcetera. In that case, the operating expense will be adjusted downward because they have booked more salaries than a comparable company is going to pay for such a management as such. So, maybe they have booked 50 million rupee salaries let us say, but actually booked 30 million; in that case, the operating expense will be reduced by 20 million; 50 minus 30 comes to 20.

In that case, the profit is going to be higher. So, both the options are, both the possibilities are there. So, the alert here is that one has to readjust looking at the peculiarity of the target, peculiarity of the condition for assessment. One has to readjust financial statement and that will be the basis for the estimation of forecasting of cash flow, profit, etcetera.

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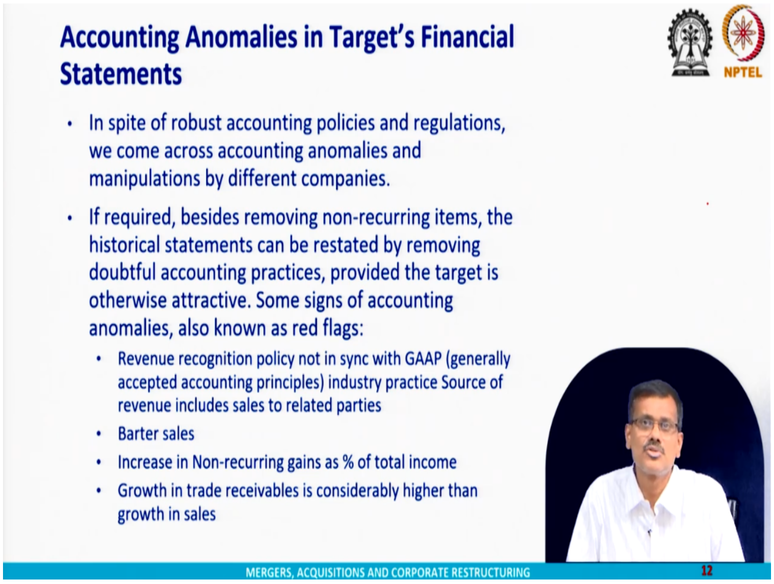

Then, in case of certain companies, it is not related to only start-up for that matter, there could be a target which is established company also but they may be following certain accounting policies which are not in sync with what the industry follows because accounting policies give a good elbow room to have certain different policies. For example, suppose you look at depreciation method, there are multiple ways of depreciation method which is possibly allowed by the regulator or the accounting standard for that matter, but industry may be following a particular accounting method of depreciation for that matter.

In that case, we expect that the company also follows what the industry is following and then when you do that, when you do the due diligence to find out that the method of depreciation followed by the target is different than the method of depreciation followed by acquiring company, in that case, you have to recast the financial statement with the method of depreciation as per the acquiring company's policy and then look at the figures as such; that is one.

That is to make it same; otherwise also, there could be deliberately companies might be misrepresenting, may be mismanipulating the financial statements. So, one has to be very careful about that. And accordingly, we have to readjust the financial statement figures; of course, one thing is that if you come across such and such anomalies more and more in a company, possibly that target may not be, we should not look at the target, we may walk away from the deal; no, we do not need this company which has got lot of accounting anomalies.

That is one option but still the target is very attractive from the strategy business product market point of view, then in that case, we should be as an acquiring company we should be readjusting the financial statements based on the best accounting practices, then do the valuation based on those figures and then quote the value as such. Do it, let us not go by what the company has actually suggested.

So, certain examples could be like when you can say that the company is not having a proper accounting policy, one of the rates will be, we have given certain examples here but it is not exact, it could be more and more things could be there. One can possibly refer to accounting anomalies separately for that but here just an alert as an acquiring company what should you look for; so, like revenue recognition.

Revenue recognition is that when you can recognise revenue. So, revenue recognition can vary. Usually, we say that the, if we are going to get the money from the customer and you have done this job then you recognise revenue. If you are not done this job but still got the money, you do not recognise revenue. We do on actual basis. Some companies may book the revenue on cash basis and so very high revenue.

Although the revenue that they have got for is for some other accounting period, so, they book in this same year, so, their accounting policy may be; so, in that case, the revenue could be overestimated. So, in that case, we have to actually lower it and then we have to adjust it and book the revenue which actually acts for the accounting policy. The companies are engaged in barter sales, so, company X sells to company Y; Y sells to company X like an exchange.

Both the companies show the sales in the top line. So, if that is found out, then you should remove those barter sales because that is not a true sale. It is not sold to the end customer as a result to another company in the same sector where may be like a neighbour as such just to; so, both the companies can possibly show more revenue by having barter sales. Then, companies might be influencing the profit by having one-time non-operating gains; maybe income on investments, maybe in gain on self-disposal of asset.

So, they are part of the top line and then accordingly profit is calculated. So, profit is higher because of those other incomes; in that case, it has to be readjusted. So, those one-time items, exceptional items should be removed and then revenue, expenses to be estimated and then one has to find out the cash flow or profit, etcetera. So, if that is increasing as a percentage non-recurring gains, then you have to look at it.

There is some problem; we have to now go back and do those recalculations. Company's receivables that you have, trade receivables because credit sales may be growing at a higher rate than the growth in sales. That means what? The company is extending more credit period so that they have more sales and but they are not able to collect this money from the customers in time.

So, that is also one of the red flag or there is some problem might be there as such. In that case, one has to look at, yes. That means what? Extra sale is because of the extensive credit period is not actual sales for the company. So, in that case, you have to underestimate the sales than what is there in the income statement.

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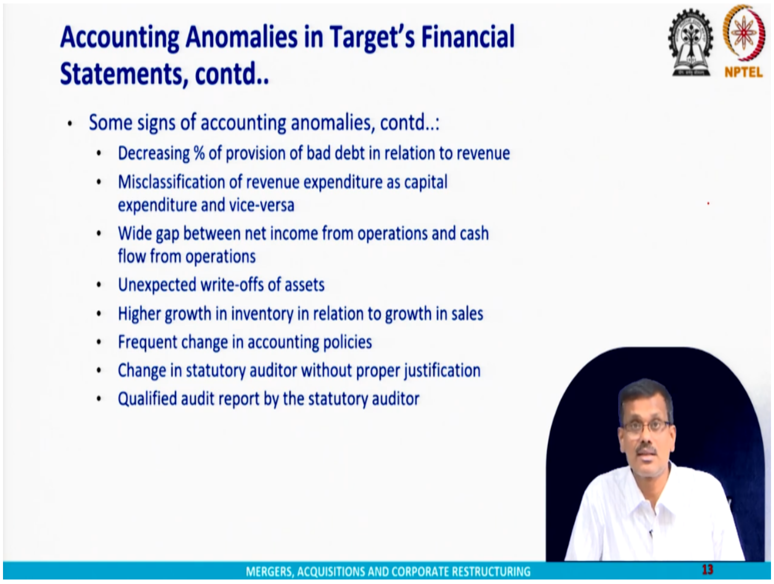

Then, companies have to create a provision for bad and doubtful debt. If you create a provision for bad and doubtful debt, what will happen? The profit of the company is going to be lower. So, since the profit is going to be lower, I do not want the profit to be lower, so, the provision for bad and doubtful debts is a certain percentage was there earlier, maybe 2%, now they say let us say 1.5%, so, what will happen?

The provision for bad and doubtful debts is going to be lower although likely that it is going to be higher but they still make a provision, lesser provision for the time being so that they show more profit now and actual bad debt could be higher than what provision they have made, so, they will have implication on the profit or cash flow in the subsequent time period also.

So, one has to look at if that percentage is declining, one has to see that what is the problem. We have to find out why it is that and make some of the queries and satisfy your way that particular decrease is okay. Then one can look take that figure, otherwise re-estimate and put a more value for the provision for bad and doubtful debt. Then, some companies what they do, they misclassify the revenue on a capital expenditure.

So, they will be actually having a revenue expenditure again, maybe repair and maintenance and instead of showing as repair and maintenance expense, they will say it is an addition to asset like capital expenditure. What will happen in that case? We will be showing less expense, means more profit, and this amount will be taken as like investment made. So, asset value will be higher, profit is also going to be higher but it is actually over estimation of asset as well as overestimation of profit.

So, one has to be careful that what they have done. So, this is another sign that yes, company can indulge and have this possible manipulations, one can do a red flag, those things. Then, the cash flow and profit are very much different; operating profit and operating cash flow should be as close as possible only because the depreciation the amount is going to be different, otherwise they should be as close as possible.

Cash flow operation and profitable operation should be as close. If that figure is very different, quite different, there could be some problem. For example, if the company has made lot of credit sales but not collected, so, that is not going to reflected in cash flow operation but it is going to be reflected in profit because revenue is recognised on this actual basis. So, that means they are providing more credit opportunity, credit period.

That is why sales is taking place but cash collection is not there. Then you have to see that there is some problem and accordingly you have to make those adjustments. There could be all of a sudden write-off of assets are there; maybe the asset was actually becoming bad, impaired, not functioning properly, they are no more useful; instead of reducing value in the previous period, now suddenly they have reduced because maybe there is some monitoring of that company.

So, that is also not correct. And inventory is growing at a growth more than sales. That means, the inventory is piling up, they are producing more or procuring more but sales is not taking place. So, that means, in that case, maybe overall cost of production may be lower but that inventory is actually, production per unit is going to be lower because more production but it is going to be a problem because you have the stock not sold.

So, lot of inventory is there and you will have the cash flow problem also. And accounting policies give some elbow room like method of inventory valuation, method of depreciation, revenue. There are certain elbow rooms, means certain alternatives may be there also. We can follow a method X, method Y like that, but if this company has to be consistent in following the methods, suppose this method that is followed for some estimation is changing frequently, that means there could be some problem in intention of the management, they are not possibly fair in their approach while preparing financial statement.

And then, there is a change in auditor more frequently, very frequently without any proper justification. Auditor can change, auditor rotation can always be there but change in auditor could be there because something else may; auditor is objecting, then change in auditor has taken place. Then, auditor gives a qualified report. Qualified report means auditor is, it is not a good report, there are certain lapses they have found out, they have asked the company to take care of it but the company has possible not agreed.

In that case, auditor may certify the report with the qualification that these things were not actually followed. So, qualified auditor report is a signal that this company's financial statements unprepared, not prepared as per the accounting rules, so, we have to be careful.

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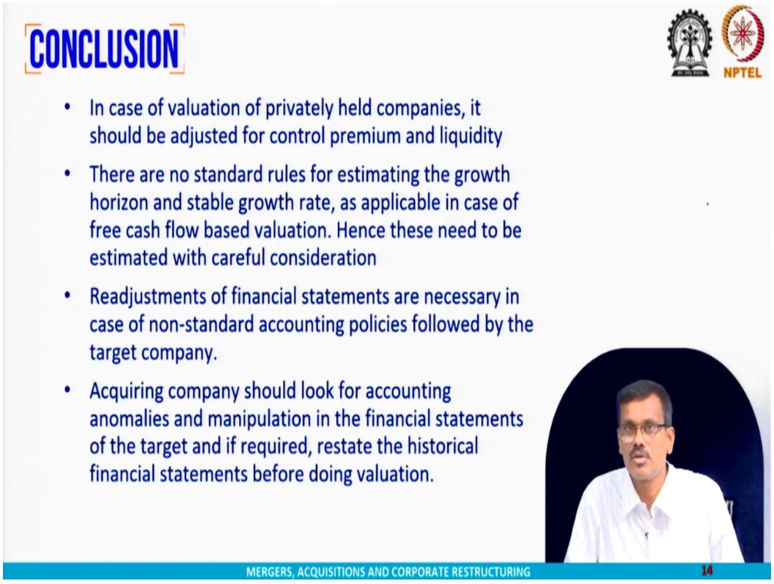

So, these are the things one has to be careful as such as per financial statement is concerned. If required the company should be, target company's financial statements should recast and new statement prepared and then valuation estimation can be done. So, in conclusion, in case of valuation of privately held companies, one should adjust for control premium and liquidity, liquidity discount for that matter and there is as far as estimation of future over growth horizon as well as the stable growth, there is no shortcut black and white fixed formula but one has to be very careful about it and can vary in a range.

And in case of again typically in privately held companies or for that matter any company for that matter, readjustments could be there necessary for financial statements and acquiring company also should look for accounting anomalies, red flags, manipulation of financial statements of the target, otherwise what will happen, we may carry those policies, accounting policies and we are going to have problem subsequently as such.

And our valuation is based on miscalculation, so, then we possibly will be ending up overpaying for the company besides taking over certain problems in the company without knowing that also. So, one has to be very careful. Once we carefully know that, then the statements can be recast and then do the valuation.

As a concluding note, in these cases, the company is actually, target is actually good product wise, strategy wise, market wise some attraction is there, that is why you are going for it; and accounting anomalies can be taken care separately and valuation can be done accordingly, in that case only, otherwise one can possibly say that we will not go for this particular target as such because the target's financial statements have lot of problems. So, this is what.

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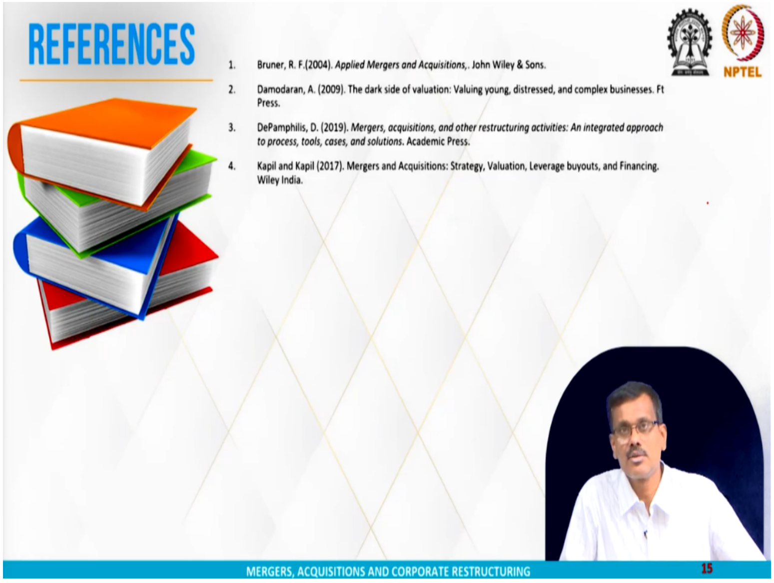

And we will be going to the next week on the Structuring of the Deal. Thank you and happy learning.