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CROSS BORDER VALUATION

AUGUST 27, 2024

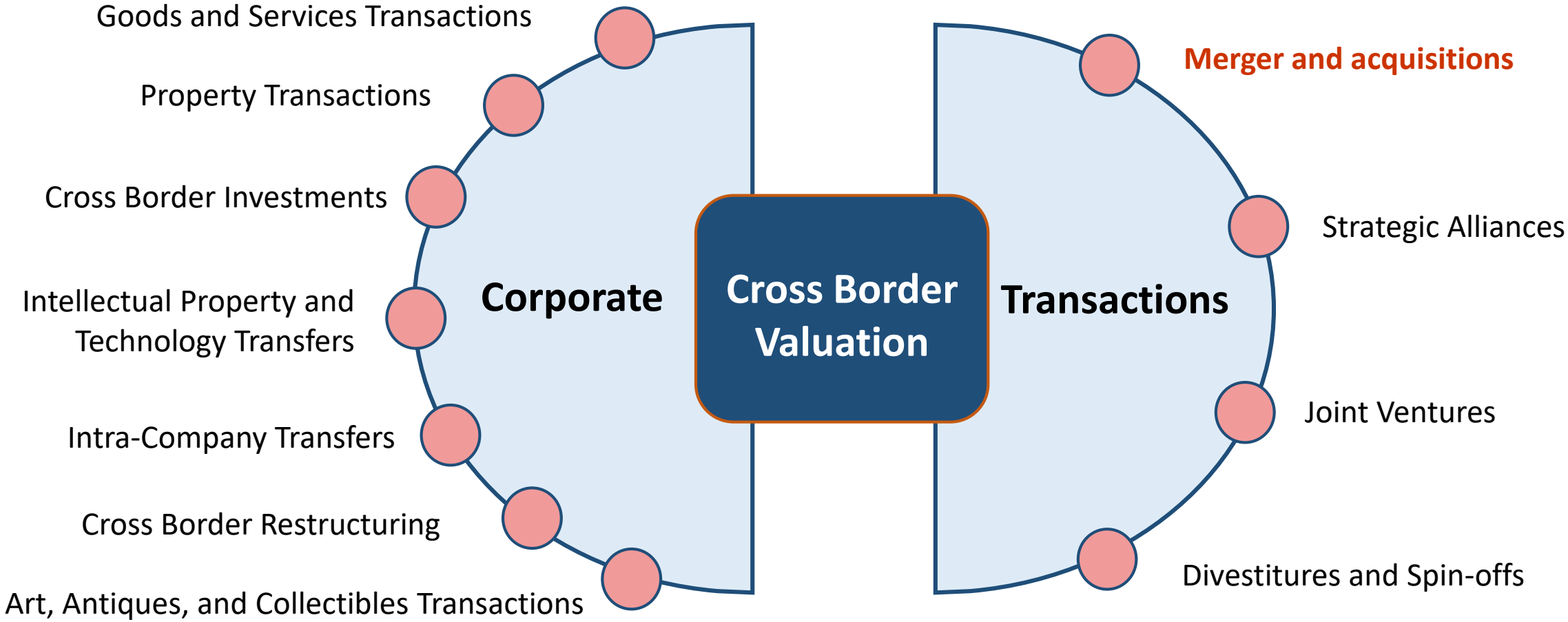
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2.	Applicability of M&A
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REQUIREMENTS OF CROSS BORDER VALUATIONS



STRATEGIC OBJECTIVE FOR CROSS BORDER TRANSACTION

- ✓ Portfolio Diversification
- ✓ Cost synergies
- ✓ Securing new product technology
- ✓ International Business expansion
- ✓ Mitigating Political, Financial, Compliance Risk, etc
- ✓ Ease supply chain Logistics
- ✓ Adding distribution network

TYPES OF MERGER AND ACQUISITION TRANSACTION

Cross-border Transaction – M&A transaction between a domestic company with an International company. These can be either

INBOUND MERGER	OUTBOUND MERGER	AMALGAMATION
Walmart and Flipkart	**Tata Steel and Corus**	**Tata Steel and Tata Steel Europe**
▪ In May 2018, Walmart Inc., an American retail giant, acquired a significant stake in Flipkart, an e-commerce company **originally incorporated in Singapore but with its primary operations in India**, for $16 billion	▪ In January 2007, Tata Steel, an Indian multinational steel producer, **acquired Corus Group, a UK-based steel manufacturer**, for $12.1 billion	▪ In 2021, Tata Steel announced the **amalgamation of its Indian operations** with Tata Steel Europe, creating a unified European business.

TYPES OF MERGER AND ACQUISITION TRANSACTION

JOINT VENTURE (JV)	DIVESTITURE
Mahindra & Mahindra and Renault	**GlaxoSmithKline Consumer Healthcare and HUL**
▪ In 2007, Mahindra & Mahindra **(India)** and Renault SA **(France)** formed a joint venture to produce small cars in India, resulting in the **Mahindra Renault Logan**	▪ This is when a company sells off a part of its business ▪ In December 2018, HUL acquired the Indian business of GSK ▪ This transaction involves international business operations and the need to evaluate a significant foreign-owned business in India.

VALUATION PROCESS- KEY STEPS

- **Steps** of Valuation as prescribed by ICAI Valuation Standard

Define the valuation base, premise of the value and valuation date

Analyze the asset to be valued and collect the necessary information

Identify the adjustments to the financial and non-financial informationfor the valuation

Consider and apply appropriate valuation approaches and methods

Arrive at a value or a range of values

VALUATION METHODS AND APPROACHES

Approach	Income Approach	Market Approach	Cost Approach
Method	Discounted cash Flow (DCF)	CCM/ Transaction Multiples/ Share Price method	Net Asset Value (NAV)
Key Steps	Financial Projections	Identify comparable companies and transaction	NAV based on Balance Sheet
	Discount Rate	Select type of multiples, exld. outliers	
	Terminal value	Apply to maintainable metric	
	Present Value of future cash flows	Listed Entity share price	

- *These methodologies remains same for domestic and International transactions but with certain key differences and associated considerations*

INCOME APPROACH

Discounted cash flow method (DCF)

- Discounted cash flow analysis is based upon the theory that the value of a business is the sum of its **expected future free cash flows**, for several periods (un stable growth period) and terminal value after expiry of that period (stable growth period).
- A discount rate is employed to convert those future values back to a present value.
- The business life is divided into two phases: unstable growth period and stable growth period – it is also known as two stage model of cash flow discounting. It can be extended to three or four stage model.

Capitalization method

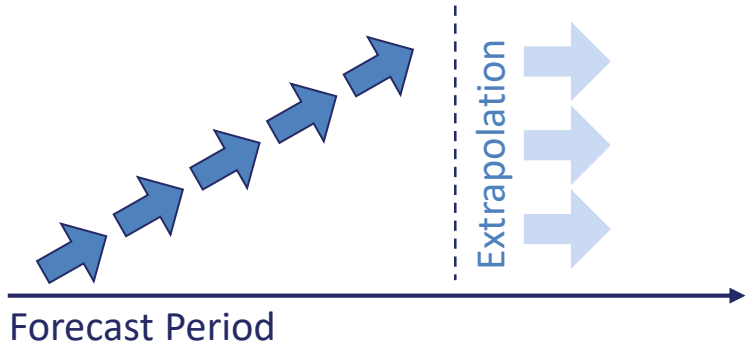
- Estimates the fair market value of a company by converting the future income stream into value by applying a capitalization rate.
- **This method is usually employed when a company is expected to experience steady financial performance for the foreseeable future and when growth is expected to remain fairly constant. (Based on Gordon growth model)**

INCOME APPROACH

Income Approach requires a lot more deeper insights to shortlist the key valuation parameters

- Company Background
- Management Business Plan
- Free Cashflows
- Discount Rate
- Business cycle / Key sensitivities

1. **FCFF** **Vs** **FCFE**

2. 

3. **Terminal Value**
   - Gordan growth
     Vs
   - Variable growth
     Vs
   - Exit multiple
     Vs
   - Salvage / Liquidation value

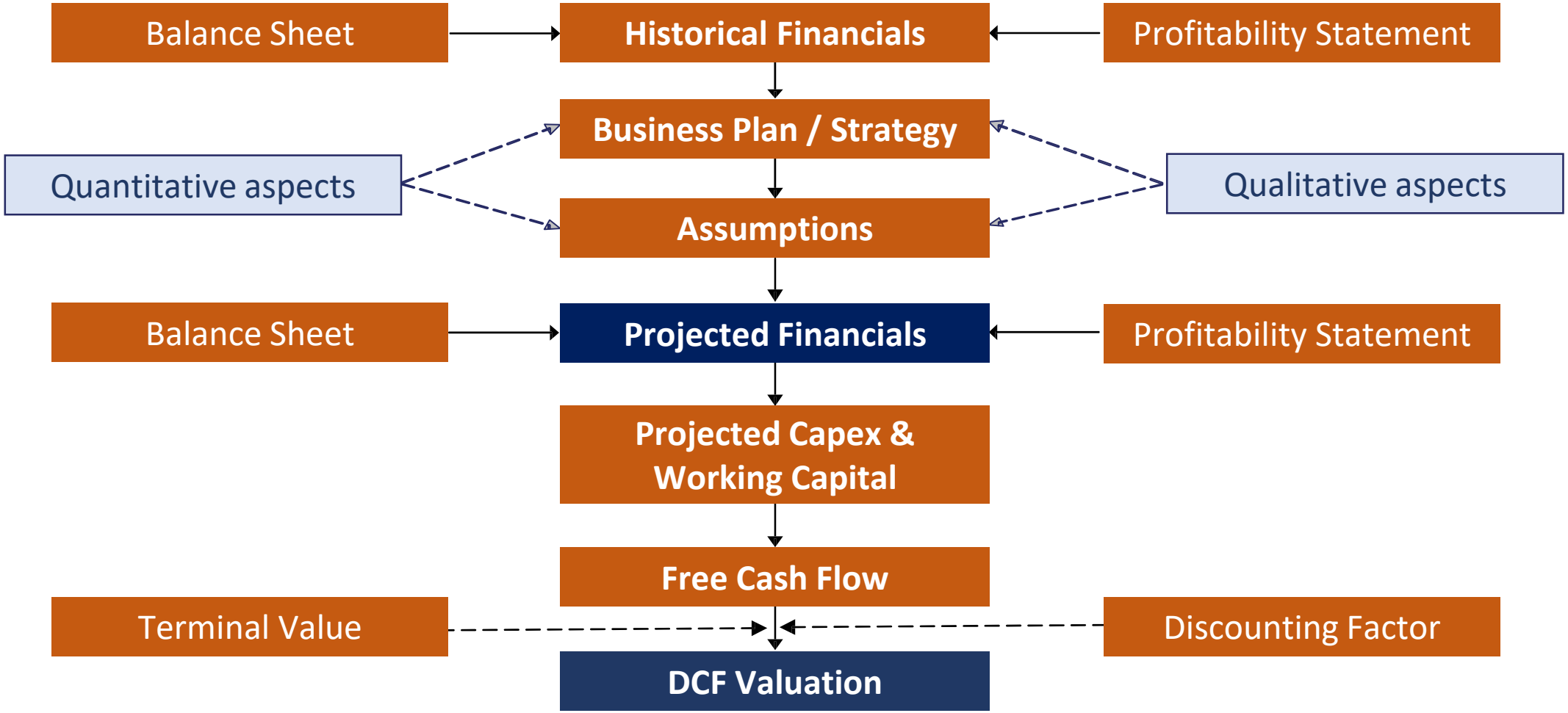
DISCOUNTED CASH FLOW METHOD

Process

- Projections – Consider the projections to determine the future cash flows expected to be generated by the asset
- Analysis – Analyze the projections and its underlying assumptions to assess the reasonableness of the cash flows
- Cash flows – Choose the most appropriate type of cash flows for the asset, free cash flows to equity or free cash flows to firm
- Discount Rate – Determine the discount rate
- Growth Rate – Determine beyond the explicit forecast period
- Present Value and Terminal Value – Apply the discount rate to arrive at the present value of the explicit period cash flows and for arriving at the terminal value.
- Enterprise to Equity Value – Adjustment in Enterprise Value to arrive at Equity Value

DISCOUNTED CASH FLOW METHOD

Key Steps



Key Parameters

1. Free Cash Flows 2. Discounting factor 3. Terminal Value

DISCOUNTED CASH FLOW METHOD

Projections – FCFF Vs FCFE

Free Cash Flows to Firm

FCFF refers to cash flows that are **available to all the providers of capital.**

- Excludes interest expenses
- FCFF is discounted by Weighted average cost of Capital
- Measures free cash flow to firm before all financing costs
- EBIT×(1−Tax Rate)+Depreciation−Changes in Working Capital−Capital Expenditures

Free Cash Flows to Equity

FCFE refers to cash flows available **to equity shareholders.**

- Accounts in interest expenses
- FCFE is discounted by Required return on Equity.
- Used to determine the equity value of the firm (focuses on equity shareholders).
- FCFF−Interest Payments×(1−Tax Rate)+Net Ne w Debt

MARKET APPROACH

Market Price Method

- Consider the traded price observed over a reasonable period while **valuing assets which are traded in the active market**
- Provides **Value Indication on a non-controlling, marketable basis**

Comparable Companies Multiple Method

- Involve valuing an asset based on market multiples derived from prices of **market comparable traded on active market**
- Provides **Value Indication on a non-controlling, marketable basis**

Comparable Transaction Multiple Method

- Involve valuing an asset based on transaction multiples derived from prices paid in transactions of comparable assets
- Provides **Value Indication on a controlling, marketable basis**

COST APPROACH

The cost approach, also known as the **asset-based approach**

It is specifically useful for asset intensive firms, valuing holding companies as well as distressed entities that are not worth more than their overall net tangible value.

Two Common Valuation methods under the Cost Approach for Business Valuation

- Replacement Cost Method
- Reproduction Cost Method

NAV Method

It values a business based on what it would cost to replace the assets owned by a business.

$$Net\ Asset\ Value = \frac{Assets - Liabilities}{Total\ no.of\ common\ shares}$$

Sum of the Parts Method

This method is used to adjudge the value of a company based on the sale value of the different parts or divisions of a business.

$$SOTP = Value\ of\ segment\ n_1 + Value\ of\ segment\ n_2 \ldots . - (ND) - (NL) + (NA)$$

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COST APPROACH

Cost Approaches are normally sanity checkpoint in many situations unless company is in a Startup phase or liquidation scenario

Book Value / Historical Cost

- Cost incurred by the Business till date to bring the asset to the current state.

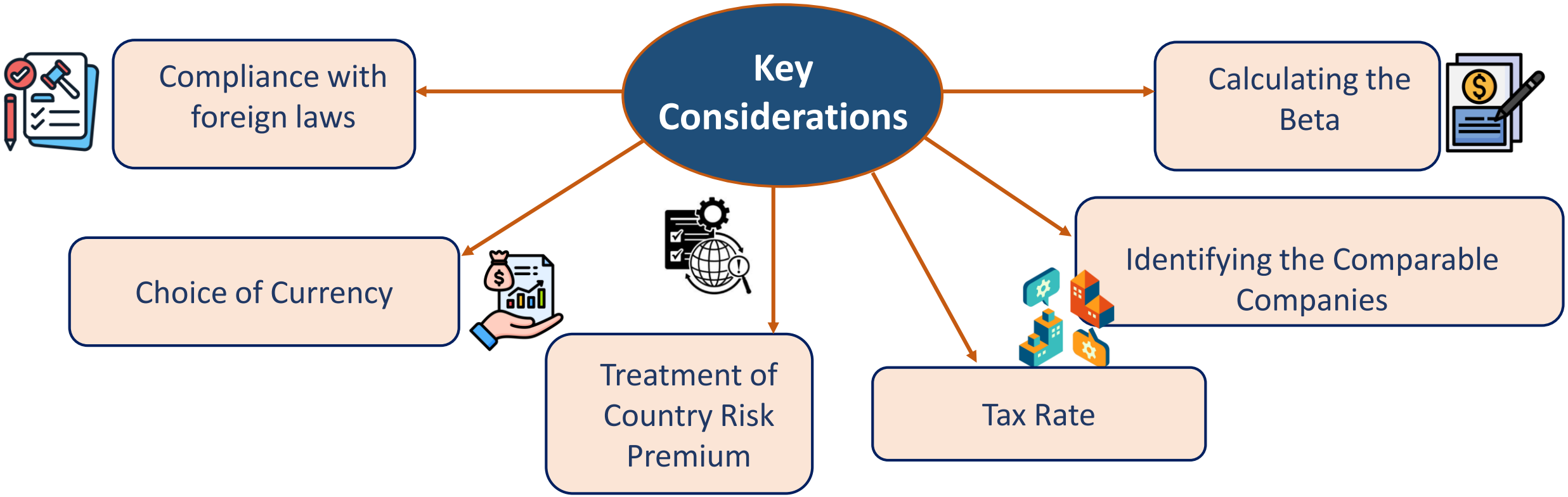
Replacement Cost

Replacement Cost Method refers to valuing an asset based on the cost that a market participant shall have to incur to recreate an asset with **substantially the same utility (comparable utility)** as that of the asset to be valued, adjusted for obsolescence

Reproduction Cost

- Reproduction Cost Method refers to the cost that a market participant shall have to incur to recreate a **replica of the asset** to be valued, adjusted for obsolescence

INTERNATIONAL VALUATION AND KEY CONSIDERATIONS

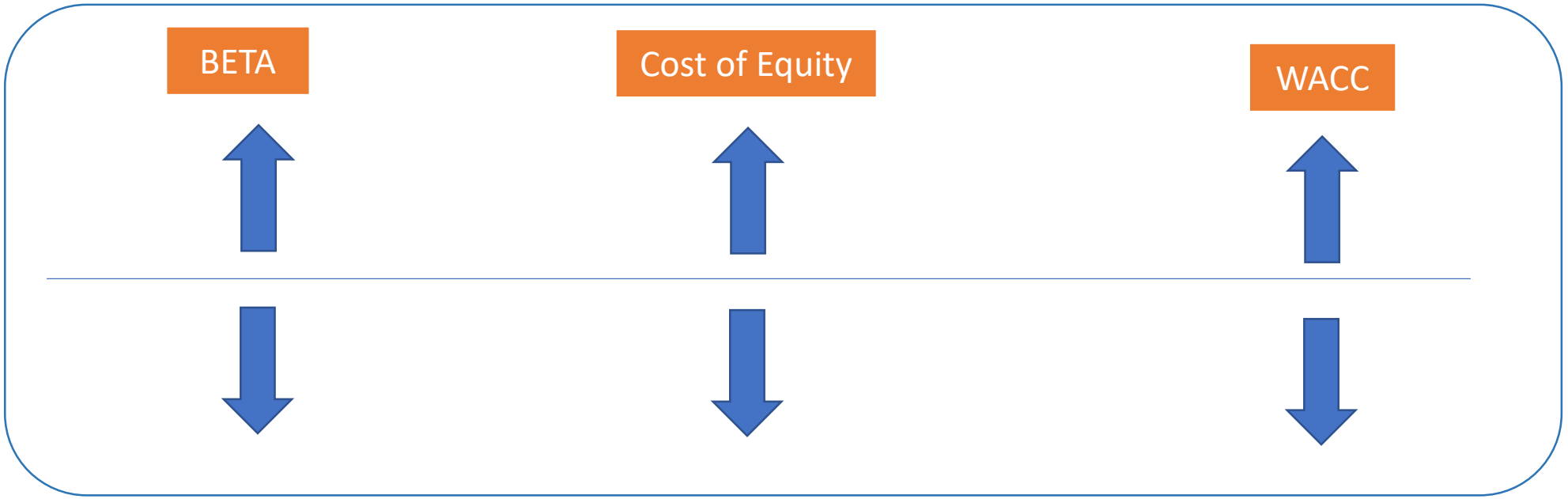


CHOICE OF CURRENCY

- ✓ Cash flows have to be in the **same currency** as your Discounting Rate
- ✓ It can be either the **home or the foreign currency** in determining cash flows.
- ✓ If you do your analysis in dollars, your cash flows have to be in nominal dollars
- ✓ **Forward or expected exchange rates** (and not the current spot rate) to be taken to make the conversion
- ✓ If you want to preserve consistency, your expected exchange rate has to be computed from either **interest rate or purchasing power parity**.

BETA

- ✓ Measure of an investment's systematic risk relative to a market index, indicating how much the investment's returns move with market changes
- ✓ It affects the WACC by changing Cost of Equity component



QUESTION

- When considering tax impacts, is it more prudent to use the statutory tax rate or the effective tax rate: Statutory or Effective?

Effective Tax Rate

The effective tax rate provides a more accurate reflection of the actual tax impact on the company's cash flows and valuation, as it accounts for various deductions, credits, and tax planning strategies.

TAX

- ✓ Corporate Income Tax Rates - Distinction between statutory and effective tax rates.
- ✓ Withholding Taxes - Taxes on dividends, interest, and royalties paid to foreign investors.
  - Affects net cash flow and valuation.
- ✓ Capital Gains Tax - Varies by country on asset disposals.
  - Impact of exemptions and rollovers.
- ✓ Tax Holidays and Incentives - Temporary tax relief affecting cash flows.
  - Consider expiration and clawback conditions.
- ✓ Currency Exchange and Tax Implications: - Tax on foreign exchange gains and losses.
  - Currency translation differences for tax reporting.

COUNTRY RISK PREMIUM

The Country Risk Premium (CRP) is the incremental return an investor anticipates to assume the investment risk in foreign markets compared to the domestic country.

- The inclusion of the country risk premium (CRP) is intended to adjust the cost of equity for the potentially adverse effects that stem from a particular country's geopolitical environment and economic conditions.
- The country risk premium is generally higher for developing markets than for developed nations
- The majority of practical models are based on the CAPM (Capital Asset Pricing Model).

FACTORS TO CONSIDER WHILE ESTIMATING COUNTRY RISK PREMIUM

- **Macroeconomic Factors** - are those that have a broad impact on the national economy, such as population, income, unemployment, investments, savings, and the rate of inflation, and are monitored by highly professional teams governed by the government or other economists.

- **Currency fluctuations**

- **Fiscal deficit** refers to the situation where the total budget expenditure exceeds the total budget receipts, excluding the government borrowings in a given fiscal year. It determines the amount the government needs to borrow for meeting its excess expenditure.

- **Political Factors**

COUNTRY RISK PREMIUM

Country Risk Premium

$$CRP = \frac{\text{Spread on Sovereign Bond Yield x Annualized Standard Deviation on Equity Index}}{\text{Annualized Standard Deviation on Bond Index}}$$





Country Risk Premium by Ashwath Damodaran

Country	*Adj. Default Spread*	*Equity Risk Premium*	*Country Risk Premium*	*Corporate Tax Rate*
Abu Dhabi	0.54%	5.32%	0.72%	15.00%
Albania	4.90%	11.18%	6.58%	15.00%
Algeria	4.90%	11.18%	6.58%	26.00%
Andorra (Principality of)	2.07%	7.38%	2.78%	18.98%
Angola	7.08%	14.11%	9.51%	25.00%
Anguilla	10.54%	18.75%	18.75%	27.25%
Antigua & Barbuda	10.54%	18.75%	18.75%	27.25%
Argentina	13.07%	22.15%	17.55%	35.00%
Armenia	3.92%	9.86%	5.26%	18.00%
Aruba	2.07%	7.38%	2.78%	25.00%
Australia	0.00%	4.60%	0.00%	30.00%

EXAMPLE

- If a country has an standard deviation of 18% and 12.5% on equity and bond index, respectively, over 5 years, what is the country's risk premium? The country's treasury bond has yielded a 3.5% return. In contrast, the sovereign bond has a 7% yield in a similar period.

Sr. no.	Particulars	Value
B2	Sovereign Bond Yield	7%
B3	Country's Treasury Bond Yield	3.5%
B4	Equity Index Yield	18%
B5	Bond Index	12.5%
	Country Risk Premium	**5.04%**

*Using Country Risk Premium Formula = (B2-B3) * (B4/B5)*

QUESTION

- Would you adjust the cash flows or the discount rate when considering a company's exposure to high-risk markets: Cash Flows or Discount Rate?

Discount Rate

Adjusting the discount rate to reflect high-risk market conditions is a common approach. However, cash flows may also be adjusted depending on the specific risks and market conditions.

TREATMENT OF COUNTRY RISK PREMIUM

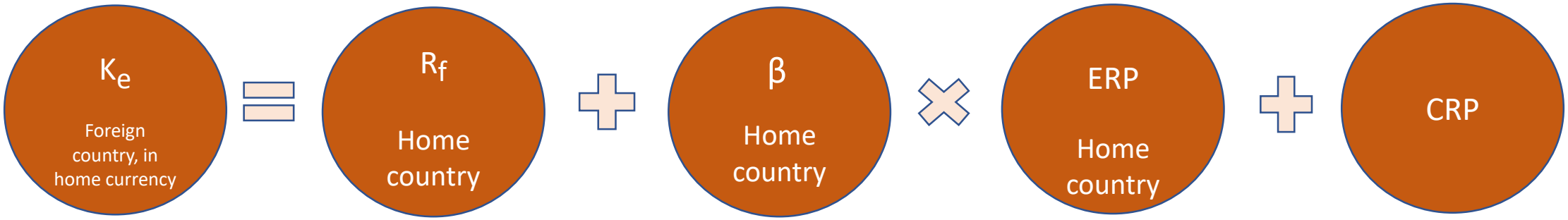
Alternative 1- Scenario Analysis

- Country risk is directly reflected in the projected Cash Flow
- And Profitability Assessment of each scenario
- No CRP is reflected in WACC
- While this approach is more specific to situation, it is very time consuming and costly
- Most Importantly it is difficult , if not impossible to derive

Alternative 2- Country Risk Premium

- Country risk is reflected in the cost of Equity and debt capital
- And in weighted Average cost of Capital (WACC)

COUNTRY YIELD SPREAD MODEL: COUNTRY RISK PREMIA (CRP)



- Where:
- $K_{e,\ foreign\ country}$ = Cost of equity capital in the foreign country (denominated in the home country currency)
- $R_{f,\ home\ country}$ = Risk free rate on government-issued bonds (in the home country currency)
- $B_{\ home\ country}$ = Beta appropriate for a company located in the home country in a similar industry as the foreign country's subject company (i.e., beta is measured using returns expressed in the home currency)
- $ERP_{\ home\ country}$ = Equity risk premium of home country
- CRP = Country risk premium, determined as the difference between the yield-to-maturity on a foreign country government bond (issued in the home country's currency) and the yield-to-maturity on a home country government bond with a similar maturity, adjusted for relative market equity.

PRICING GUIDELINES

PARTICULARS	GUIDELINES	LISTED COMPANY	UNLISTED COMPANY
Issue by company to person resident outside India	**Price not less than**	The rule prescribes that the price must be worked out in accordance with SEBI guidelines.	The fair value worked out as per any internationally accepted pricing methodology for valuation on an arm's length basis, duly certified by A Chartered Accountant or A SEBI registered Merchant Banker or A practicing Cost Accountant.
Transferred from a person resident in India to a person resident outside India			
Transferred by a person resident outside India to a person resident in India	**Price not more than**		

PRICING GUIDELINES

PARTICULARS	METHODOLOGY
Swap of Equity Instruments	Irrespective of the amount, valuation involved in the swap arrangement shall have to be made by a **Merchant Banker** registered with the SEBI or an **investment banker** outside India registered with the appropriate regulatory authority in the host country.
Subscription to MOA	Such investments shall be made at **Face Value** subject to entry route and sectoral caps
Share Warrants	Their pricing and the price or conversion formula shall be **determined upfront**.
Company going through delisting Process	Pricing as per **SEBI** (Delisting of Equity Shares) Regulations, 2009.
CCPS / CCDs	Issue Price / Formula to be specified upfront at time of issue **Price @ Conversion Date > FMV @ Issue Date**

Note that these pricing guidelines shall **not be applicable for investment in equity instruments by a person resident outside India on a non-repatriation basis.*

REGULATORY CONSIDERATIONS

Law	Incidence	Method	Who can do
Companies Act	Preferential Issue – Unlisted Co- Sec 62 & Sec 42	• Internationally accepted Valuation methods	Registered Valuer
	S/230 to 231 & 234 – Arrangement/ Merger / Demerger	• Internationally accepted Valuation methods	Registered Valuer
RBI / FEMA	Inbound / Outbound	• Listed Shares – SEBI Guidelines • Unlisted Co – International Accepted Valuation Methodology	MB / CA
SEBI	Takeover Regulation	• Direct Acquisition • Indirect Acquisition	Acquirer / Manager to offer (MB) Registered Valuer
	Preferential Issue (ICDR)	• Frequently traded • Infrequently traded – All valuation parameters have to be taken care of. (Valuation methodologies as amended from time to time as per SEBI regulations)	Merchant Banker Registered Valuer
Income Tax	Unquoted Shares – Sec 50CA & 56(2)(x) r.w. Rule 11 UA	Co in which public are <u>not substantially interested</u> • Issue of unquoted equity – NAV or DCF Certificate • Quoted Equity – traded / floor price • Unquoted Preference Shares – Valuation certificate	MB/CA as the case may be
IBC	Asset Valuation – Regulation 35	• Fair Value & Liquidation Value – IAVM	Registered Valuer

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