VALUATIONS

Let’s talk business beyond the literature

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“Knowing the worth is empowering ”

— CA Vaibhav Jain

Inc42 Media

Flipkart Likely To Go Public In 2021 At Valuation Of $40-$45 Bn

Flipkart may go public as early as next year at a valuation of $45 - $50 Bn. The ecommerce giant would look at an overseas listing, either in the ...

4 hours ago

TechCrunch

India's online learning platform Unacademy raises $150 million at $1.45 billion valuation

India's online learning platform Unacademy raises $150 million at $1.45 billion valuation. Manish Singh@refsrc / 3:34 am PDT•September 2, ...

2 weeks ago

TechCrunch

Indian fantasy sports app Dream11's parent firm raises $225M at over $2.5B valuation

Indian fantasy sports app Dream11's parent firm raises $225M at over $2.5B valuation. Manish Singh@refsrc / 12:45 am PDT•September 14, ...

2 days ago

Economic Times

RIL buys out retail & wholesale biz of Future group for Rs 24,713 crore

Reliance Retail and Fashion Lifestyle (RRFLL) and RRVL will take over certain borrowings and current liabilities related to the business and ...

2 weeks ago

Entrackr

Jio dilutes 25% stake; raises fresh funds from Intel Capital

The latest investment values Jio platforms at an equity valuation of Rs 4.91 lakh crore and an enterprise value of Rs 5.16 lakh crore.

Jul 3, 2020

ETtech.com

Byju's gets fresh funds from US private equity biggie Silver Lake at $10.8 billion valuation

Byju's gets fresh funds from US private equity biggie Silver Lake at $10.8 billion valuation. Silver Lake's investment comes just weeks after tech ...

1 week ago

Livemint

GSK sells HUL stake for Rs25,480 crore in largest secondary trade on exchanges

"GSK has, through its subsidiaries GlaxoSmithKline Pte Ltd and Horlicks Ltd, today agreed to the sale of 133,772,044 ordinary shares in HUL at a ...

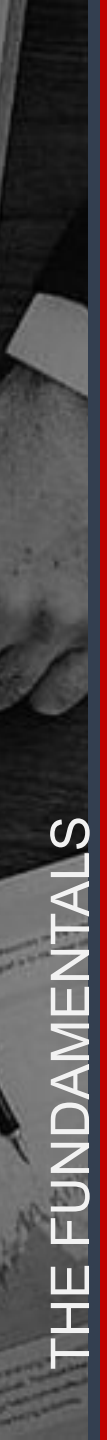
May 7, 2020

BUSINESS VALUATION

BUSINESS VALUATION

- ✓ Business Valuation can be looked at as both, a science and an art.
- ✓ As a science, it derives its basic principles from the theory of corporate finance and investments.
- ✓ As an art, it evolves out of the myriad ways analyst value businesses in practice.
- ✓ While valuing companies, the practitioners need to be proficient in the theory of corporate finance to get theoretically consistent estimates of enterprise value as well as develop practical skill out of experience and rational mind set while applying those theoretical concepts in a practical world and steering through complex scenarios ensuring the accuracy and reliability of the estimates as well as outputs of the whole valuation exercise.

THE FUNDAMENTALS



THE FUNDAMENTALS

Fundamental Analysis involves examining the economic, financial and other qualitative and quantitative factors related to a Business/ Entity

It attempts to study everything that can affect the security's value, including macroeconomic factors (like the overall economy and industry conditions) and individually specific factors (like the financial condition and management of companies).

It also involves delving into a company’s financial statements such as profit and loss account and balance sheet.

To sum up, Fundamental analysis is the examination of the underlying forces that affect the wellbeing of the economy, industry groups, and companies

QUALITATIVE V/s QUANTITATIVE

Quantitative: Capable of being measured or expressed in numerical terms.

Qualitative: Related to or based on the quality or character of something, often as opposed to its size or quantity.

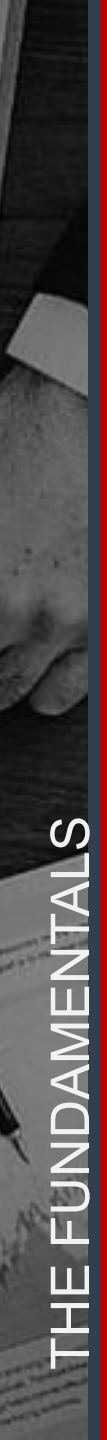
- ✓ Quantitative fundamentals are numeric, measurable characteristics about a business. It's easy to see how the biggest source of quantitative data is the financial statements. You can measure revenue, profit, assets and more with great precision.

- ✓ Turning to qualitative fundamentals, these are the less tangible factors surrounding a business - things such as the quality of a company's board members and key executives, its brand-name recognition, patents or proprietary technology.

THE FUNDAMENTALS

Before diving into pool of numbers and the universe of spreadsheets, one should acknowledge that Valuation is much beyond numbers. Therefore, the practitioner should take a moment and first understand business of the subject entity and the environment in which it is operating.

This would enable the practitioner to draw a comprehensive understanding of the subject entity and carry out the valuation exercise with more precision and in a realistic manner.



THE FUNDAMENTALS

The stepping stones of Business Valuations is getting the fundamentals right and understanding the business and the environment in which it is operating is a primary one.

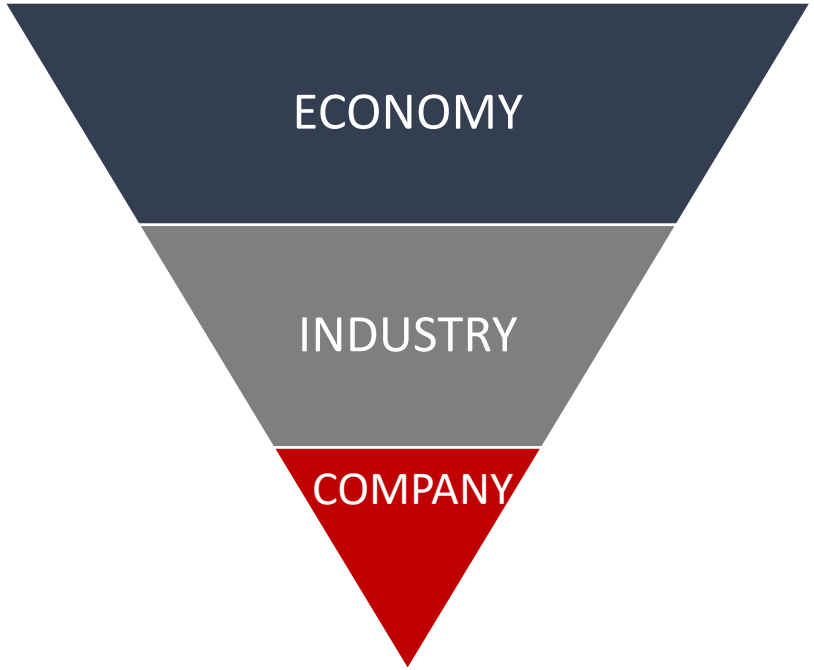
One has to analyse and gain understanding of

- Macro Economy to gain a birds eye view
- The Industrial level economics
- The subject entity/company

There can be n number of ways to assess the above mentioned but following a pre-empted framework can also come handy and ensure all the boxes are ticked. Going forward in the session, we will get acquainted to framework and tools that can enable the practitioner to gain the understanding of the business in a holistic manner.

EIC FRAMEWORK

The analysis is a 3 layer analysis wherein the analysis of economy, industry and company is carried out. The logic behind 3 layer is that the performance of the company depends on the performance of the industry and economy as a whole. In the era of the globalization we may add one more layer to the diagram to represent the international economy.



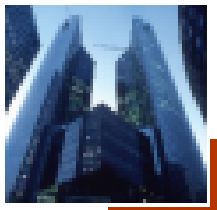
EIC FRAMEWORK

Economy

- GDP Growth rates
- Sectoral analysis of GDP
- Foreign policies
- Inflation rate
- Unemployment rate
- Per Capita income
- Monsoon condition
- Overall debt situation
- Interest rates
- Economic policies of the government

Industry

- Nature of industry
- Lifecycle of industry
- Specific industry policies
- Degree of competition
- Labour situation
- Consumption pattern
- Taxation laws
- Exposure to external/overseas forces
- Technological innovation



Company

- Products and services offered
- Management
- Business model
- Capital Structure
- Market share
- Management decisions and corporate governance
- Ratio analysis
- Marketing strategies
- New launch

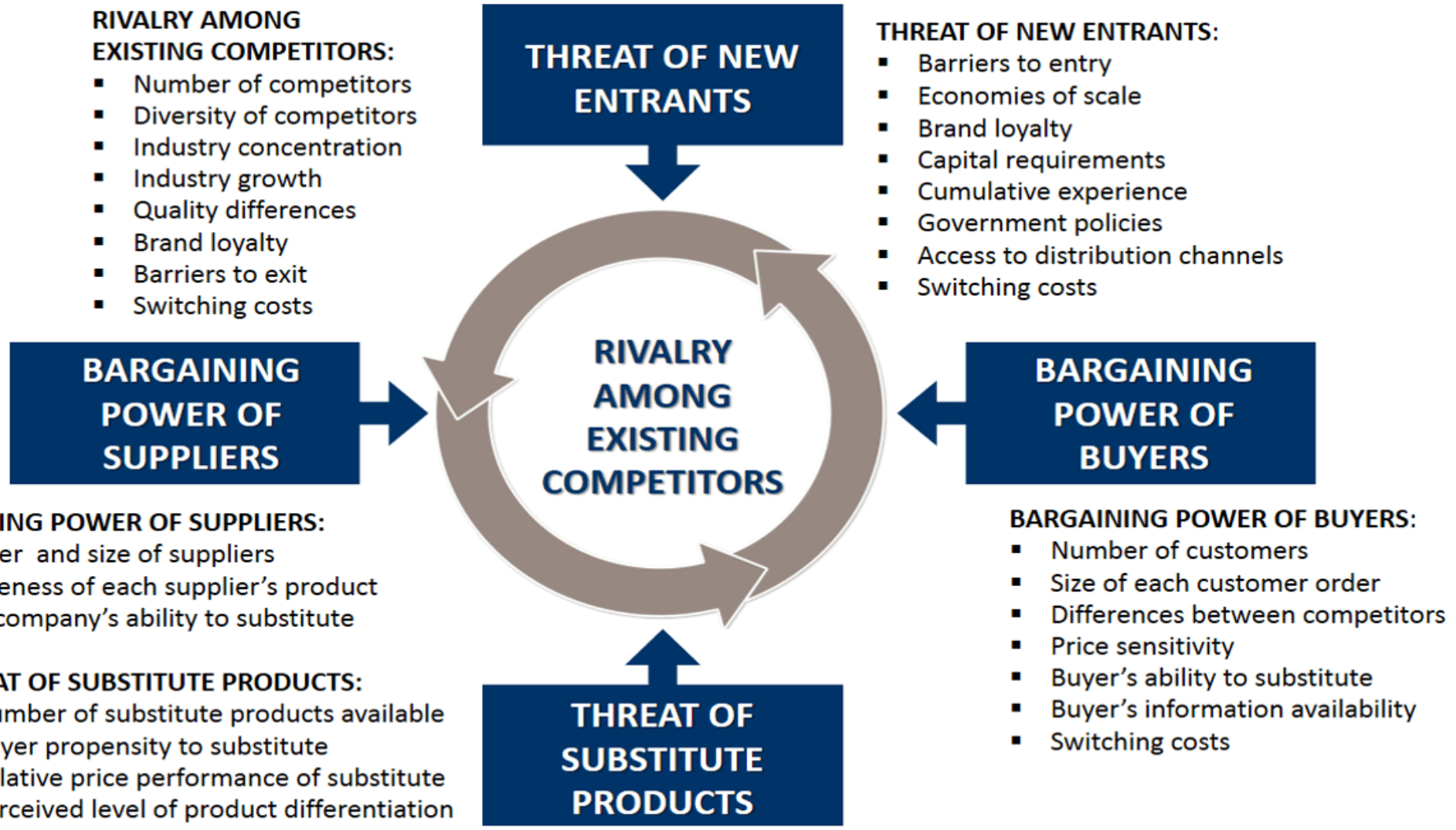
THE FUNDAMENTALS

Porter's Five Forces Model

Porter's Five Forces is a business analysis model that helps to explain why different industries are able to sustain different levels of profitability.

The model is widely used to analyze the industry structure of a company as well as its corporate strategy. Porter identified five undeniable forces that play a part in shaping every market and industry in the world. The forces are frequently used to measure competition intensity, attractiveness and profitability of an industry or market.

Porter's Five Forces Model



Porter's Five Forces Model

Buyer's Power

Buyers have the ability to influence the decision-making process of a company. Buyers with a lot of power can force prices down or demand that the company put more value into a service or product. Buyers are able to gain all the value for themselves, consequently decreasing profitability for the industry. If a company has many smaller buyers, the company is able to lose one such customer without any detrimental effects on the business. However, if the company has few larger buyers, this is not the case. Buyers have power if the following occur:

- A large volume of product is purchased by fewer buyers.
- Buyers are able to switch companies without incurring costs to themselves. This is due to the undifferentiated and standard nature of the products or services.
- Buyers have complete information on how the industry is working, including demand, actual market prices, and even supplier costs. This information can place buyers in a better negotiating position.

Porter's Five Forces Model

Supplier's Power

Similar to buyers, suppliers can also influence industry decision making. Suppliers are able to dictate terms of business such as price, quality, delivery times, etc. A company should not be dependent on one large supplier but have many smaller suppliers in order to decrease supplier power. Suppliers retain their power due to the following:

- Suppliers are concentrated or have a monopoly on supplies.
- There are no real substitutes available to compete against.

Porter's Five Forces Model

Potential Entrants

These are individuals looking to enter the industry and create start-ups to compete with the existing companies and gain market share. Barriers to entry are the most critical variables which determine the position of an existing company in the industry. If the factors to start the business-like capital expenditure, technical know-how, regulations, cost advantages, customer's brand loyalty etc. are high, the barriers for new entrants will be higher. The absence of these will allow for easier access for new entrants.

Substitutes

These are alternatives to the existing products or services available that customers can easily switch to. These substitutes have the most power when providing products/services with the same function but at higher quality and lower cost. This concept can restrict industry profitability due to the improvement of price-performance tradeoff, therefore producing higher profits for others.

Porter's Five Forces Model

Industry Rivalry

Firms with the same industry have the tendency to compete in an attempt to dominate the market. Rivalry is dependent on the number of firms within the same market and the extent to which they collude with each other. Rivalry occurs because there is opportunity or pressure for improvement. Firms compete using a variety of strategies, including price competition, advertising battles, product introductions, customer services changes and extended warranties. Rivalry is able to keep prices down, improve quality and therefore benefits industry customers.

THE FUNDAMENTALS

Porter's Five Forces Model

NETFLIX

Netflix is a US-based internet streaming media provider founded by Reed Hastings and Marc Randolph in 1997. It originally started with providing DVD-by-mail service in North America and now provides digital streaming with services available worldwide. Although Netflix is the most popular online subscription service for streaming entertainment in the world, there are some issues which threaten the long-term viability of their business model. Below is an assessment of Netflix using Porter's Five Forces model to determine how market forces may affect the company's business.

Porter's Five Forces Model

NETFLIX

Power of Buyers

The bargaining power of buyers is high because:

- Customer loyalty is weak. Since customers have zero switching cost, they can cancel the subscription anytime and switch to a new or alternate service provider.
- Customers are highly price-sensitive. They tend to switch to a new or alternate service whenever the cost is increased. For instance, in 2011, Netflix divided their DVD-by-mail service and streaming service into two separate services, which was earlier priced $10 per month for both together. They increased the cost to $7.99 per month for each and in less than 3 months' time, they lost around 800,000 customers. In 2014, they increased the cost from $7.99 to $8.99 per month and gave 2 years exemption from price increase to the existing subscribers to mitigate this risk.

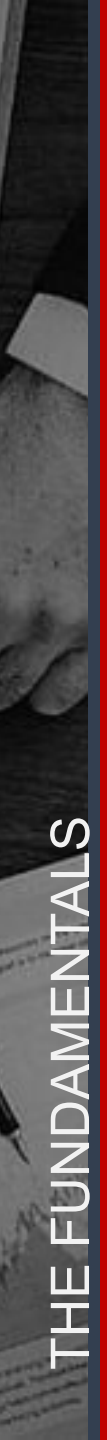
Porter's Five Forces Model

NETFLIX

Power of Buyers

The bargaining power of buyers is high because:

- Customer subscription fees are the major stream of revenue since commercials are not included.
- There is a considerable threat posed by piracy sites which provide free streaming services and customers may compromise quality for this benefit.
- Mitigation of these concerns can considerably reduce the bargaining power of buyers. Offering original content (for example, original TV series like House of Cards, Orange is the New Black, and Arrested Development) which is available only through Netflix is one of the ways by which they are mitigating this risk.



THE FUNDAMENTALS

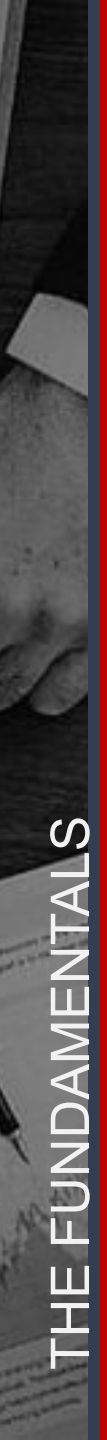
Porter's Five Forces Model

NETFLIX

Power of Suppliers

The bargaining power of suppliers is high because:

- Suppliers are contracted with Netflix through Licensing Agreements. Once the agreement expires, a supplier may switch to a new/alternate service provider and this will have a significant impact on the business as it reduces the volume of content available for Netflix customers. For instance, in 2013, after the contract with Netflix expired, Viacom contracted with Amazon and Netflix lost access to air their programs.
- Suppliers are also offering their own digital streaming services. Hulu, a joint venture of 21st Century Fox, NBCUniversal, and The Walt Disney Company, offers high volumes of own content, as well as shows from various other networks. A part of their subscription service supports commercials and hence mitigates the consumer price-sensitivity risk by creating an additional revenue stream that makes them less reliant on subscription volume to remain profitable.
- Suppliers own a majority of the content and Netflix is highly dependent on them for large volumes of content with high quality, which is a threat to the long-term viability of their business model.
- Mitigation of these concerns can considerably reduce the bargaining power of suppliers. As a mitigation strategy, Netflix pursued backward integration by making original content, thereby reducing their dependency on suppliers..



Porter's Five Forces Model

NETFLIX

Potential Entrants

The threat of new entrants is moderate because:

- Netflix works on a high economy of scale with high product variety, maintaining low cost and increasing profit. New entrants with low investment capital are less likely to enter this market, but bigger companies like Google and Apple with strong financial and technical capabilities can be a huge threat to Netflix.
- Competition in online streaming is likely to intensify in the future since the movie and television industry is a well-recognized growth sector.
- Traditional service providers are entering the market. For instance, Crave TV owned by Bell, one of Canada's leading telecommunication companies, has entered the Canadian market. They provide online streaming service at a much lower cost than Netflix but the service is available only for Bell customers, while Netflix is available for anyone with access to the internet. Likewise, HBO and CBS are new entrants in the US market with a competitive advantage of owning large volumes of content and brand name.

Porter's Five Forces Model

NETFLIX

Substitutes

The threat of substitutes is moderate because:

- Certain customer segments still tend to rely on substitutes like Satellite and Cable TV, DVDs and Rentals, and Movie Theatres for entertainment. Customers will continue to rely on television to watch live shows which get broadcasted on specific channels and on theatres to watch newly released movies.
- While there is an increasing trend in the popularity and demand for digital streaming services, rapid technological advancements may result in new and innovative substitutes that could pose a threat in the future.

THE FUNDAMENTALS

Porter's Five Forces Model

NETFLIX

Industry Rivals

Competitive rivalry is moderate because:

- Although the competitive environment is high with industry rivals like Amazon, Hulu, YouTube, HBO, and several other networks, a collaborative environment is emerging among the competitors. For instance, products like Amazon Fire TV Stick and Google Chromecast give consumers access to Netflix and other 3rd party services.
- Consumers are subscribing to two or more services at a time and hence multiple organizations will get the market share.

THE FUNDAMENTALS

S.W.O.T. Analysis

SWOT (strengths, weaknesses, opportunities, and threats) analysis is a framework used to evaluate a company's competitive position.

SWOT analysis assesses internal and external factors, as well as current and future potential.

A SWOT analysis is designed to facilitate a realistic, fact-based, data-driven look at the strengths and weaknesses of an organization, its initiatives, or an industry

SWOT is an industry analysis tool that helps the analyst identify Strengths, Weaknesses, Opportunities and Threats of a business or project within an industry. Strengths and Opportunities are the key to identifying comparative advantages within an organization, and Weakness and Threats stem from external pressure. This tool is often used by decision makers within a corporate setting to determine projects feasibility. As an industry analysis tool, it is somewhat lacking in depth compared to Porter's Five Forces but can complement the over all fundamental analysis

THE FUNDAMENTALS

S.W.O.T. Analysis

SWOT can be done by one person or a group of members that are directly responsible for the situation assessment in the company. Basic swot analysis is done fairly easily and comprises of only few steps:

Step 1. Listing the firm's key strengths and weaknesses
Step 2. Identifying opportunities and threats

THE FUNDAMENTALS

S.W.O.T. Analysis

Strengths and Weaknesses

Strengths and weaknesses are the factors of the firm's internal environment. When looking for strengths, ask what do you do better or have more valuable than your competitors have? In case of the weaknesses, ask what could you improve and at least catch up with your competitors?

Where to look for them?

Some strengths or weaknesses can be recognized instantly without deeper studying of the organization. But usually the process is harder and managers have to look into the firm's:

- Resources: land, equipment, knowledge, brand equity, intellectual property, etc.
- Core competencies
- Capabilities
- Functional areas: management, operations, marketing, finances, human resources and R&D
- Organizational culture
- Value chain activities

THE FUNDAMENTALS

S.W.O.T. Analysis

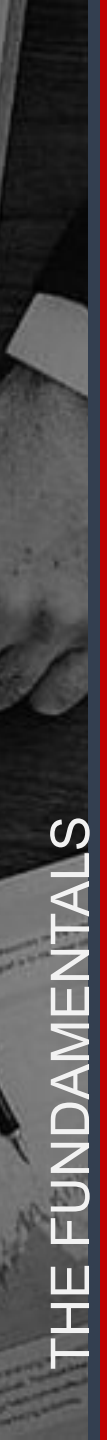
Strength or a weakness?

Often, company's internal factors are seen as both, strengths and weaknesses, at the same time. It is also hard to tell if a characteristic is a strength (weakness) or not. For example, firm's organizational structure can be a strength, a weakness or neither! In such cases, you should rely on:

Clear definition. Very often factors which are described too broadly may fit both strengths and weaknesses. For example, "brand image" might be a weakness if the company has poor brand image. However, it can also be a strength if the company has the most valuable brand in the market, valued at $100 billion. Therefore, it is easier to identify if a factor is a strength or a weakness when it's defined precisely.

Benchmarking. The key emphasize in doing swot is to identify the factors that are the strengths or weaknesses in comparison to the competitors. For example, 17% profit margin would be an excellent margin for many firms in most industries and it would be considered as a strength. But what if the average profit margin of your competitors is 20%? Then company's 17% profit margin would be considered as a weakness.

VRIO framework. A resource can be seen as a strength if it exhibits VRIO (valuable, rare and cannot be imitated) framework characteristics. Otherwise, it doesn't provide any strategic advantage for the company.



THE FUNDAMENTALS

S.W.O.T. Analysis

Opportunities and threats

Opportunities and threats are the external uncontrollable factors that usually appear or arise due to the changes in the macro environment, industry or competitors' actions. Opportunities represent the external situations that bring a competitive advantage if seized upon. Threats may damage your company so you would better avoid or defend against them.

Where to look for them?

PESTEL. PEST or PESTEL analysis represents all the major external forces (political, economic, social, technological, environmental and legal) affecting the company so it's the best place to look for the existing or new opportunities and threats.

Competition. Competitor's react to your moves and external changes. They also change their existing strategies or introduce new ones. Therefore, the company must always follow the actions of its competitors as new opportunities and threats may open at any time.

Market changes. The most visible opportunities and threats appear during the market changes. Markets converge, starting to satisfy other market segment needs with the same product. New geographical markets open up allowing the firm to increase its export volumes or start operations in a new country. Often niche markets become profitable due to technological changes. As a result, changes in the market create new opportunities and threats that must be seized upon or dealt with if the company wants to gain and sustain competitive advantage.

THE FUNDAMENTALS

S.W.O.T. Analysis

Opportunity or threat?

Most external changes can represent both opportunities and threats. For example, exchange rates may increase or reduce the profits gained from exports. This depends on the exchange rate, which may rise (opportunity) or fall (threat) against the home country currency. The organization can only guess the outcome of the change and count on analysts' forecasts. In such cases, when organization cannot identify if the external factor will affect it positively or negatively, it should gather unbiased and reliable information from the external sources and make the best possible judgement..

THE FUNDAMENTALS

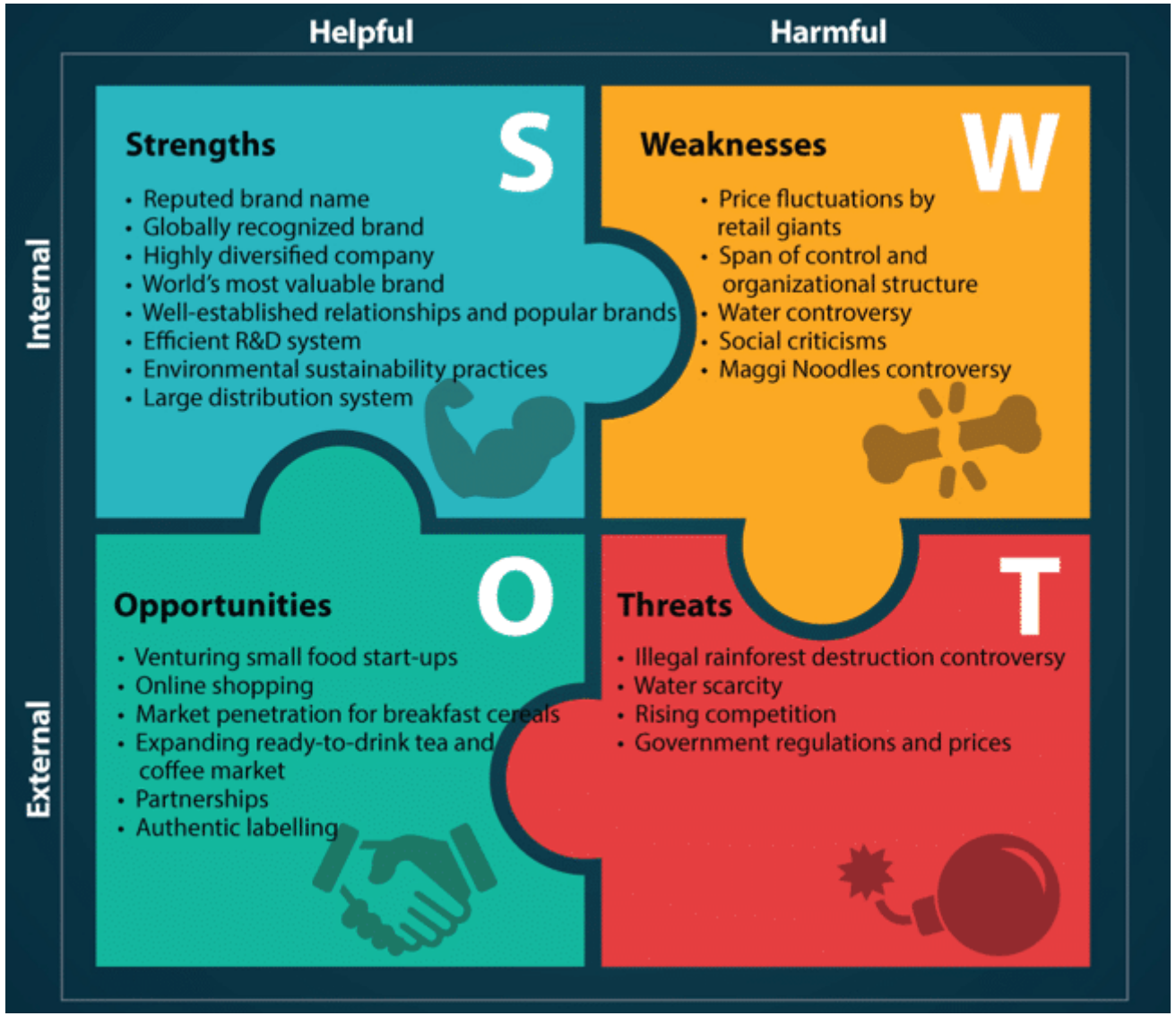
S.W.O.T. Analysis

Guidelines for successful SWOT

The following guidelines are very important in writing a successful swot analysis. They eliminate most of swot limitations and improve it's results significantly:

- Factors have to be identified relative to the competitors. It allows specifying whether the factor is a strength or a weakness.
- List between 3 – 5 items for each category. Prevents creating too short or endless lists.
- Items must be clearly defined and as specific as possible. For example, firm's strength is: brand image (vague); strong brand image (more precise); brand image valued at $10 billion, which is the most valued brand in the market (very good).
- Rely on facts not opinions. Find some external information or involve someone who could provide an unbiased opinion.
- Factors should be action orientated. For example, "slow introduction of new products" is action orientated weakness.

S.W.O.T. Analysis - NESTLE



THE FUNDAMENTALS

P.E.S.T. / P.E.S.T.E.L. / S.T.E.E.P.L.E. Analysis

PEST analysis is an analysis of the political, economic, social and technological factors in the external environment of an organization, which can affect its activities and performance.

PESTEL model involves the collection and portrayal of information about external factors which have, or may have, an impact on business

PEST or PESTEL analysis is a simple and effective tool used in situation analysis to identify the key external (macro environment level) forces that might affect an organization. These forces can create both opportunities and threats for an organization. Therefore, the aim of doing PEST is to:

- find out the current external factors affecting an organization;
- identify the external factors that may change in the future;
- to exploit the changes (opportunities) or defend against them (threats) better than competitors would do.

The outcome of PEST is an understanding of the overall picture surrounding the company.

THE FUNDAMENTALS

P.E.S.T. / P.E.S.T.E.L. / S.T.E.E.P.L.E. Analysis

PEST Variations:

STEP = PEST in more positive approach.
PESTEL = PEST + Environmental + Legal
PESTELI = PESTEL + Industry analysis
STEEP = PEST + Ethical
SLEPT = PEST + Legal
STEEPLE = PEST + Environmental + Legal + Ethical
STEEPLED = STEEPLE + Demographic
PESTLIED = PEST + Legal + International + Environmental + Demographic
LONGPEST = Local + National + Global factors + PEST

P.E.S.T. / P.E.S.T.E.L. / S.T.E.E.P.L.E. Analysis

P	E	S	T	E	L
- Government policy - Political stability - Corruption - Tax policy - Labor law - Trade restrictions	- Economic growth - Exchange rate - Interest rate - Inflation rates - Disposable income - Unemployment rate	- Population growth rate - Age distribution - Career attitudes - Safety emphasis - Health consciousness - Lifestyle attitudes - Cultural barriers	- Technology incentives - Level of innovation - Automation -R&D activity Technological change - Technological awareness	- Weather - Climate - Environmental policies - Climate change - Pressures from NGO's	- Discrimination laws - Antitrust laws - Employment laws - Consumer protection laws - Copyright and patent laws - Health and safety laws

THE FUNDAMENTALS

GE/ McKinsey Matrix

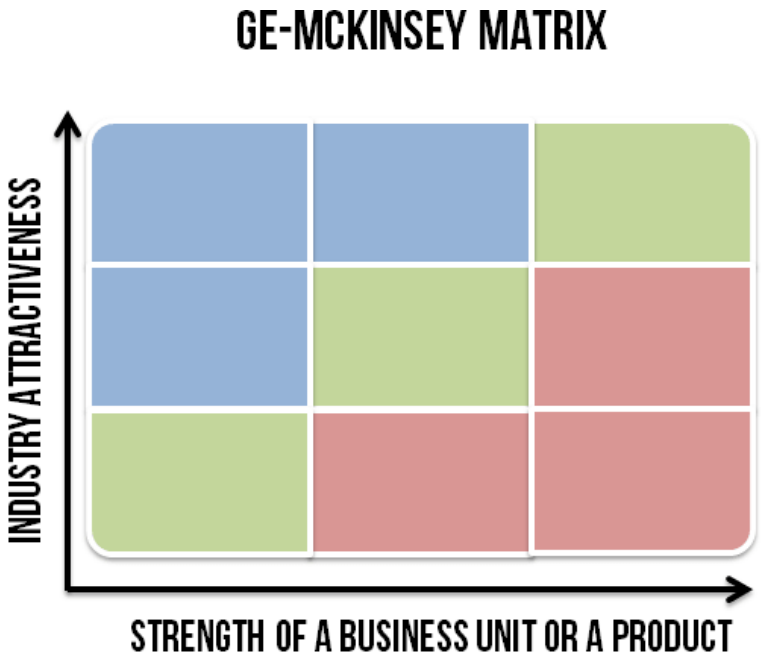
In the 1970s, General Electric (GE) commissioned McKinsey & Company to develop a portfolio analysis matrix for screening its business units. This matrix or GE Matrix is a variant of the Boston Consulting Group (BCG) portfolio analysis.

The GE McKinsey Matrix has also many points in common with the MABA analysis. MABA is an acronym that stands for Market, Attractiveness, Business position and Assessment.

The GE McKinsey Matrix also compares product groups with respect to market attractiveness and competitive power. Another name for this type of analysis is Portfolio analysis. The portfolios of businesses consist of all combinations of products and/ or services that are offered to the market/ target groups. Originally, this Matrix made an analysis of the composition of the portfolio of GE business units. Later, this matrix proved to be very useful in other companies as well.

GE/ McKinsey Matrix

Multi business companies manage complex business portfolios, often, with as much as 50, 60 or 100 products and services. The products or business units differ in what they do, how well they perform or in their future prospects. This makes it very hard to make a decision in which products the company should invest. At least, it was hard until the BCG matrix and its improved version GE-McKinsey matrix came to help. These tools solved the problem by comparing the business units and assigning them to the groups that are worth investing in or the groups that should be harvested or divested.



GE/ McKinsey Matrix

The Business Units are evaluated on two axes: industry attractiveness and a competitive strength of a unit.

Industry Attractiveness

Industry attractiveness indicates how hard or easy it will be for a company to compete in the market and earn profits. The more profitable the industry is the more attractive it becomes. When evaluating the industry attractiveness, analysts should look how an industry will change in the long run rather than in the near future, because the investments needed for the product usually require long lasting commitment.

GE/ McKinsey Matrix

Industry Attractiveness

Industry attractiveness consists of many factors that collectively determine the competition level in it. There's no definite list of which factors should be included to determine industry attractiveness, but the following are the most common:

- Long run growth rate
- Industry size
- Industry profitability: entry barriers, exit barriers, supplier power, buyer power, threat of substitutes and available complements (use Porter's Five Forces analysis to determine this)
- Industry structure (use Structure-Conduct-Performance framework to determine this)
- Product life cycle changes
- Changes in demand
- Trend of prices
- Macro environment factors (use PEST or PESTEL for this)
- Seasonality
- Availability of labor
- Market segmentation

GE/ McKinsey Matrix

Competitive strength of a business unit or a product

Along the X axis, the matrix measures how strong, in terms of competition, a particular business unit is against its rivals. In other words, managers try to determine whether a business unit has a sustainable competitive advantage (or at least temporary competitive advantage) or not. If the company has a sustainable competitive advantage, the next question is: “For how long it will be sustained?”

The following factors determine the competitive strength of a business unit:

- Total market share
- Market share growth compared to rivals
- Brand strength (use brand value for this)
- Profitability of the company
- Customer loyalty
- VRIO resources or capabilities (use VRIO framework to determine this)
- Your business unit strength in meeting industry’s critical success factors (use Competitive Profile Matrix to determine this)
- Strength of a value chain (use Value Chain Analysis and Benchmarking to determine this)
- Level of product differentiation
- Production flexibility

THE FUNDAMENTALS

GE/ McKinsey Matrix

Step 1. Determine industry attractiveness of each business unit

- Make a list of factors. The first thing you'll need to do is to identify, which factors to include when measuring industry attractiveness. We've provided the list of the most common factors, but you should include the factors that are the most appropriate to your industries.
- Assign weights. Weights indicate how important a factor is to industry's attractiveness. A number from 0.01 (not important) to 1.0 (very important) should be assigned to each factor. The sum of all weights should equal to 1.0.
- Rate the factors. The next thing you need to do is to rate each factor for each of your product or business unit. Choose the values between '1-5' or '1-10', where '1' indicates the low industry attractiveness and '5' or '10' high industry attractiveness.
- Calculate the total scores. Total score is the sum of all weighted scores for each business unit. Weighted scores are calculated by multiplying weights and ratings. Total scores allow comparing industry attractiveness for each business unit.

GE/ McKinsey Matrix

Step 2. Determine the competitive strength of each business unit

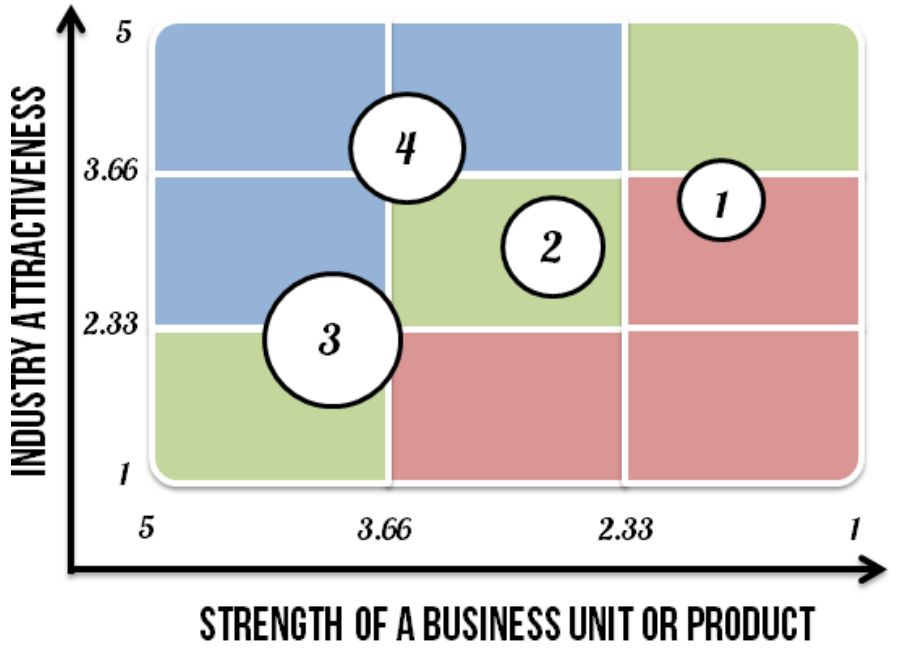
'Step 2' is the same as 'Step 1' only this time, instead of industry attractiveness, the competitive strength of a business unit is evaluated.

- Make a list of factors. Choose the competitive strength factors from our list or add your own factors.
- Assign weights. Weights indicate how important a factor is in achieving sustainable competitive advantage. A number from 0.01 (not important) to 1.0 (very important) should be assigned to each factor. The sum of all weights should equal to 1.0.
- Rate the factors. Rate each factor for each of your product or business unit. Choose the values between '1-5' or '1-10', where '1' indicates the weak strength and '5' or '10' powerful strength.
- Calculate the total scores.

GE/ McKinsey Matrix

Step 3. Plot the business units on a matrix

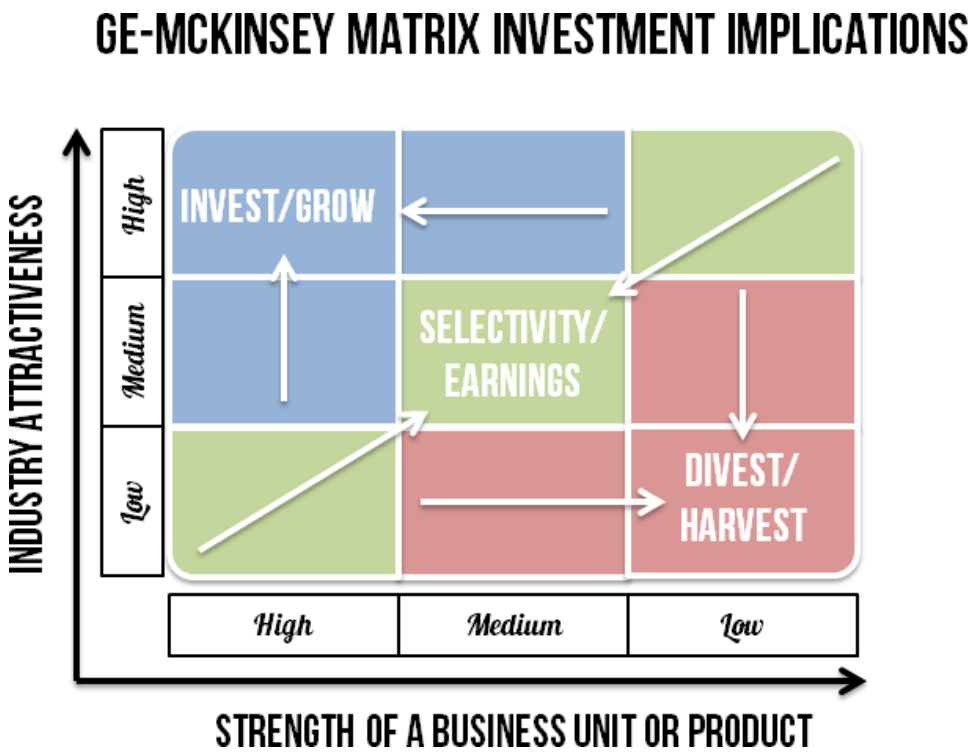
'With all the evaluations and scores in place, we can plot the business units on the matrix. Each business unit is represented as a circle. The size of the circle should correspond to the proportion of the business revenue generated by that business unit. For example, 'Business unit 1' generates 20% revenue and 'Business unit 2' generates 40% revenue for the company. The size of a circle for 'Business unit 1' will be half the size of a circle for 'Business unit 2'.



GE/ McKinsey Matrix

Step 4. Analyze the information

There are different investment implications you should follow, depending on which boxes your business units have been plotted. There are 3 groups of boxes: investment/grow, selectivity/earnings and harvest/divest boxes. Each group of boxes indicates what you should do with your investments.



GE/ McKinsey Matrix

Investment implications			
Box	Invest/Grow	Selectivity/Earnings	Harvest/Divest
Invest or not?	Definitely invest	Invest if there's money left and the situation of business unit could be improved	Invest just enough to keep the business unit operating or divest

Step 4. Analyze the information

Invest/Grow box. Companies should invest into the business units that fall into these boxes as they promise the highest returns in the future. These business units will require a lot of cash because they'll be operating in growing industries and will have to maintain or grow their market share. It is essential to provide as much resources as possible for BUs so there would be no constraints for them to grow. The investments should be provided for R&D, advertising, acquisitions and to increase the production capacity to meet the demand in the future.

Selectivity/Earnings box. You should invest into these BUs only if you have the money left over the investments in invest/grow business units group and if you believe that BUs will generate cash in the future. These business units are often considered last as there's a lot of uncertainty with them. The general rule should be to invest in business units which operate in huge markets and there are not many dominant players in the market, so the investments would help to easily win larger market share.

GE/ McKinsey Matrix

Investment implications			
Box	Invest/Grow	Selectivity/Earnings	Harvest/Divest
Invest or not?	Definitely invest	Invest if there's money left and the situation of business unit could be improved	Invest just enough to keep the business unit operating or divest

Step 4. Analyze the information

Harvest/Divest box. The business units that are operating in unattractive industries, don't have sustainable competitive advantages or are incapable of achieving it and are performing relatively poorly fall into harvest/divest boxes. What should companies do with these business units?

First, if the business unit generates surplus cash, companies should treat them the same as the business units that fall into 'cash cows' box in the BCG matrix. This means that the companies should invest into these business units just enough to keep them operating and collect all the cash generated by it. In other words, it's worth to invest into such business as long as investments into it doesn't exceed the cash generated from it.

Second, the business units that only make losses should be divested. If that's impossible and there's no way to turn the losses into profits, the company should liquidate the business unit.

THE FUNDAMENTALS

GE/ McKinsey Matrix

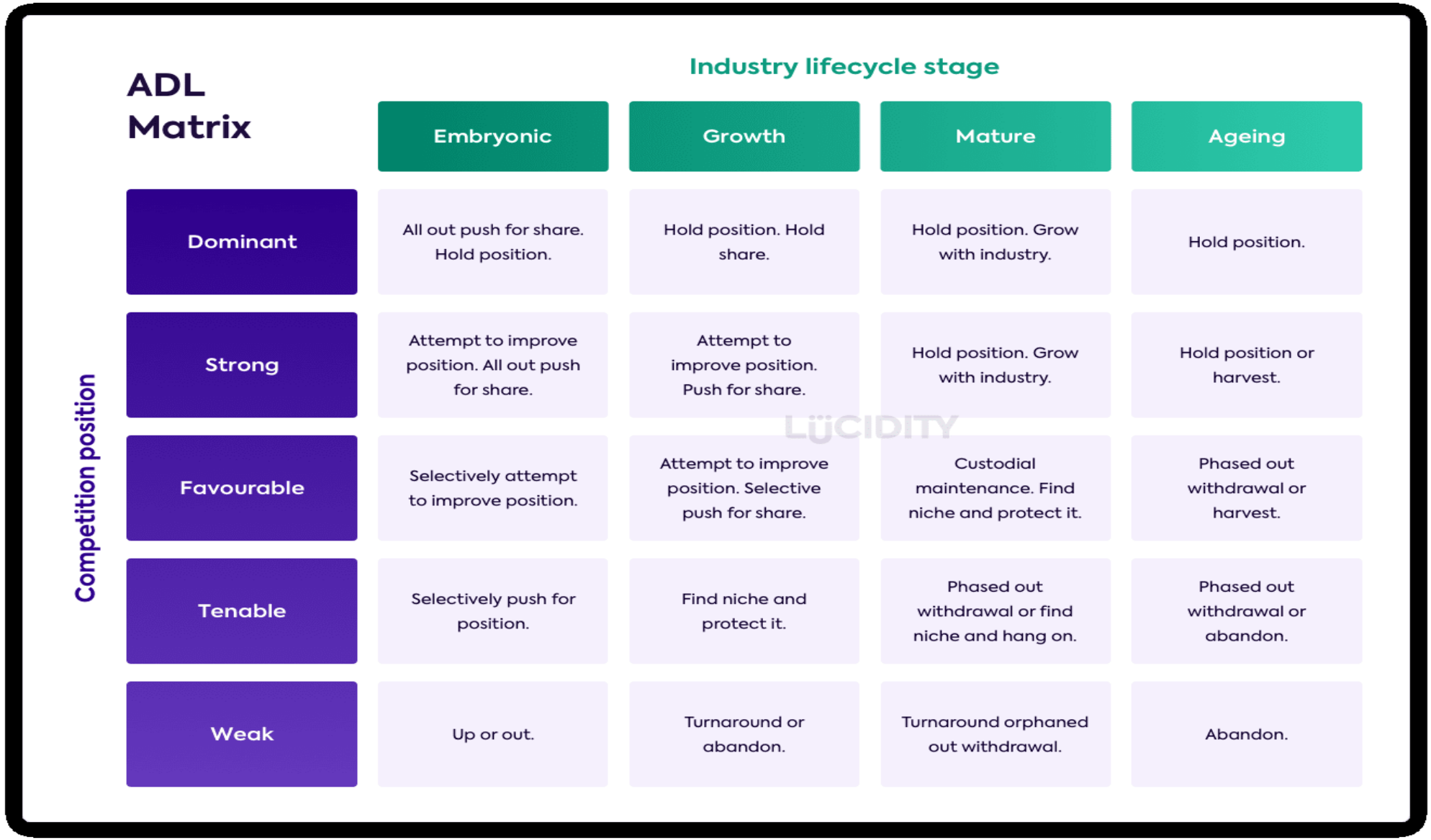
Additional Notes:

The GE McKinsey matrix only provides the current picture of industry attractiveness and the competitive strength of a business unit and doesn't consider how they may change in the future. Further analysis may reveal that investments into some of the business units can considerably improve their competitive positions or that the industry may experience major growth in the future. This affects the decisions we make about our investments into one or another business unit.

The last step is to decide where and how to invest the company's money. While the matrix makes it easier by evaluating the business units and identifying the best ones to invest in, it still doesn't answer some very important questions:

Is it really worth investing into some business units?
How much exactly to invest in?
Where to invest into business units (more to R&D, marketing, value chain?) to improve their performance?
Doing the GE McKinsey matrix and answering all the questions takes time, effort and money, but it's still one of the most important product portfolio management tools that significantly facilitate investment decisions.

ADL Matrix



ADL Matrix

Competition position	Industry lifecycle stage: Embryonic	Growth	Mature	Ageing
Dominant	All out push for share. Hold position.	Hold position. Hold share.	Hold position. Grow with industry.	Hold position.
Strong	Attempt to improve position. All out push for share.	Attempt to improve position. Push for share.	Hold position. Grow with industry.	Hold position or harvest.
Favourable	Selectively attempt to improve position.	Attempt to improve position. Selective push for share.	Custodial maintenance. Find niche and protect it.	Phased out withdrawal or harvest.
Tenable	Selectively push for position.	Find niche and protect it.	Phased out withdrawal or find niche and hang on.	Phased out withdrawal or abandon.
Weak	Up or out.	Turnaround or abandon.	Turnaround orphaned out withdrawal.	Abandon.

LUCIDITY

THE FUNDAMENTALS

Company Level Analysis

In previous slides we understood various tools and techniques to understand the business and the environment in which it operates, through those we could gain company level understanding as well but it becomes critical to point out the areas at company level which an analyst should focus on to draw a better understanding. These can be:

Business Strategy Analysis
Business Model Analysis
Associated Business Risk Assessment
Core Competencies / MOAT
Competition Analysis
Historical Financial Analysis (the number game)
Cash Flow Analysis
Market outlook regarding the business

All these and previously discussed topics will be explained through a Real – Life Case Study for better understanding

THE CURIOUS CASE OF GODREJ CONSUMER PRODUCTS LIMITED

The following case study is done purely for educational purpose and in no manner endorse or encourage the participant to be influenced and take decisions, one should carefully study and/or consult professionals to make informed decisions

COMPANY OVERVIEW

NSE TICKER – GODREJCP	BUSINESS - FMCG	CATEGORY - LARGECAP

Godrej Consumer Products ltd. is one of the leading home grown FMCG company. GCPL was incorporated on 29 November 2000 after getting demerged with Godrej Soaps ltd. The company mainly operates in 5 main segments namely - Household Insecticides, Soaps, Hair Colors, Liquid Detergents, and Air Fresheners. Some of the well-known products of the company in these segments include HIT, Godrej No. 1, Cinthol, Good knight, Aer, Kesh Kala Hair Oil, Godrej Rich Creme Hair Dye, EZEE and many more. Company has its manufacturing units in Himachal Pradesh, Assam, Sikkim and Madhya Pradesh. Apart from domestic presence, company has build a strong International presence through a slew of acquisitions over the years in Indonesia, Africa, USA and Middle-East.

COMPANY OVERVIEW

INDIA MARKET SHARE -

- Ranked 1st in Household Insecticides with 50% Market share.
- Ranked 1st in Air Fresheners.
- Ranked 1st in Hair color segment with 25% Market share.
- Ranked 2nd in Soaps with 12% Market share.

REVENUE DISTRIBUTION –

In fiscal year 2020, 46 per cent of company's revenues came from International business, with Indonesia and Africa accounting for 41 per cent. In FY20, companys's major revenue contributor was Hair Care segment which accounted for 31%. The other two major revenue contributor segments were – Personal wash and Household insecticides accounting for 22% and 28% respectively. Air care contributed for around 4% and others around

KEY MANAGEMENT & DIRECTORS			
CEO and MD	**Chairman**	**Directors**	**Business Heads**
• Nisaba Godrej • Vivek Gambir	• Adi Godrej	• Ireena Vittal • Narendra Ambwani • Pirojsha Godrej • Tanya Dubash • Nadir Godrej	• Dharnesh Gordhan • Sunil Kataria • Jose Toscano • Akhol Chandra

COMPANY OVERVIEW

ACQUISITIONS –

- In October 2007 GCPL acquired Global Mid East FZE which was 100% subsidiary of Godrej International Ltd.
- In April 208 the company acquired 100% stake in Kinky Group Properties Ltd South Africa which is one of the leaders in South African Hair Category.
- On 2 December 2010 Godrej Consumer Products Ltd (GCPL) announced that it has acquired a 100% stake in Naturesse Consumer Care Products Limited (NC) and Essence Consumer Care Products Limited (EC).
- On 1 June 2011 Godrej Consumer Products Ltd (GCPL) announced that it has entered into an agreement for the rights to acquire 51% stake in Darling Group Holdings. The Darling Group manufactures and distributes the full range of hair extension products - which is among the largest hair care categories in Africa.
- In 2016, company acquired US based SON and 75% stake in Kenyan based Canon chemicals.
- In 2020, company acquired remaining 25% in Canon chemicals.

COMPANY OVERVIEW

ACHIEVEMENTS –

- GCPL was awarded as Conscious Capitalist Company of the year in 2015 by Forbes.
- GCPL has been awarded the Porter Prize 2016 for Creating Shared Value impact at the 5th Porter Prize award ceremony organised by the Institute for Competitiveness, India, in New Delhi.
- The Malanpur plant was awarded Gold rating in their first Green Company Rating assessment by the Confederation of Indian Industry - Sohrabji Godrej Green Business Centre. The rating assesses the environmental impact of a company's activities or operations.
- GCPL won the 'Women Empowerment' award at the 6th Asia Best CSR Practices Awards 2016 by CMO Asia.
- GCPL was ranked number 12 on the 'Great Place to Work – Best Workplaces in Asia 2017' list and among the top 19 Best Employers in India in the 'Aon Hewitt Best Employers 2017' survey.
- GCPL was nominated for CNBC IBLA outstanding company of the year award 2019.

INDUSTRY OVERVIEW

INTRODUCTION -

Godrej Consumer Products limited operates in FMCG or Consumer Goods industry. The FMCG industry is the fourth largest sector in the Indian economy. Household and personal care products accounts for 50% of the sales in the industry, healthcare accounts for 31-32% and food and beverage accounts for remaining 18-19%. Mostly sold FMCG segments include Toiletries, Cosmetics and Household Products.

MARKET SIZE in 2020 -

The retail market in India is estimated to reach US$ 1.1 trillion in 2020 from US$ 840 billion in 2017, with modern trade expected to grow at 20-25 per cent per annum, which is likely to boost revenue of FMCG companies. Revenue of FMCG sector reached Rs 3.4 lakh crore (US$ 52.75 billion) in FY18 and is estimated to reach US$ 103.7 billion in 2020. FMCG market is expected to grow at 9-10 per cent in 2020. Rise in rural consumption will drive the FMCG market. It contributes around 36 per cent to the overall FMCG spending. FMCG urban segment witnessed growth rate of 8 per cent, whereas, rural segment grew at 5 per cent in the quarter ended September 2019.

SOURCE – ibef.org

INDUSTRY OVERVIEW

PORTERS 5 FORCES MODEL FOR FMCG INDUSTRY

INDUSTRY OVERVIEW

FMCG INDUSTRY SWOT ANALYSIS

S

- Presence of strong brands in product-line
- Availability of wide range of products
- Low operational costs
- Greater understanding of Consumer needs

W

- Lower scope of Investing in technology
- Low export levels
- Counterfeit Products
- Me- too products, which illegally mimic the
- labels of established brands.

O

- Untapped Rural Market
- Increase in consumer spending
- Export potential in neighboring countries
- Large Domestic Market

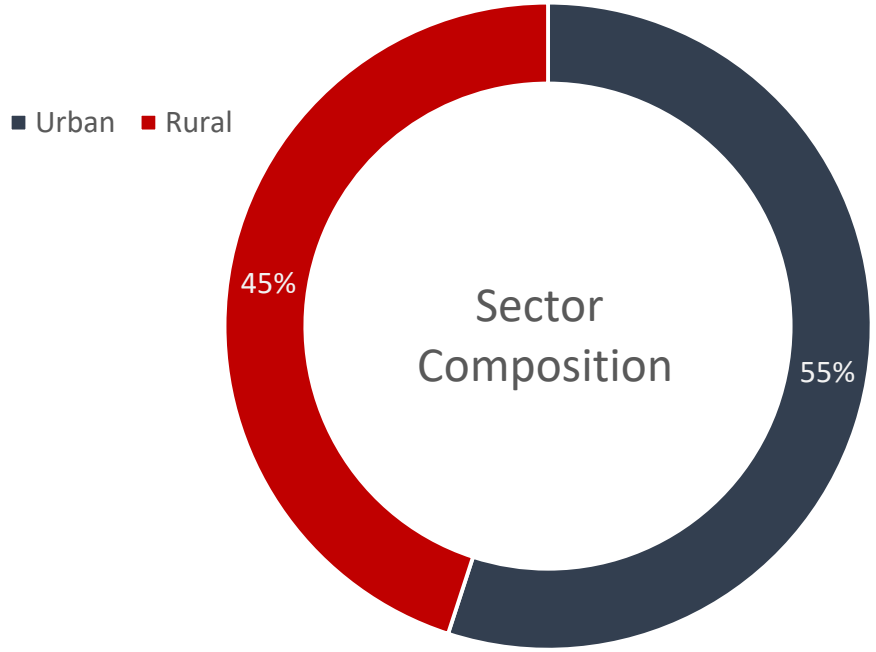
T

- Slow down in Rural demand
- Overall slowdown in country
- The removal of import restrictions resulted in replacement of domestic brands
- Tax and Regulatory structure

INDUSTRY OVERVIEW

SECTOR COMPOSITION

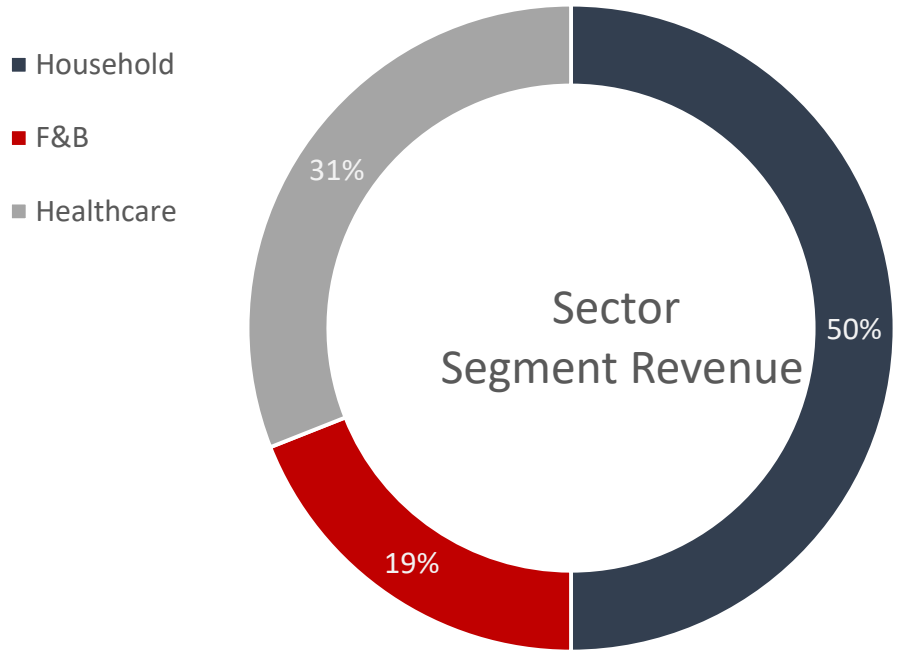
- The Rural demand accounts for 45% as compared to around 55% of the Urban demand.
- This indicates a lot of potential which is left to explore in the Rural sector.
- As a result of Covid-19, demand in overall Rural and Urban areas fell drastically. But, as of July 2020, the Rural demand was back to around 75% of pre-covid levels.
- But, as of July 2020, the Rural demand was back to around 75% of pre-covid levels.
- It is expected that In the next nine months, the overall fast-moving consumer goods (FMCG) segment is expected to grow at around 5% but rural will expand at double the rate of urban.



INDUSTRY OVERVIEW

SEGMENT REVENUE

- The major Revenue contributor segment is Household with half of the revenue pie.
- Healthcare and Personal care contributes around 31% revenue.
- Food and Beverages account for 19%.



BUSINESS MODEL

INPUTS

Finance : Equity, Debt & Profits re-invested in Business and Brands

Intellectual Capital:

- Strong Legacy of the Godrej Group.
- Investment in R&D.
- Innovative Products and strong Brands

Human Capital

- Skilled Manpower
- Investment in training and development
- Fostering Diversity and inclusion
- Prioritizing Safety

Social and Relationship Capital

- Consumer engagement models
- Partnerships with Suppliers, Retailers and Wholesalers
- Investment in CSR.

BUSINESS MODEL

OUTPUTS

Finance:

- Comparable consolidated revenue decline of 2%.
- Flat consolidated PAT.
- Dividend paid of Rs 8 per share.

Intellectual Capital:

- 2x more new products launched compared to previous years.
- Introduced E-commerce first products.
- 77% increase in e-commerce reach.

Human Capital

- Consistently ranked in the top quartile of best employers in internal employee engagement survey scores
- 21 per cent women in senior leadership roles.
- Zero man days lost due to adverse industrial relations

Social and Relationship Capital

- Rural direct distribution reach through 8 million outlets in India, across 66,000 villages.
- Number of active outlets in Indonesia increased by 17%
- 4,32,633 young people trained across India & Kenya since 2013.

BUSINESS MODEL

Purpose

To bring the goodness of Health and Beauty to consumers in Emerging Markets.

Vision

To be the leading emerging markets focused multi-local FMCG player.

Strategy

- Extending leadership in core categories and geographies.
- Accelerating innovation and building purposeful brands.
- Leveraging digital.
- Enhancing go-to-market.
- Making supply chain best-in-class.
- Fostering an inclusive, agile, and high-performance culture.
- Building a more inclusive and greener world.

PRODUCT PORTFOLIO

Hair Care

Home Care

Personal Care

INNOVATION

Indian Business

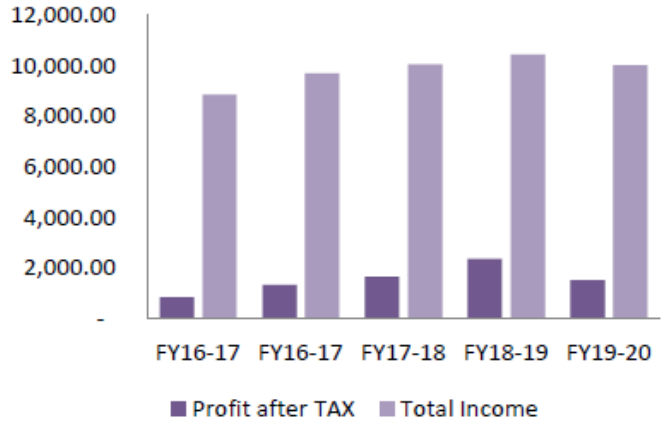
- Foraying Into Incense Sticks With A 100% Natural Variant
- Introduced First-ever Powder To Liquid Hand wash At Disruptive Price
- Entered Male Grooming Category
- Introduced New Format In Household Insecticides To Up-Trade Coil Users And Recruit New Users.
- Forayed In Herbal Based Powder (HBP) Hair Colors

International Business

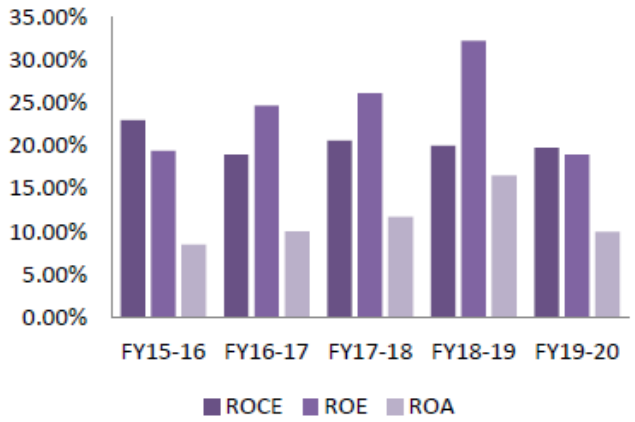
- Indonesia: Taking Category Beyond Mosquitoes
  Introduced New Paper Based Mosquito Repellent To Disrupt Coils Segment
- Guam: Introduced African Pride Moisture Miracle Wet Hair Care Range In The USA
  Darling Brand Re-launched In Nigeria
  Wet Hair Care Launches

KEY FINANCIAL TRENDS

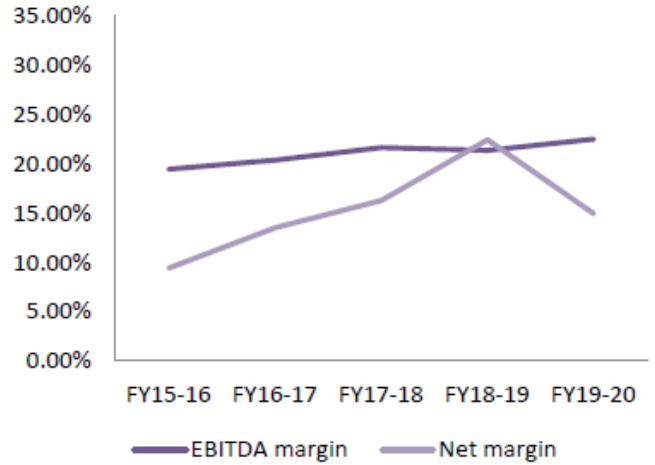
PAT and TOTAL INCOME



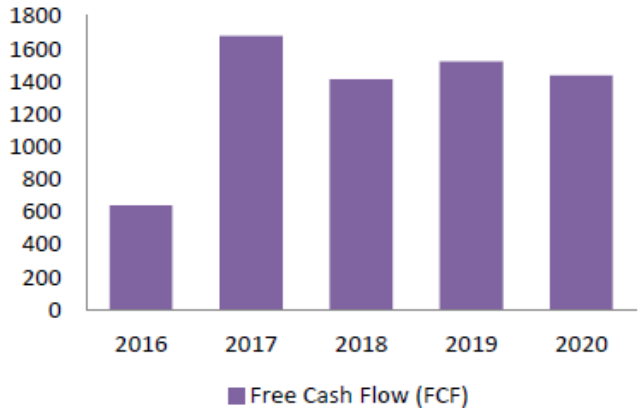
ROCE, ROE and ROA



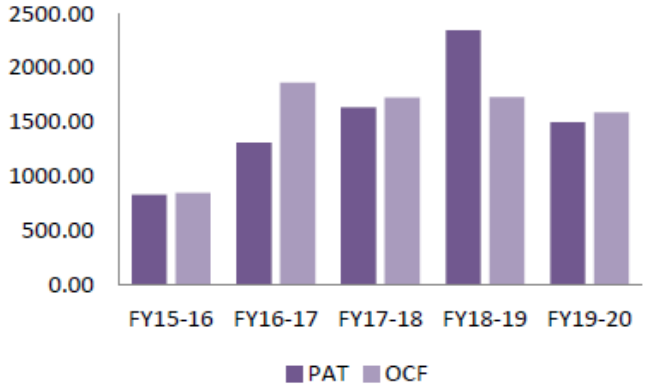
EBITDA and PAT MARGINS



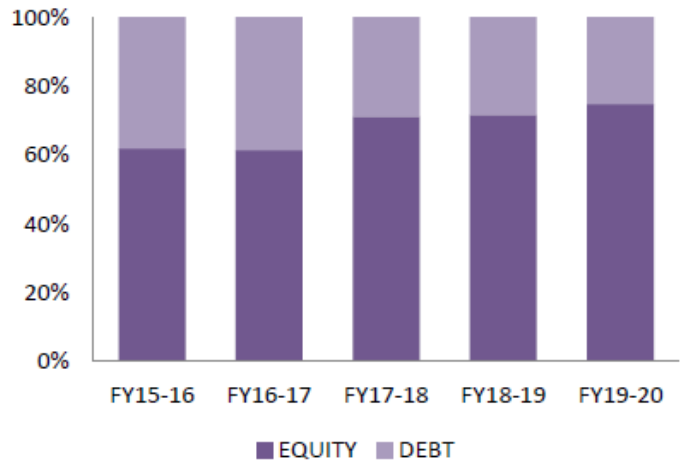
FREE CASH FLOW



PAT and OCF

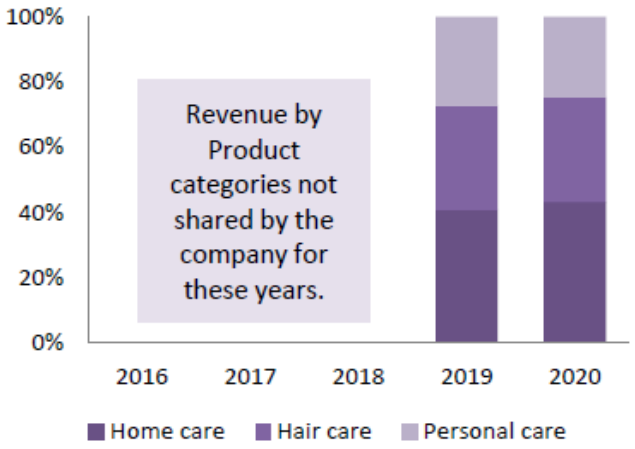


CAPITAL STRUCTURE

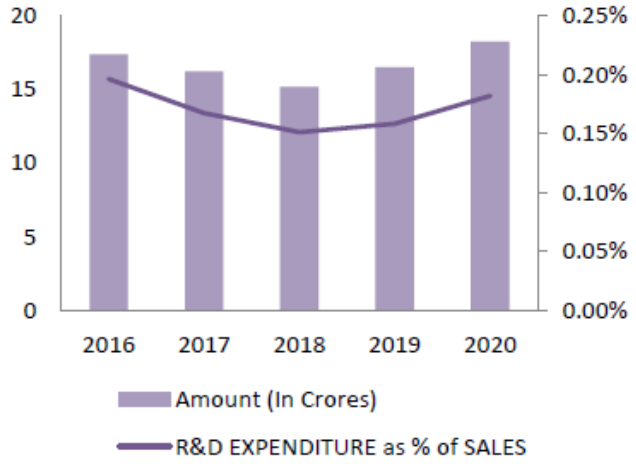


KEY OPERATIONAL TRENDS

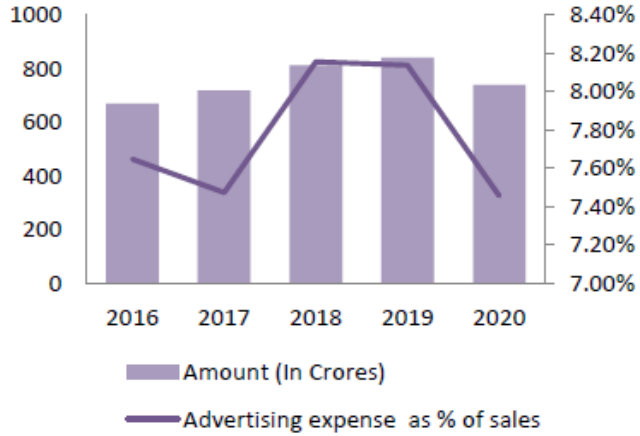
REVENUE by PRODUCT CATEGORY



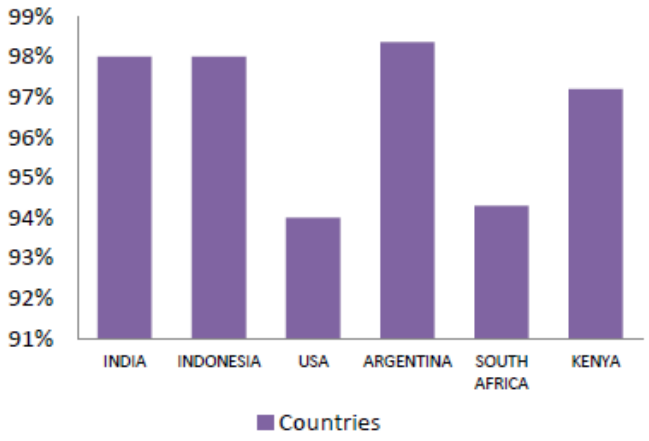
R&D EXPENDITURE



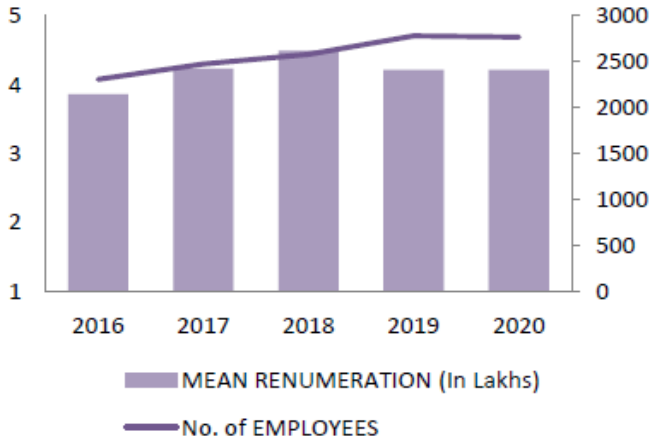
ADVERTISING EXPENSE



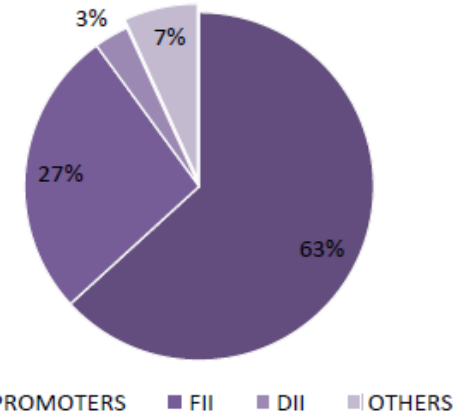
GLOBAL FIL RATES



EMPLOYEES and MEAN RENUMERATION



SHAREHOLDING PATTERN



KEY FINANCIAL HIGHLIGHTS

CASH AND DEBT

CASH AND DEBT					
In Crores	FY 15-16	FY16-17	FY17-18	FY18-19	FY19-20
Cash and cash equivalents	612.59	895.05	898.02	862.21	602.87
Bank Balances	141.2	17.61	62.19	32.51	167.29
Short term Borrowings	-181.89	-232.55	-154.33	-270.94	-518.7
Long term Borrowings	-2449.03	-3108.25	-2380.32	-2604.78	-2145.04
Net Cash and Debt	**-1877.13**	**-2428.14**	**-1574.44**	**-1981**	**-1893.58**

- GCPL has not defaulted on any of its Borrowings till date.
- Company pays 2.50% - 60.00% interest on its borrowings in Argentina due to country's hyperinflationary economy.
- Company majorly has unsecured borrowings because of its reputation and history of not defaulting.

HEDGING POLICY

FOREIGN EXCHANGE					
In Crores	FY15-16	FY16-17	FY17-18	FY18-19	FY19-20
Foreign exchange earned	195.66	197.75	397.69	219.82	204.22
Foreign exchange used	253.49	315.33	324.04	448.53	458.39
Net Flow	**-57.83**	**-117.58**	**73.65**	**-228.71**	**-254.17**

- GCPL carries out its international operations in Argentina, Indonesia, USA, Africa and many other emerging countries.
- Company has a lot of exposure to foreign exchange risk and will continue to have in recent future.
- To mitigate the risk company by setting appropriate exposure limits, periodic monitoring and using foreign exchange forward contracts.

KEY FINANCIAL HIGHLIGHTS

EMPLOYEE STOCK GRANT SCHEME

EMPLOYEE STOCK OPTION SCHEME					
In Crores	FY 15-16	FY16-17	FY17-18	FY18-19	FY19-20
O/s at beginning of the year	1,74,121	1,41,096	1,28,895	2,24,011	2,95,015
Add : Bonus during the year	-	-	1,22,214	1,02,049	-
Add : Granted during the year	71,121	58,376	1,11,829	98,343	1,62,917
Less : Exercised during the year	-86,922	-66,993	-1,27,886	-1,14,546	-1,50,256
Less : Fortified during the year	-17,333	-3,584	-11,041	-14,842	-17,543
Total	**1,41,096**	**1,28,895**	**2,24,011**	**2,90,133**	**2,90,133**

- Company set up ESGS in 2011 with approval of shareholders.
- The scheme applies to eligible employees of the company based on performance, grade, level, etc.

FREE CASH FLOW

Free Cash Flow Estimate (In INR Crs)					
In Crores	FY15-16	FY16-17	FY17-18	FY18-19	FY19-20
Net cash from Operating Activities	847.27	1,860.22	1,723.35	1,728.85	1,588.11
Capital Expenditures	(208.13)	(180.29)	(311.49)	(207.73)	(152.02)
Free Cash Flow (FCF)	**639.14**	**1,679.93**	**1,411.86**	**1,521.12**	**1,436.09**

- Company doesn't seem to have any major CAPEX apart from regular maintenance capex ranging from Rs 150 – 350 crores.
- Company's operating cash flow is more than its PAT.

KEY OPERATIONAL HIGHLIGHTS

REVENUE BY PRODUCT CATEGORY

- Company's major revenue comes from Hair care segment which accounts for 31%.
- Personal wash and Household insecticides account for 22% and 28% respectively.
- In view of recent Covid-19 pandemic, company has launched Hand Sanitizers which is expected to boost the revenue.
- Air care segment generates around 8% revenue for the company.

GEOGRAPHICAL PRESENCE

- Company has a solid presence in India and Indonesia which contribute around 70% of their revenues.
- Apart from this the company is present in Africa, USA, Middle East and Latin America.
- In 2018, company made 100% disinvestment in its UK business.
- Management is looking to expand more in emerging markets.
- The company overall hasn't performed well in International markets but the management is expecting a turnaround in coming years.

SUPPLY CHAIN NETWORK

- The company has a strong distribution network of over 1.2million outlets.
- The company is mainly focusing on improving rural supply chain by expanding it to 5.3million outlets over the years.
- In fiscal year 2020, the company engaged with over 22,000 shop floor employees to improve manufacturing process, productivity per person, and employee connect and relations.
- Around 98% of customer demand is met through immediate stock availability, without backorders or lost sales.

KEY OPERATIONAL HIGHLIGHTS

IMPACT OF COVID-19

- Company's revenue have taken a hit in FY19-20 as a result of Covid-19.
- As a result of imposition of nation-wide lockdown, company's manufacturing plants, warehouses, offices were shut from 2nd half of March 2020.
- The operations at some of the company's International locations were also shut down/ scaled down over various periods and being operated as per the local guidelines of social distancing and high hygiene standards, wherever permitted.
- Management is closely monitoring the situation and taking appropriate actions to scale up operations.
- 80% of company's products are in Health and Hygiene, management is betting on this to be a major driver of sales growth in coming quarter amid this crisis.

PRODUCT LAUNCHES

- Company entered into Rs 5,500cr male grooming market with the launch of 8 new variants for face, body, hair and beard applications under CINTHOL in 2018.
- The company has launched 2x more products in FY20 compared to previous years according to the management.
- Premium AER Fresheners, Expert Crème – re launch, Cinthol Charcoal Soap, Shampoo Hair Colour were some products which were launched by the company in FY20.
- With a current situation of pandemic, where consumer will focus on Hygiene, the company has launched 12 products under its hygiene brand Godrej Protekt.

WORK CULTURE

- GCPL has workforce from around 36 countries.
- 25 per cent of white-collar and 56.5 per cent of blue-collar team members are women.
- Company is consistently ranked in the top quartile of best employers in internal employee engagement survey scores.
- It has trained over 73,000 employees on safety.
- Company recently started project Rainbow to empower people from LGBTQ community to join GCPL.
- Company has programs focusing on Mental wellness of its employees.

RISK MANAGEMENT

RISK	MITIGATION	EFFECTIVENESS
Supply Chain Risks Includes risks in inadequate planning while procuring raw materials and inability to deliver material to consumer as per agreed delivery dates.	Making manufacturing and supply chain future ready. Investments to ramp up process and become more agile as well as building good relationship with partners.	Company's FILL rates have improved globally. Reduced obsolescence in India to 0.13%. Improvement in productivity is seen in the company.
Economic Risks Political, Macro-Economic risk as well as Inflation risk. Impact of economic environments on consumer behaviour and devaluation of local currency.	Building a strong Risk Committee, along with regional business and finance teams, closely monitors the political economy of each geography to respond and adapt to emerging situations.	GCPL has one of the best management with ability to deal with risks. Company has been doing good in managing Economic Risks and has not seen any major impact of it as of today.
Competitive Risks Dependency on a few product categories to drive sales, Greater aggression by competitors, low switching costs and Competitive market conditions and new entrants.	Ramping up go-to-market, creating an online presence to understand consumer preferences to reach deeper and improve penetration. Enhancing its distribution chain and investing in R&D to launch out innovative products.	GCPL is leader in the country in Hair color, household insecticides and air freshners. It has created a strong distribution network especially in Rural markets. Some of company's products have created a reputation in the market which helps company to retain its customers.

RISK MANAGEMENT

RISK	MITIGATION	EFFECTIVENESS
Regulatory Risks Includes Compliance, New Regulations and regulatory changes	Company's legal and Audit teams are in constant communication with key government departments and industry bodies to keep track of new and emerging regulations.	GCPL has the highest levels of statutory compliance and ensure adherence to all regulations and laws of the land.
Liquidity Risk Liquidity risk is the risk which company will not be able to meet its cash obligations.	GCPL maintains adequate sources of financing including debt and overdraft.	Company doesn't seem to have any liquidity issues.

INCOME STATEMENT ANALYSIS

Summary Income Statement						
In Crores	2016	2017	2018	2019	2020	*CAGR%*
Revenue	8,836.96	9,684.10	10,044.54	10,423.10	10,023.10	*3.20%*
COGS	3,867.24	4,132.52	4,274.36	4,554.33	4,261.68	*2.46%*
Gross Profit	**4,969.72**	**5,551.58**	**5,770.18**	**5,868.77**	**5,761.42**	***3.76%***
Operating expense	3,250.10	3,578.56	3,595.52	3,642.40	3,506.09	*1.91%*
EBITDA	**1,719.62**	**1,973.02**	**2,174.66**	**2,226.37**	**2,255.33**	***7.01%***
Depreciation and Amortization	100.63	141.57	155.68	169.98	197.28	*18.33%*
EBIT	**1,618.99**	**1,831.45**	**2,018.98**	**2,056.39**	**2,058.05**	***6.18%***
Finance Costs	119.01	145.22	160.74	224.25	217.41	*16.26%*
Share of Net profits of investees	0.10	0.82	1.08	0.63	0.81	*68.70%*
PBT	**1,500.08**	**1,687.05**	**1,859.32**	**1,832.77**	**1,841.45**	***5.26%***
Exceptional items*	-333.51	0.08	179.56	252.56	-81.05	*-29.79%*
Tax	336.05	379.16	404.70	-256.20	263.82	*-5.87%*
PAT	**830.52**	**1,307.97**	**1,634.18**	**2,341.53**	**1,496.58**	***15.86%***
Other Comprehensive income	-70.93	-83.41	36.95	138.51	223.20	*0.00%*
TOTAL COMPREHENSIVE INCOME	***759.59***	***1,224.56***	***1,671.13***	***2,480.04***	***1,719.78***	***22.67%***

Exceptional item mainly includes restructuring cost and proceeds from disinvestment in UK business.

INCOME STATEMENT ANALYSIS

Revenue –

- Revenue has grown at a considerably good rate over the years.
- It mainly includes revenue from sales and other minor items such as export incentive, GST refunds, scrap sales etc.

Operating Expense –

- Operating expenses have been fairly stable, accounting for around 36-37% of revenue.

Depreciation and Amortization –

- Company's depreciation expense is negligible as company hasn't have any major capital expenditure over the years.
- It accounts for around 1-2% of company's revenue.

Finance Costs -

- It includes interest on loans, bill discounting charges and interest on lease liabilities.
- It accounts for 1.5-3% of company's revenue.

Income Tax –

- Company pays around 15% as tax.

BALANCE SHEET ANALYSIS

Summary Balance Sheet						
In Crores	FY16	FY17	FY18	FY19	FY20	*CAGR %*
Assets						
Non-Current Assets	6,260.93	8,814.18	8,795.03	9,481.67	10148.67	*12.8%*
Current Assets	3,492.80	4,210.65	5,168.78	4,688.41	4808.34	*8.3%*
TOTAL ASSETS	***9,753.73***	***13,031.32***	***13,963.81***	***14,170.08***	***14,957.01***	***11.3%***
Equity Share capital	34.05	34.06	68.13	102.22	102.23	*31.6%*
Other Equity	4,232.91	5,267.89	6,190.18	7,164.70	7,796.13	*16.5%*
Total Equity	**4,276.98**	**5,301.95**	**6,258.31**	**7,266.92**	**7,898.36**	***16.6%***
Non-Current Liabilities	2,762.15	4,346.43	3,529.53	3,011.38	2512.09	*-2.3%*
Current Liabilities	2,714.60	3,382.94	4,175.97	3,891.70	4546.56	*13.8%*
Total Liabilities	**5,476.75**	**7,729.37**	**7,705.50**	**6,903.08**	**7,058.65**	***6.5%***
TOTAL EQUITY AND LIABILITIES	***9,753.73***	***13,031.32***	***13,963.81***	***14,170.08***	***14,957.01***	***11.3%***

BALANCE SHEET ANALYSIS

Non-Current Assets -

- PPE has grown from Rs847.09 cr to Rs1205.02 cr at a CAGR of 9.2%.
- PPE attributes to around 8% of company's total assets.
- Goodwill has grown at a CAGR of 6.6%.
- Goodwill as a percentage of total assets has fairly gone down from 42% to 35% over the years.
- Overall company has enough Non-Current assets to fulfill its liabilities.

Current Assets -

- Company's inventories have grown considerably well from Rs1,306.98 cr to Rs 1700 cr at a CAGR of 6.8%
- Rising inventories have helped the company improve its Fill rates.
- Company's investments are rising at a CAGR of 42.5%.
- Cash reserves were growing well until FY20 where it dropped by around 30% compared with FY19.

Non-Current Liabilities -

- Company's Non-current liabilities have decreased as a result of decrease in deferred tax liabilities.
- Borrowings have also dropped from Rs2,449 cr to Rs2,145 cr over the years.

Current Liabilities -

- Company's borrowings have grown over the years at a CAGR of 30%.
- Other liabilities include lease liabilities and trade payables.
- Company's provisions for doubtful debts attribute to 1.2-2.5% of its Current liabilities.

CASH FLOW ANALYSIS

Summary Cash flow Statement						
In Crores	FY16	FY17	FY18	FY19	FY20	*CAGR %*
Profit Before Exceptional Items and Tax	**1,500.08**	**1,687.05**	**1,859.32**	**1,832.77**	**1,841.45**	***5.26%***
Adjustments	168.65	259.93	287.75	348.61	364.58	*21.26%*
Operating Cash Flows Before Working Capital Changes	**1,668.83**	**1,946.98**	**2,147.07**	**2,181.38**	**2,206.03**	***7.23%***
Working capital changes	-464.53	340.62	-15.54	0.57	-261.51	*-13.38%*
Income Taxes paid (net)	-336.03	-407.29	-392.75	-435.07	-344.05	*0.59%*
Restructuring Cost	-20.90	-20.09	-15.43	-18.03	-12.56	*-11.95%*
Net Cash Flow from Operating Activities	***847.27***	***1,860.22***	***1,723.35***	***1,728.85***	***1,588.11***	***17.01%***
Investing Inflows	333.22	164.40	415.62	884.61	335.45	*0.17%*
Investing Outflows	-935.47	-2,334.16	-755.45	-633.06	-869.39	*-1.81%*
Net Cash Flow used in Investing Activities	***-602.25***	***-2,169.76***	***-339.83***	***251.55***	***-533.29***	***-2.99%***
Financing Inflows	419.62	984.48	0.01	0.01	247.34	*-12.38%*
Financing Outflows	-621.84	-319.83	-1,384.02	-2,038.74	-1542.67	*25.50%*
Net Cash Flow from/ (used in) Financing Activities	***-202.47***	***664.65***	***-1,384.01***	***-2,038.73***	***-1295.33***	***59.04%***
NET INCREASE / (DECREASE) IN CASH AND CASH EQUIVALENTS	***42.55***	***355.11***	***-0.49***	***-58.33***	***-240.51***	***0.00%***

CASH FLOW ANALYSIS

Operating Activities –

- Company's Operational Cash flow is higher than its Net Profits which indicates that firms is in a healthy position.
- Working Capital changes have been fluctuating over the years.
- Income Tax paid by the company have been significantly reduced by the company as a percentage of its net income.
- Operating Cash flow has grown at a good rate except in last few years at a CAGR of 17%.

Investing Activities -

- Company spends a significant amount in purchase and maintenance of PPE and other Intangible assets every year.
- Company acquired SON which is a US based company and Canon Chemicals, a Kenya based company which led to a cash outflow of approx Rs1,400 cr.
- Company made a 100% divestment in its UK business which led to significant cash inflows in FY18.
- Company parks its excess cash into mutual funds, non-convertible debentures and deposits with NBFC's.

Financing Activities -

- Company finances its operations from loans and borrowings by banks. Most of the loans of the company are unsecured, this might be due to company's reputation in the market.
- Company pays regular dividends to its shareholders.
- Finance cost has increased over the years except in FY20.

RATIO ANALYSIS

Profitability Ratios

Profitability Ratios	2016	2017	2018	2019	2020
Earnings per share	24.39	38.40	23.99	22.91	14.64
Diluted earnings per share	24.39	38.39	23.98	22.90	14.64
Gross margin	56.24%	57.33%	57.45%	56.31%	57.48%
EBITDA margin	19.46%	20.37%	21.65%	21.36%	22.50%
EBIT margin	18.32%	18.91%	20.10%	19.73%	20.53%
PBT margin	16.98%	17.42%	18.51%	17.58%	18.37%
Net margin	9.40%	13.51%	16.27%	22.46%	14.93%
TCI margin	8.60%	12.65%	16.64%	23.79%	17.16%

- EPS has gone down drastically due to low earnings and rising number of shares.
- Company is able to maintain higher and stable gross margins which is a good sign.
- EBITDA margins are rising marginally on account of stable operating expenses.
- EBIT and PBT margins have also risen marginally as a result of low DA and Interest expense as a part of revenue.
- Net margin has gone down considerably in last year.

RATIO ANALYSIS

Efficiency Ratios

Efficiency Ratios					
	2016	2017	2018	2019	2020
Return on capital employed	23.00%	18.98%	20.63%	20.01%	19.77%
Return on equity	19.42%	24.67%	26.11%	32.22%	18.95%
Return on assets	8.52%	10.04%	11.70%	16.52%	10.01%
Return on working capital	1.07	1.58	1.65	2.94	5.72
Asset turnover	0.91	0.74	0.72	0.74	0.67
Equity turnover	2.07	1.83	1.60	1.43	1.27
Inventory turnover	2.96	2.93	2.71	2.92	2.50
Receivables turnover	7.83	9.34	7.98	7.98	8.56
Payables turnover	2.33	2.21	1.55	1.60	1.66

- Company' ROCE has been decreasing over the years which is a concern.
- ROE and ROA were growing except in FY20 citing poor results.
- Return on working capital has improved as a result of low current liabilities in recent years.
- Asset turnover is decreasing which indicates company isn't using its assets at its full potential.
- Equity turnover is decreasing over the years but it is still able to generate returns.
- Inventory turnover is very low compared to other companies as company has a large stock of inventories.
- Receivables turnover ratio is constant overall.
- Payables turnover is decreasing which indicates company is taking longer to pay its suppliers.

RATIO ANALYSIS

Liquidity Ratios

Liquidity Ratios					
	2016	2017	2018	2019	2020
Working capital	778.2	827.71	992.81	796.71	261.78
Current ratio	1.29	1.24	1.24	1.20	1.06
Quick ratio	0.81	0.83	0.86	0.80	0.68
Cash ratio	0.28	0.27	0.23	0.23	0.17
Inventory days	123.36	124.76	134.73	124.91	145.87
Receivable days	46.62	39.08	45.75	45.75	42.62
Payable days	156.76	165.50	235.55	228.21	219.66

- Company is in a healthy position to meet its day-to-day obligations.
- Current ratio is looking healthy but has declined over the years.
- However, Quick ratio indicates that the company may not be able to fulfill its short-term obligations.
- Cash ratio is also not looking good, indicating that the company won't be able to meet its short term obligations via cash which is the most liquid asset.
- Company is holding up its inventories for quite a long time as it has some products which are more in demand during monsoon season and in order to overcome fluctuating consumer demands.
- Company's receivable days have been constant over the years.
- Time taken by the company to pay to its suppliers is increasing over the years.

Note – *Formulas used to calculate the ratios are taken according to understanding of the analyst and to maintain a consistency.*

RATIO ANALYSIS

Solvency Ratios

Solvency Ratios					
	2016	2017	2018	2019	2020
Debt / equity	0.65	0.82	0.56	0.41	0.32
Debt / capital	0.39	0.45	0.36	0.29	0.24
Debt / assets	0.28	0.33	0.25	0.21	0.17
Liabilities / equity	1.28	1.46	1.23	0.95	0.89
Liabilities / assets	0.56	0.59	0.55	0.49	0.47
Interest coverage	13.60	12.61	12.56	9.17	9.47

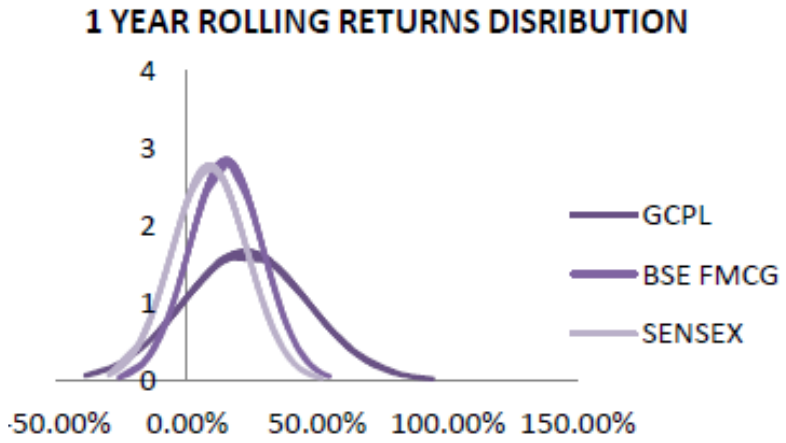
- Company's Debt-to-Equity ratio is decreasing which is a very good sign, indicating that company is using very less debt to fund its operations.
- Debt-to-Capital and Debt-to-Asset ratios are also on a decline, which again is a good sign.
- Company's Interest Coverage ratio is extremely healthy which indicates that the company does not have any issues regarding interest payment.
- Overall company is able to manage its debt extremely well.

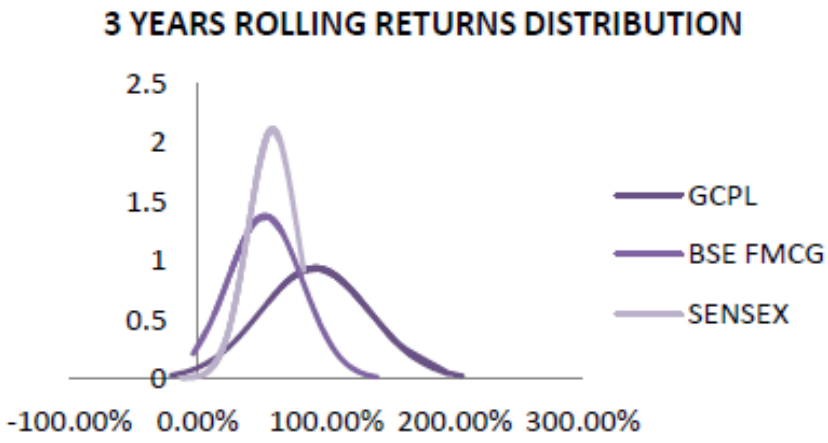
RISK RETURN ANALYSIS

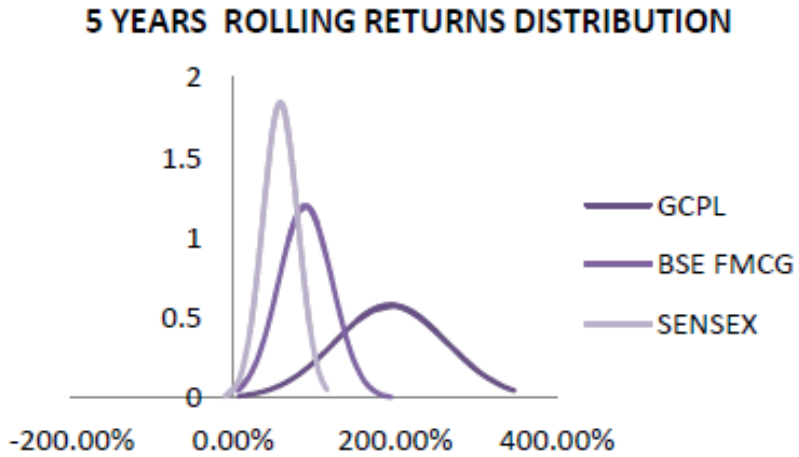
The following returns have been calculated from 1st April 2010 to 7th August 2020

Risk Return Analysis									
	1 yr			3 yr			5 yr		
Measure	GCPL	BSE FMCG	SENSEX	GCPL	BSE FMCG	SENSEX	GCPL	BSE FMCG	SENSEX
Mean return	22.5%	15.0%	8.8%	91.7%	52.8%	58.7%	194.96%	89.7%	58.67%
Variance	5.7%	2.0%	2.1%	18.0%	8.4%	3.6%	47.4%	11.0%	4.7%
SD	24.0%	14.0%	14.4%	42.5%	28.9%	18.8%	68.8%	33.2%	21.6%
Annual mean return	22.5%	15.0%	8.8%	24.2%	15.2%	16.6%	24.2%	13.7%	9.7%
Annual variance	5.7%	2.0%	2.1%	5.7%	2.7%	1.2%	8.1%	2.1%	0.9%
Annual SD	24.0%	14.0%	14.4%	12.5%	8.8%	5.9%	11.0%	5.9%	4.0%
Max return	94.3%	54.7%	51.8%	206.1%	139.9%	83.1%	347.52%	139.94%	116.26%
Min return	-38.7%	-26.0%	-29.9%	-20.1%	-2.9%	-11.8%	8.13%	6.6%	-9.59%
Correlation		0.7431	0.2435		0.7160	0.1224		0.86235	0.34576
Covariance		0.0249	0.0084		0.0879	0.0098		0.19709	0.05144
Beta		0.4345	0.1461		0.4874	0.0543		0.41608	0.1086
Return / SD	0.94	1.07	0.61	1.93	1.72	2.81	2.19	2.31	2.42
Risk free rate	5.9%	5.9%	5.9%	5.9%	5.9%	5.9%	5.9%	5.9%	5.9%
Sharpe ratio	0.69	0.65	0.20	1.46	1.05	1.81	1.65	1.32	0.95
Treynor ratio		0.38	1.14		0.38	3.38		0.44	1.68
Skewness	0.2257	0.2501	-0.0106	-0.2966	0.7143	0.1661	-0.3947	0.28188	-0.3529
Kurtosis	0.1723	-0.0791	-0.1440	0.0043	-0.2614	-0.6011	-0.5063	-0.0312	-0.4439
Median return	23.1%	14.0%	9.9%	95.7%	44.0%	33.2%	194.23%	85.7%	62.97%

RISK RETURN ANALYSIS







Source – Yahoo Finance, BSE

SOURCES OF INFORMATION

Primary Sources -

Annual Reports(FY16 – FY20)
Conference calls
Investor Presentations
Management conversations

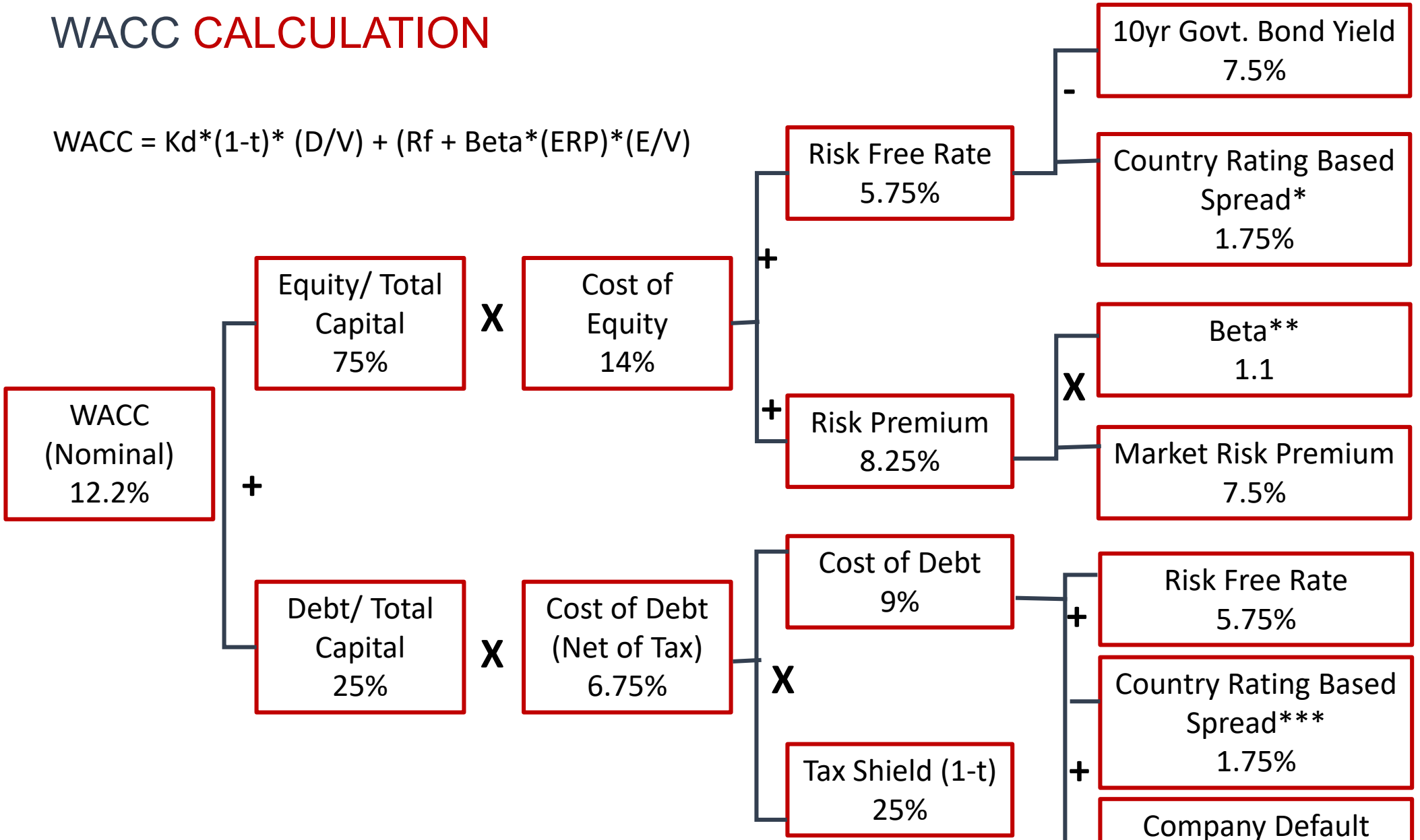
Secondary Sources -

ibef.org
NSE.com
BSE.com
Yahoo Finance

WACC & CAPM – NUANCES

WACC CALCULATION

WACC = Kd*(1-t)* (D/V) + (Rf + Beta*(ERP)*(E/V)



*Based upon sovereign ratings of the country

**** Bottoms up Beta is preferred over regression Beta based on company's historical price volatility vs market**

*****Based on rating**

Cost of Debt

WACC = Kd*(1-t)* (D/V) + (Rf + Beta*(ERP)*(E/V)

Pre-Tax Cost of Debt

- The cost of debt should be assumed to be the current cost of issuing new long term debt for the company or project being analyzed
- Don't use book interest rate (i.e. interest rate company is actually paying) if its is different from current cost of debt of the company being analyzed

Potential Sources

- Recent debt issued by the company
- Current bond yield on the company's debt
- Adding rating based default spread (both country default spread and company default spread) to risk free rate
- Alternatively we can add just company default spread to 10 year government bond rate as government bond rate already includes country default spread.
- If the company is not rated, then we can calculate synthetic ratings of the company based on its interest coverage

Cost of Debt

WACC = Kd*(1-t)* (D/V) + (Rf + Beta*(ERP)*(E/V)

Example: The company has $500 mn debt outstanding at the interest rate of 6% p.a. remaining maturity of the debt is 5 years. If the company wants to raise fresh debt today, the cost is 10%. Current risk free interest rate in the economy is 7%. Please calculate current cost of debt and market value of debt of the company

Current cost of debt for the company should be 10% not 6% for following reason:

- 6% interest rate is not relevant in current scenario. How a company can borrow at rate lower than the risk free rate
- The saving of 4% (10% -6%) to be enjoyed by the company over next 5 years till the maturity of debt, should be adjusted in the market value of debt. This is how we can reward company for low rate of interest for next 5 years. This is how the bond market works. Yield on the bond keeps changing according to the current interest rate by changing market price of bonds

Market Value of Debt

Tax Rate

WACC = Kd*(1-t)* (D/V) + (Rf + Beta*(ERP)*(E/V)

Marginal Tax Rate

The prevailing statutory (combined federal and state) tax rate should be used in calculating the after-tax cost of debt

Capital Structure

Capital Structure Weightings

(D/D+E)

Debt includes all interest bearing liabilities (short term debt, long term debt, capital lease etc.). Also includes

- Asset deficit for employee benefit obligation
- Operating leases if capitalized = The debt value of operating leases is the present value of the future lease payments, discount rate would be the cost of debt for the company.

In determining the weightings of the various components of the capital structure, the company's target capital structure should be used

- This proportion should be determined after taking into account future expectations of the company's anticipated, long-run capital structure

The debt component should be indicative of the book value of the debt

- In general, book value is a close proxy to market value
- For companies in cyclical industries, consider using average debt

The equity component should be indicative of the public market value* of the equity

*if the company is not public, use comparable analysis

Risk Free Rate

WACC = Kd*(1-t)* (D/V) + (Rf + Beta*(ERP)*(E/V)

Usually government bond rates are good measure of risk free rate of the country. But that's true if the country has no default spread (like AAA rated US country). If the country has default spread because of lower sovereign rating then that default spread should be subtracted from government bond yield to calculate true risk free rate.

For example for country like India, 10 year government bond yield (7.7%) is not risk free rate as India has Baa3 (Moody's)sovereign rating with default spread of 2.2%. So risk free rate in India is 5.5% (7.7% -2.2%)

Which government security?
Selection of security depends upon duration of project being analyzed. If analysis is done for short term projects then short term government securities should be used as risk free rate and for long term project it should be long term security return

Therefore if we are doing analysis for shorter duration investment then treasury bills can be taken as risk free rate
In case of valuation of companies, we capture and discount cash flows for entire life of the company which usually goes upto infinity. It means we should consider longest available security return as risk free rate. However its a frequent practice to consider YTM on 10 years government as a better proxy of risk free rate.

Compared to treasury bills because of better duration matching and less volatility (i.e. beta).
Compared 20 years/ 30 years bonds because of less liquidity premium compared to longer term bonds

Note: There should be consistency in securities used in risk free rate and ERP

Note: If the government bond is not available in the country then GDP growth rate can be used as proxy of risk free rate as usually GDP growth rate is close to risk free rate of the country

Risk Free Rate – Currency Effect

How to deal with currency effect in valuation.?

Currency of Risk free rate should be same as currency of flows. If we are valuing company in US $ then cash flows and risk free rate both should be in US $. If we do this valuation in Indian rupees then risk free rate will increase by approx.3% due to higher inflation rate but at the same time growth will also increase by 3% due to inflation effect in nominal growth rate.

Valuation should not be function of currency. Ideally valuation of the company in different currency should give same valuation based on purchasing power parity theory (i.e. difference in the inflation would be affected in both cash flows and interest rate). But if the interest rates are not adequately reflecting difference in inflation rates across currencies, then we would get different valuation of the same company in different currencies.

Exchange rates are momentum driven, but fundamentals ultimately prevails. So best way to predict exchange rates to convert future cash flows is to calculate it based on purchasing power parity as follows:

Forward Exchange Rate = Spot Rate* (1+Inflation Rate- Target currency)/(1+Inflation Rate Current Currency)

Risk Free Rate – Real V/s Nominal

Using real or nominal risk free rate is dependent upon cash flows you are discounting. If cash flows are projected in nominal term then risk free rate should also be nominal or visa versa.

Real risk free rate = Nominal risk free rate - expected long term inflation

Or

Return on in inflation indexed treasury

In the situation of high and unstable inflation, we do projections in real terms (i.e. by ignoring growth coming due to inflation) and also consider real discount rate to discount this real projected cash flows to present value.

Beta

WACC = Kd*(1-t)* (D/V) + (Rf + Beta*(ERP)*(E/V)

Beta is a measure of exposure to macro economic risk (systematic risk). It's the risk of variance around the expectation of investors. The companies are exposed to two types of risk; 1) Business Risk and 2) Leverage Risk.

- Business risk is the risk associated with the operation of the company (e.g. business risk of DLF is different from ITC.DLF caters to real estate sector whereas ITC caters to FMCG sector)

- Leverage risk is the risk associated with having debt in the capital structure. More the debt in the capital structure of the company higher would be risk of bankruptcy resulting in higher beta

Total beta of the company is also called levered beta as it includes both the risk business as well as leverage risk.

Unlevered beta includes only business risk

There are two approaches to calculate beta

Beta

WACC = Kd*(1-t)* (D/V) + (Rf + Beta*(ERP)*(E/V)

Approach 1: Regression Beta: Calculated based on historical price volatility relative to the market

Beta = Covar(re,rm)/Var (rm)

Where, re = %age change in stock price
rm = %age change in market index

Period: 2-3 years data is sufficient to calculate regression beta. Too short period beta may be noisy due to small data size. Too large period beta may not be relevant due to change in risk profile of the company.

Weekly change is preferred over daily change

Step 1: Calculate regression beta of the company based on its historical price volatility relative to the market
Step 2: Unlever the beta calculated under step 1 with the current capital structure of the company (take out the current leverage risk from levered beta)
Step 3: Relever the beta calculated under step 2 with the target capital structure of the company

Note: Step 2 and 3 are required in case the target leverage is different from current leverage

Beta

WACC = Kd*(1-t)* (D/V) + (Rf + Beta*(ERP))*(E/V)

Approach 2: Bottom Up Beta: Calculated based on beta of peer group companies

Step 1: Take levered beta of peer group companies (more the number of peers, better it would be)
Step 2: Calculate Unlevered Beta of the peers based on their respective capital structure
Step 3: Calculate the average unlevered beta of the industry
Step 4: Relever the beta calculated under step 3 with the target capital structure of the company being analyzed

Bottom up beta is generally preferred over regression beta due to following reasons:

- Law of large numbers: chances of error would be less in case of bottom up beta as its based on the data of larger number of firms compared to just one firm data in case of regression beta.
- If there are some exceptional movements in the stock price of the company in the past not explained by the market, in that case regression beta tend to be low even for the high risky company

Unlevered Beta = Levered Beta*(Equity/Equity+Debt*(1-Tax rate)
Use current capital structure in case of regression beta or industry average capital structure in case of bottoms up beta

Relevered Beta = Unlevered Beta*(Equity + Debt*(1-Tax rate)/Equity)
Use the target capital structure of the company being analyzed.

Equity Risk Premium

WACC = Kd*(1-t)* (D/V) + (Rf + Beta*(ERP)*(E/V)

The equity risk premium ("ERP") represents the excess return demanded by investors over a risk-free rate. This excess return compensates investors for taking on the relatively higher risk of the equity market

Sources:

- Historical rates of returns of local indices above a country's risk free rate can be used to estimate the equity risk premium.
- Survey based expected ERP from the market where research agency try to gauge the expected ERP by conducting surveys on the market representatives.
- Other sources include predictive models of equity risk premium

ERP based on other matured market: In case we don't have enough data or data is highly distorted to calculate ERP for the country, we can calculate ERP for the country with reference to matured market ERP as follows

ERP of the country = Matured Market ERP + Country Risk Premium (where company is situated)

Approach 1: Country risk premium = Country default spread
Approach 2: (Refinement on Approach 1)
Country risk premium = Country default spread X (Std. Deviation of Equity Index of Country/Std. Deviation of Bond Price)

How Valuation is Related to Return on Capital

Valuation of a firm is dependent on what excess return it is generating or will generate for its stakeholders.

Value of the firm can be explained as:

Value of the Firm = Book Value + Value of Excess Return on the historical and new investment

It means the firm creates value for its stakeholders by generating excess return on the investment which it has made in the business. If the firm is not generating any excess return for its stakeholders (i.e. ROE = Ke or ROCE = WACC) then its value would be exactly equal to book value. In such situation it becomes indifferent for it to carry on or shut down its business.

If the firm is generating return less than its cost of capital (i.e. ROE <ke or ROCE < WACC) then it is destroying wealth of the stakeholders by carrying on the operation. In such situation, it makes more sense for it to shut down its operation and distribute the net worth among its stakeholders.

Value of Company = Value of Assets in Place + Value of Growth Asset
Value of Asset in Place = Book Value + Value of Excess Return on Existing Assets
Value of Growth Asset = Value of Excess Return on New Investment to be made in future.

How Valuation is Related to Return on Capital

Its important to distinguish between excess return the firm is generating on its investment and excess return it is expected to generate on future investment. Value of growth depends on later part. Value of the firm will increase with the increase in future expected growth only in case if positive excess return on new investment.

Impact of Future growth on the Value	If
Positive	Return on new investment > Cost of Capital
Negative	Return on new investment < Cost of Capital

	Reinvestment	Reinvestment Rate	Return on Reinvestment	Excess Return	Value Creation
Firm	CAPEX net of D&A * ΔWC	Reinvestment/(EBIT*(1-tax))	ROCE = ΔEBIT net of Tax/ Reinvestment0	ROCE-WACC	(Excess Return*Reinvestment0)/WACC
Equity	CAPEX net of D&A * ΔWC - ΔDebt	Reinvestment/Net Income	ROCE = Δnet Income/ Reinvestment0	ROE-Ke	(Excess Return*Reinvestment0)/Ke
Per Share	EPS-Dividend	1-Dividend pay out ratio	ROE = Δ EPS/ Reinvestment0	ROE-Ke	Excess Return*Reinvestment0)/Ke

VALUATION ADJUSTMENTS: PREMIUMS & DISCOUNTS

VALUATION ADJUSTMENTS: PREMIUMS & DISCOUNTS.

After initially estimating the value of a business, that estimate may be adjusted upward (premium) or downward (discount) to reflect other factors related to the ownership interest in question. For example, a controlling interest in a business is worth more on a per-share basis than a minority interest, as the holder of a controlling interest has authority over business decisions, whereas the minority interest holder does not. This section briefly examines some common premiums and discounts.

Business valuations typically begin with a base value, using techniques applicable to a broad range of businesses. A premium or discount is an upward or downward adjustment to this base value, to reflect some different characteristics of the particular business being considered. These characteristics are reflected in various ways. If one uses a discounted cash flow approach to valuation, a higher or lower discount rate could reflect the special characteristics. Alternatively, the analyst could adjust the initial valuation estimate upward or downward for specific features of the business. Knowing how to identify and quantify premiums and discounts is one of the specific skills of a business valuation expert

The following situations can increase or decrease the discount premium:

Control premium: The buyer acquires a controlling interest—usually defined as more than 50% of the voting power—in the acquired company. Because of all the powers a controlling owner has, a controlling ownership interest is clearly worth more than a non-controlling interest. These premiums can be in the 30–50% range.

Minority interest discount: A minority interest discount, also known as a discount for lack of control, is the logical opposite of a control premium. If the ability to exercise control commands a premium, the lack of that ability is worth less.

Strategic acquisition premium: Sometimes the acquisition of a business may be important from a strategic perspective. For example, an acquisition may complement the existing product line, broadening the geographic market, ensure a source of supply, or eliminate a key competitor, for a specific buyer.

The following situations can increase or decrease the discount premium:

Lack-of-marketability discount: Publicly traded equity shares have a high degree of liquidity—they can be readily converted into cash at close to prevailing prices. Because investors value liquidity, a negative factor exists when the investor lacks the ability to sell on short notice at a market price. Studies report that thinly traded stocks realized a 30–50% price decline when the brokerage firm that was their sole market-maker went out of business. 2 Studies of restricted stock of public companies that itself cannot be publicly traded find discounts for the lack of marketability ranging from about 20% to 70%. 3 Ownership interests in nonpublic companies almost always are discounted for the lack of marketability.

Key person discount: Some acquisitions include an arrangement for the key person(s) to join the new company for a period of time. In other cases, the key persons do not accompany the acquisition, perhaps due to death or retirement. When the key person does not continue with the business, attributes such as the loyalty of customers, suppliers, or employees may be lost, as well as the key person's particular business skills. Research studies and court cases find the key person discount to typically be in the range of 5–10% in public companies, and 10–25% in private companies.

Discounts may be applied to base business valuations for factors other than those described earlier. One possibility is a discount for contingent liabilities, reflecting potential future claims resulting from past business activities that will become the responsibility of a buyer. Such contingent liabilities involve potential litigation such as product liability, potential environmental claims, or potential tax adjustments for prior years. Because these liabilities are situation-specific, the valuation analyst must look sharply for them!

The above discussion indicates that discounts are more frequent than premiums. After achieving a base valuation, the analyst considers adjustments for the various factors discussed above. Note that the impact of these factors can be incorporated into the base analysis—for example, by adjusting the estimates of future income or cash flows—or can be reflected as an adjustment to the base value calculation. However incorporated into the business valuation analysis, discounts can have a large effect on the ultimate value.

THANK YOU

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