# Rationale and Valuation techniques for MERGERS AND ACQUISITIONS

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**IBM to Buy Daksh e-Services. Deal Worth Close to USD 150 Million……**

**Bank of America to Pay $47 Billion in Shares to Buy FleetBoston……..**

**J.P.Morgan Chase to buy Bank One….**

**HCL Tech Buys 51% Stake in Deutsche Soft……**

**Idea Buys 75% Stake in Escotel……**

**GM May buy 80% of Fiat Next Year……..**

We come across such headlines on newspaper front pages day in and day out. Why do companies merge? Why do they pay millions and billions of dollars for such acquisitions? Why should a business takeover another? How does a seller put a price on his offer? This article seeks to examine the rationale for Mergers and Acquisitions, popularly known as M and A, as well as valuation techniques that are used in such situations along with some case studies.

## M AND A AS A BUSINESS STRATEGY

Broadly, there are two ways to grow a business - through organic growth and through inorganic growth. While taking the organic growth path, the company incrementally grows its people, customers, infrastructure resources and thus revenues and profits, an inorganic growth would provide instantaneous growth enabling the company to skip a few steps on the growth ladder. Mergers and Acquisition (M&A) is an inorganic growth strategy.

## CATEGORIES OF M &A s

Mergers, acquisitions, takeovers, etc. are terms that are generally used interchangeably, but often differ by situation. Merger normally refers to unification of two equal players into one entity. Acquisition refers to one player buying out another to combine the bought entity with itself. Takeovers could be Amicable (*such as IBM's acquisition of Daksh*) or Hostile (*such as Oracle's bid for Peoplesoft*). Again, such deals could be Domestic (*HLL's acquisition of Modern Foods*), International (*IBM's acquisition of*

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*PricewaterhouseCoopers' consulting business*) or Cross border (*Tata Tea's acquisition of Tetley*). Also, the acquisition could be a Purchase where one business buys another or a Management Buy Out, where the management buys the business from its owners (*BPEP management's acquisition of private equity business from ING*).

## RATIONALE FOR M & A

There are several reasons for M&A. ***M&A has been widely used in developed economies as a growth strategy and is now increasingly getting accepted by Indian businesses as a critical tool of business strategy.*** It is increasingly becoming the order of the day in businesses especially in rapidly evolving businesses like information technology, telecommunications, business process outsourcing as well as in traditional businesses. Indian businesses are also rapidly using M&A to grow internationally.

Results of the International Business Owners Survey recently carried out by Grant Thornton through 6,900 interviews conducted in 26 countries in Europe, Africa, Asia-Pacific and the Americas, say that ***34% of businesses will use M&A as a method to maintain or improve profitability***. Businesses are acquired to gain strengths, expand customer base, cut competition or enter into a new market or product segment (*European media groups such as Bertelsmann, Pearson, etc. have driven their growth by expanding into the United States through M&A).* When HLL acquired Lakme, it got an entry into the cosmetics market through an estab-

lished brand. Similarly, when Glaxo and SmithKline Beecham merged, they not only gained market share, but eliminated competition between each other. IBM-Daksh is a case in point for acquiring a competence (*detailed case study later in this section).* Tata Tea's acquisition of Tetley was made to leverage Tetley's international marketing strengths (*Tetley has a strong market network in 35 countries across the world while Tata Tea's strengths lie in tea production*). Ashok Leyland Information Technology (ALIT) was acquired by Hinduja Finance, a group company, so that it could set off the accumulated losses in ALIT's books against its profits.

In order to maximise value creation it is important to focus on one's core competencies. It is therefore equally important to plan for selling a business as it is to acquire a business. Grant Thornton's International Business Owners' survey results show that 56% of businesses will eliminate non-core services activities to maintain or improve profitability.

Hence, a key reason for divesting a business could be to focus on core activities (HLL is trying to prune non-core brands to concentrate on power brands through sale of brands like Dalda, Glucovita, etc.). The other reasons could be declining profitability or as an exit opportunity for promoters. The table shows the key rationale for some of the well known transactions based on public knowledge.

**Rationale for M&A**

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|---|---|
| Instantaneous growth, Snuffing out competition, Increased market share· | • HLL - Lakme, Glaxo - Smithkline, Daimler - Chrysler |
| Acquisition of a competence or a capability | • ICICI - ITC classic (retailer net work & depositor's base), IBM - Daksh |
| Entry into new markets/ product segments | • Vodafone - Mannesman, Mannesman - Orange, Tata - Tetley |
| ·Access to funds | • TDPL - Sun Pharma since TDPL did not have funds to launch net products |
| Tax benefits | • Ashok Leyland Information Technologies with Hinduja Finance |

Typically financial investors or venture capitalists look for exit opportunities through a trade sale to a strategic investor at some stage. With the venture capital industry maturing internationally and in India, currently

many such firms are looking at such exit options. According to a survey by Grant Thornton Corporate Finance, over the next six months, almost 65% of mid-market venture capitalists believe they are likely to realise a higher number of disposals than they were able to achieve during the past six months.

A business could be demerged to form two different businesses for tax purposes or to correct market under-valuation by creating greater focus in each business. *(Ramco Systems demerged by Ramco Industries).*

## VALUATION FOR M&A

*Beauty lies in the eyes of the beholder; valuation in those of the buyer.* The value of a business is a function of the business logic driving the M&A. and is based on bargaining powers of buyers and sellers. Since business is based on expectations which are dynamic, valuation also tends to be dynamic and not static which means that the same transaction would be valued by the same players at different values at two different times.

There are several techniques to value a business. Broadly, these can be classified into earnings based valuation, market based valuation and asset based valuation. Earnings based valuation (discounted cash-flow being the most common technique) takes into consideration the future earnings of the business and hence the appropriate value depends on projected revenues and costs in future, expected capital outflows, number of years of projection, discounting rate and terminal value of business. Thorough diligence has to be exercised in deciding these above factors since these factors would differ from sector to sector and company to company.

In a cost to create approach, the cost for building up the business from scratch is taken into consideration and the purchase price is typically the cost plus a margin. This is suitable in cases like build-operate-transfer deals. The value of a business is estimated in the capitalized earnings method by capitalizing the net profits of the business of the current year or average of three years or a projected year at required rate of return.

While using the market based valuation for unlisted companies, comparable listed companies have to be identified and their market multiples *(such as market capitalizations to sales or stock price to earnings per share)* are used as surrogates to arrive at a value.

The asset based value considers either the book value (assets net liabilities) or the net adjusted value (revalued net assets). If the company has intangible assets like brands, copyrights, intellectual property etc., these are valued independently and added to the net asset value to arrive at the business value. Sometimes, if the business were not to be acquired on a going concern basis, the liquidation value (or the realization from sale of assets) is considered for the purpose of valuation.

Premiums and discounts are typically attached to a business valuation, based on the situation. These could be market share premium, controlling stake premium, brand value premium, small player discount or unlisted company discount. In addition, it may be required to work out various potential scenarios in each methodology and arrive at the likely probabilities of each while deriving the values.

Timing is very critical while divesting a business since valuation depends on the timing. Timing of sale is crucial keeping in mind economic cycles (*deal valuation takes into consideration GDP growth rates*), stock market situations (*which would decide market multiples*), global situations (*like a war or terrorist attacks*). In times like the above, the price expectations between the buyer and the seller would widely vary. For example, during a stock market lull, there could be a situation where there

### Valuation Techniques

**Earnings based valuation**

- discounted Cashflow/ Free cashflow
- Cost to create approach
- Capitalised earnings method

**Market based valuation**

- Market capitalization for listed companies
- Market multiples of comparable companies for unlisted company

**Asset based**

- Net Adjusted Asset Value or economic book value
- Intangible Asset Valuation
- Liquidation Value

are more buyers but no sellers due to the low valuation.

The basis for M&A is the expectation of several future benefits arising out of synergies between businesses. There is a risk involved in realizing this synergy value. This could be due to corporate, market, economic reasons or wrong estimation of the benefits / synergies. A key case in point here is the high valuations at which internet companies were acquired in the year 2000 (*such as Satyam's acquisition of India World for USD 100 Million*).

There are also social and cultural issues post-merger. These are primarily related to work culture, management style and human resources. Synergies fructify only when these issues could be sorted out very early in the merger.

It is also important to try and work out valuations from as many of the above methods as possible and then try and see which methodology is to be taken in and which are to be rejected and derive a range of values for the transaction in different situations in case one is called upon to assist in advising the transaction valuation. Some methods like Net Asset value or past earnings based methods may prove inadequate in case of growing businesses or those with intangible assets.

Some case studies are listed below based on actual Indian situations and an analysis based on published data is given below.

## CASE STUDY - RATIONALE FOR M&A AND VALUATION

### IBM acquisition of Daksh e-Services

The USD 89 billion IBM pro-

poses to buy 100% stake in Daksh e-Services. Daksh is one of the leading independent third party BPO services providers in India and ranks among the top three. Daksh was estimated to have revenues of about USD 50 Million and net profits of USD 10 Million for FY 2004. The deal is expected to be completed by May 2004 and the value of the deal is estimated to be between USD 130 to 170 Million. This works out to a sales multiple of 3 and earnings multiple of 15.

While the valuation could typically be considered to be on the higher side (*smaller firms in this space would command a revenue multiple of 1 to 1.5*), several factors have made the deal worth its premium. These include the larger size of Daksh, the fact that it was IPO-ready and customer synergies (*IBM has several existing contracts with the two large customers of Daksh - Sprint and Aetna* ). Also, IBM has recently increased its India focus and it currently has 4500 people working in the software services and BPO areas.

The deal proves beneficial for Daksh as well considering that it is now stronger to face the stiff competition from not only Indian third party players, but large multinational players as well. Also, the deal would provide reasonable returns for its current financial investors and give them an exit opportunity.

## CASE STUDY - VALUATION ANALYSIS

### Listed software company X to merge with unlisted company Y

Company X and company Y were in the software services business. X was a listed company and Y was an unlisted entity. X and Y decided to merge in order to benefit from marketing, operational synergies and economies of scale. With both companies being mid-sized, the merger would make them a larger player, open new market avenues, bring in expertise in more verticals and wider management expertise. For company X, the benefit lied in merging with a newer company with high growth potential and for company Y, the advantage was in merging with a business with track record, that too a listed entity.

The stock swap ratio considered after valuation of the two businesses was 1:1. Several key factors were considered to arrive at this valuation. Some of them were very unique to the businesses and the deal:

- Valuation based on book value / net asset value would not be appropriate for X and Y since they are in the knowledge business, unless other intangibles assets like human capital, customer relationships etc. could be identified and valued.
- X and Y were valued on the basis of a) expected earnings b) market multiple
- While arriving at a valuation based on expected earnings, a higher growth rate was consid-

ered for Y, it being on the growth stage of the business life cycle while a lower rate was considered for X, it being in the mature stage and considering past growth.

- Different discount factors were considered for X and Y, based on their cost of capital, fund raising capabilities and debt-equity ratios
- While arriving at a market based valuation, the market capitalization was used as the starting point for X which was a listed company. Since X had a significant stake in Z, another listed company, the market capitalization of X reflected the value of Z as well. Hence the market capitalization of Z had to be removed to the extent of X's stake from X's value as on the valuation date.
- Since Y was unlisted, several comparable companies had to be identified, based on size, nature of business etc. and a composite of their market multiples had to be estimated as a surrogate measure to arrive at Y's likely market capitalization, as if it were listed. This value had to be discounted to remove the listing or liquidity premium since the surrogate measure was estimated from listed companies.
- After arriving at two sets of values for X and Y, a weighted average value was calculated after allotting a higher weight for market based method for X (being a listed company) and a higher weight for earnings based method for Y (being an unlisted but growing company). The final values for X and Y were almost equal and hence the 1:1 ratio was decided.

## CASE STUDY - RATIONALE FOR M&A AND VALUATION

### Citigroup to buy 100% stake in e-Serve International

US-based banking major Citigroup has announced that it intends to buy out the 55.6 per cent public shareholding in its publicly listed subsidiary, business process outsourcing company e-Serve International, for Rs 550 crore. Citigroup is looking at offering e-Serve's existing shareholders up to Rs 800 per share for buying their holding in the company. This puts the enterprise value of e-Serve at more than Rs 1,000 crore. Citigroup is the largest shareholder with its current stake of 44.4 per cent. Citigroup is also the sole customer of e-Serve which makes it a captive unit of the banking major. e-Serve provides back office services to Citigroup companies.

Citigroup has offered a price of Rs 800 per share as against the closing price of Rs. 630 on the date of announcement (April 8, 2004). Also, the price is at a 26% premium over the 52 week average share price. Why would Citigroup which already owns the largest stake want to buy out all of e-Serve, that too at a premium?

Citigroup expects several potential integration benefits from the buyout. Since e-Serve caters not only to Citibank's requirements, but more importantly, to Citibank's customers requirements through its call centre and other back office operations. Citibank feels it is crucial to have full stakeholding of e-Serve to ensure operational flexibility and control.

Also, from a financial and business perspective e-Serve has grown by leaps and bounds since it started business as a small check processing centre in 1992. Today e-Serve's 5,000 employees provide services to Citibank India and Citigroup businesses in Europe, Africa, North America and South Asia. The company had a net profit of Rs115.1 million on revenue of Rs850 million in the quarter to Dec. 31 2003. e-Serve is expected to grow at 30% in revenue and profits in the next two years.

This acquisition is strategic in nature considering not only internal synergies, but also the India outsourcing story. India is becoming the preferred back office centre to the world's leading companies.

In summary, the challenge to valuing for M&As is to obtain a thorough understanding of the business dynamics of both the parties, the rationale for the merger, the industry dynamics, the resulting synergies as well as the likely risks of the transaction are required in order to ensure that the valuation is such that it is a 'win-win' for both the parties and is financially viable. It is also important to understand that there are no hard and fast rules since one is projecting the future which is 'unknown' based on current understanding. Therefore, experience, good judgment and diligence are important in working out values.