Analysis of Acquisition Premiums for Outbound M&A's by Indian Companies

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Abstract

This project explores the some of the costliest outbound M&A's by Indian Companies. The aim of the study is value the acquisition premiums and comment if they were overpriced or not. If overpriced then reasons were found out for the high acquisition premiums. Four deals namely Tata – Corus deal, Hindalco – Novelis deal, Tata Motors – JLR deal and Dr. Reddy Laboratories – Betapharm deal were analyzed and were valued again to determine a suitable acquisition premium. The methodology that was followed was DCF which involved estimating the Free Cashflows and discounting them to get to the Enterprise Value of the firm.

Keywords: M&A's, DCF, Acquisition Premium, Free Cash-flows, Enterprise Value.

INTRODUCTION

India is one of the fastest growing economies in the world and is predicted to become the third largest economy after the United States and China. India's economic transformation has allowed Indian firms to gain significant attention in the world economy.

Indian firms' outbound M&A activity gained traction beginning around 2000 and picked up considerable speed in 2005. By 2005, Indian firms' outbound M&A deals generated \$9.5 billion, representing 58 percent of the country's deal value for the year. Of the outbound deals in 2005, the majority of Indian firms' acquisitions were concentrated in Europe and North America. India's outbound M&A deals and value skyrocketed in 2007 with the rise of cross-border mega-deals. In 2007, six of India's top 10 outbound M&A deals totaled more than \$30 billion in value, five times that of the previous year. Moreover, there is some evidence that in 2007 and 2008, outbound acquisitions by Indian firms exceeded inbound investment by foreign multinationals into India.

With the advent of the global credit crisis, Indian M&A activity slowed considerably in 2009. However, 2010 saw a significant recovery, with total outbound deals valued at approximately \$22.5 billion. Outbound deals accounted for

45 percent of total M&A deal value in 2010, compared to 12 percent in 2009. Both the number and value of outbound deals were significantly larger in 2010 than in 2009. Outbound deals in 2010 also appeared to be in line with predictions that Indian firms would veer away from targets in developed economies to targets in emerging economies, as well as in the other BRIC countries, Brazil, Russia, and China.

REVIEW OF LITERATURE

1. Raplh Villiger, Boris Bogdan (2005) addresses one of the main concerns with regard to DCF valuation of Pharmaceutical organizations. The study mentions that DCF valuations of established success rates do not distinguish between projects that fail to pass safety or efficacy trials and those that are abandoned for lack of economic viability. The fact that 30% of all pharma R&D abandonments are for economic reasons is a strong argument to counter the assumption of constant growth rates in DCF to evaluate new drug development.
2. Jose Pablo Dapena (2008) focuses on the analysis on growth options, its structure and valuation. The following assumptions are taken: Capital markets are complete, the value of the business in each state of the nature is known. The paper illustrates on the growth decisions a manager takes while valuing the firm. The

mentioned are expand business vertically (buy out or set up business within the value chain), expand business horizontally (buy out or set up business not directly related with the value chain), expand the business (gain market share)

3. Ruback, (2010) focuses adaptations to the discount cash flow (DCF) method when valuing forecasted cash flows that are biased measures of expected cash flows. The paper imagines a simple setting where the expected cash flows equal the forecasted cash flows plus an omitted downside. The study says that there is an inherent optimism in the forecast of cash flows by managers when trying to value the firm. The likely result is that the forecasted cash flows over-estimate the expected cash flows so that the forecasted cash flows are an upward biased estimate of the estimated cash flows. Because the environment and the available opportunities change constantly, there is no empirical basis for evaluating the accuracy of either the cash flow forecasts in the various scenarios or the associated probabilities, making it difficult to empirically adjust the forecasted cash flows towards an unbiased estimate of expected cash flows.
4. Stefan Lutz (2011) in their paper assess that in valuing a firm using the discounted cash flow method (DCF) requires the joint determination of the market value of its equity (MVE) together with the equity risk premium (ERP) the firm should earn, since the latter is part of the discount rate used in the calculation of the MVE. This paper presents a theoretical derivation of how MVE and ERP can be calculated simultaneously under fairly general conditions. Besides firm data on free cash flow to equity the only external data used are the risk-free rate of interest and a parameter indicating the required market risk premium per return volatility?
5. Although the DCF method is widely used and has been applied since the 1960s, there are still numerous problems appraisers will encounter during real-life valuations, where the literature has not reached a consensus. To deal with the uncertainty, experienced appraisers recommend conducting a sensitivity analysis. In the course of such an analysis, single input factors are changed to assess the influence on the final value. This help to identify the major value drivers of the project. As studied by Pereiro (2002), the most influential input factors change from company to company. While unit prices have significant influence on the final value for consumer goods producers, it is less important for sellers of high margin and low volume products. In an attempt to identify the generally most relevant value drivers, Akalu (2002) assigned the highest influence on the company value to the

operating cost and the cost of capital. Appraisers should thus focus on making detailed predictions for the most influential input factors and try to keep the others as simple as possible.

OBJECTIVE AND METHODOLOGY

1 Objective

The objective of the paper is to explore some of the costliest outbound M&A's by Indian Companies. The aim of the study is value the acquisition premiums and comment if they were overpriced or not.

Four deals namely Tata – Corus deal, Hindalco – Novelis deal, Tata Motors – JLR deal and Dr. Reddy Laboratories – Betapharm deal were analyzed and were valued again to determine a suitable acquisition premium. The methodology that was followed was DCF which involved estimating the Free Cashflows and discounting them to get to the Enterprise Value of the firm.

2 Methodology

2.1 Intrinsic value Derivation

The DCF method is used to value a firm. DCF value depends on the present value of the cash flows generated with an asset. The approach requires three main steps: Modeling plausible future cash flows for the short-to-mid-term horizon, estimating the terminal value and determining the appropriate discount rate. The sum of the discounted cash flows equals the total value of the asset. By subtracting the initial investment outlay from the asset value, Net Present Value (NPV) of the project is calculated, which corresponds to the economic value generated along the lifespan of the asset.

Based on analysis of the historical financial performance and the current economic environment, the expected Free Cash Flows (FCF) over the life of the project under valuation is estimated. The FCFs are those liquid funds which are available for distribution to the debt and equity holders of the organization after the investment in working capital and fixed assets were carried out. As the level of precision for the cash flow projections diminishes over an extended planning horizon, appraisers resolve this problem by assuming a constant cash flow on a plausible, sustainable level after a pre-specified amount of years.

This is coherent with the assumption that all companies will eventually reach a stable state and generate constant cash flows which are essentially perpetuity and can be valued as such. The present value of these perpetual cash flows, the so-called terminal value, is then discounted together with the free cash flows back to the actual valuation data with an adequate rate of return, which corresponds to the risks associated with the investment. The sum of these discounted values equals the asset's total value. If the project is partly debt financed, the market value of the debt obligations at the valuation date needs to be subtracted to determine the equity value.

DCF calculations for all the four deals were based on certain assumption. The same were reported in the analysis section.

2.2 Projecting the Cash Flows

The initial decision when forecasting cash flows is to settle on the length of the extraordinary growth period, i.e. after how many years the company is expected to generate a stable level of cash flows. Depending on firm-specific characteristics like the size (smaller firms are more likely to grow for a longer period of time than large ones), the market potential, the current growth rate (firms which are already experiencing rapid growth are more likely to continue to do so) and the sustainability of a competitive advantage, which is necessary to generate consistent growth, the length of the extraordinary growth period can range from 0 to 15 years (Damodaran, 2006). For this planning horizon the annual FCFs are forecasted with a high level of detail.

Usually, as a first reference point, the recent financial performance, especially sales or revenue growth as well as the other value drivers are analyzed instead of starting from scratch. Although the explanatory power of historical growth in regard to future growth is doubted, this analysis can be expected to reveal valuable information on how the company performed and why it was successful or not (Brealey et al., 2006). An analysis of the recent macroeconomic conditions provides further information, as the financial results can only be evaluated in the economic context. Profits or losses from economic boom phases or recessions have to be adjusted to correspond to a more balanced scenario.

2.3 Terminal Value Estimation

The Terminal Value corresponds to the present value of all future cash flows which are generated after the detailed planning horizon. There are two different methods of estimating the terminal value under a going concern premise (in contrast to a liquidation premise, where the selling value of the company's accumulated assets would represent the terminal value). One uses a Multiple factor to earnings, revenues or book values. The other approach assumes that the cash flow in the last year of the detailed planning horizon will grow at a constant rate forever. This cash flow stream can be valued using a perpetual growth model:

$$\text{Terminal value}_t = \text{Cash flow}_{t+1} / (r - g_{\text{Stable}})$$

Where r equals the company's discount rate and g_{Stable} is the rate with which the cash flows will grow each year. Depending on the company under valuation, a no-growth ($g_{\text{Stable}} = 0$) or negative growth scenario ($g_{\text{Stable}} < 0$) can also be appropriate.

2.4 Deriving the Discount Rate - the Capital Asset Pricing Model

During a DCF valuation, the riskiness of the investment is reflected by the discount rate. It corresponds to the rate of return that investors could expect from an alternative investment which yields cash flows with the same risk pattern. Risk in the valuation context addresses the likelihood of getting a return on the investment which deviates from the expected level. The deviation can either be positive for the investor (the so-called upside risk) as well as negative (downside-risk) and both tendencies are equally considered.

$$E(R_i) = R_f + \beta_i [E(R_M) - R_f]$$

$$\beta_i = \frac{\text{Cov} \left(\begin{matrix} R_i \\ R_M \end{matrix} \right)}{\text{Var} \left(\begin{matrix} R_M \end{matrix} \right)}$$

According to the CAPM, the expected return for an asset is determined by the rate which investors could expect without taking any risks, plus an individual risk premium. This risk premium depends on the general level of market risk and a factor which measures a stock's exposure to market risk. In the CAPM formula r_f denotes the so-called risk-free rate, which is the

expected return from a riskless investment, i.e. where the expected return is known with certainty. In practice, highly-liquid long-term sovereign bonds issued by governments with excellent ratings are considered as risk-free investments and their yields (either current or historical averages) are used. r_m is the average return holders of the market portfolio can expect. Thus the term $(r_m - r_f)$ the so-called Market Risk Premium, measures the extra return investors expect for investing their funds in an asset with average risk (called the market portfolio) instead of the risk-free investment.

ANALYSIS AND INTERPRETATION

1 TATA STEEL - CORUS DEAL

Assumptions taken in DCF

1. Growth Rates:

Steel Industry moves in cycles with fluctuating demand. This industry generally needs a trigger for high growth to occur. In 2008, during downturn time when the whole economy was shrinking, steel demand went up because Beijing Olympics was taking place. Therefore the growth rates have been assumed keeping this cycle in view, few years were assumed as high growth period and few years were assumed as low demand periods and accordingly growth rates have been taken.

2. EBITDA Margins:

EBITDA margins were assumed to be around 10.5% based on the historical margins and as time goes by the margins would decrease owing to competition and increased raw material prices. Hence the margins have been decreased by 100 basis points over a 5 year span accordingly.

3. Depreciation & Amortization & Capex:

D&A has been assumed a constant of 3.5% based on the historical averages. Capex is maintained a little over D&A because Capex consists of two components: Growth capex and maintenance capex. Maintenance capex substitutes for the D&A and growth capex is to achieve the extra sales growth year on year.

4. Change on Working Capital:

Increase in Working Capital as a percent of sales taken at 2.8% as steel industry is capital intensive and reduced by 40 basis points, assuming that the company would be continuously improving its working capital and ideally want its change in working capital to 0% when it reaches perpetuity.

5. Terminal Growth rate:

It is assumed to be 3% because though the US and European economies would at 2% or less than 2% in future, the emerging economies (BRIC) nations would go grow at more than 3% and hence the average perpetuity growth rate is assumed to be 3%.

Table 1 Tata Corus Deal Capitalisation & Valuation Parameters (Perpetuity growth rate analysis).

Perpetuity growth rate (g)	0.03
WACC	0.089892
Terminal value of Unlevered Cash flows	361.6936
Implied Terminal Value 2010E	6220.254
Net Present Value of Unlevered FCFs	992.0704
Net Present Value of Terminal Value	4044.739
Implied Enterprise Value (in million)	5036.809
Net Financial Cash /(Debt)	1600
Market value of Minority Interest	26
Implied Equity Value	3410.809

Table 2 Tata Corus Deal Sensitivity Analysis

		Enterprise Value			Equity Value		
		Perpetuity Growth Rate			Perpetuity Growth Rate		
WACC		0.025	0.03	0.035	0.025	0.03	0.035
	0.085	5101	5497	5971	3475	3871	4345
	0.09	4704	5037	5427	3081	3411	3801
	0.095	4356	4633	4955	2730	3007	3329

2 HINDALCO - NOVELIS DEAL

Assumptions taken in DCF

1. Growth Rates:

Aluminum Industry moves in cycles with fluctuating demand. Therefore the growth rates have been assumed keeping this cycle in view, few years were assumed as high growth period and few years were assumed as low demand periods and accordingly growth rates have been taken.

2. EBITDA Margins:

EBITDA margins were assumed to be around 10% based on the historical margins and as time goes by the margins would decrease owing to competition and increased raw material prices. Hence the margins have been decreased by 200 basis points over a 10 year span accordingly.

3. Depreciation & Amortization & Capex:

D&A has been varied according to the cycles, with high D&A in growth cycle and low D&A in downturn cycle. Capex is maintained a little over D&A because Capex consists of two components: Growth capex and maintenance capex. Maintenance capex substitutes for the D&A and growth capex is to achieve the extra sales growth year on year.

4. Change on Working Capital:

Increase in Working Capital as a percent of sales taken at has been increased during the downturn cycle as more cash would be tied up because of delayed payments from the customers.

5. Terminal Growth rate:

It is assumed to be around 2.5% given the volatility of the automobile markets and assuming that the market would get saturated in 10 years time.

Table 3 Hindalco-Novelis Deal Capitalisation & Valuation Parameters (Perpetuity growth rate analysis).

Perpetuity growth rate (g)	0.025
WACC	0.100424
Terminal value of Unlevered Cash flows	470.6633
Implied Terminal Value 2010E	6396.278
Net Present Value of Unlevered FCFs	1990.743
Net Present Value of Terminal Value	2456.567
Implied Enterprise Value (in million)	4447.31

Table 4 Hindalco-Novelis Deal Sensitivity Analysis

		Enterprise Value		
		Perpetuity Growth Rate		
WACC		0.02	0.025	0.03
	0.095	4574	4772	5000
	0.1	4283	4447	4635
	0.105	4072	4213	4372

3 TATA MOTORS - JLR DEAL

Assumptions taken in DCF

1. Growth Rates:

Automobile industry is dependent on economy and demand varies accordingly. In times of downturn and recession the revenues drop and in times of expansion the revenues increase because of a greater demand. Hence growth rates were initially increased assuming it to an expansionary period and then gradually decreased assuming to be a down turn period in order to account for all the economic cycles to get a fair valuation.

2. EBITDA Margins:

A bell curve was followed in forecasting the EBITDA margins, with margins varying from as high as 12% to a mediocre 6%.

3. Depreciation & Amortization & Capex:

Capex has been increased during high growth periods as sales would increase and additional capex is needed for the extra sales. Similarly capex was decreased during downturn periods and demand can be satisfied with the existing capacity. D&A was also varied accordingly and was maintained a little low than capex.

4. Change on Working Capital:

Automobile is a highly capital intensive industry and

hence change in working capital as a percent of sales was assumed to be high up to 4.5% and gradually be decreased by 150 basis points to 3% over a 10 year time frame.

5. Terminal Growth rate:

It is assumed to be around 2.5% given the volatility of the automobile markets and assuming that the market would get saturated in 10 years time.

Table 5 Tata JRL Deal Capitalisation & Valuation Parameters (Perpetuity growth rate analysis).

Perpetuity growth rate (g)	0.025
WACC	0.100424
Terminal value of Unlevered Cash flows	460.8527
Implied Terminal Value 2010E	6262.953
Net Present Value of Unlevered FCFs	-420.777
Net Present Value of Terminal Value	2405.362
Implied Enterprise Value (in million)	1984.586

Table 6. Tata JRL Deal Sensitivity Analysis

		Enterprise Value		
		Perpetuity Growth Rate		
WACC		0.02	0.025	0.03
	0.095	2108	2302	2526
	0.1	1824	1985	2168
	0.105	1617	1755	1911

4 DRL - BETAPHARM DEAL

Assumptions taken in DCF

1. Growth Rates:

Pharma industry revenue growth rates depend on the number of blockbuster drugs released by the company and the number of patents it has or the number of patents which get expired. Hence Pharma companies can have very low revenues in years of R&D and have high revenues when new products are released. The revenues also come down when patents get expired and the drug would then become generic for every other firm to manufacture. Revenue growth also depends on the economy, in cycles of recession and downturn the western Pharma was deeply affected and revenues went down significantly. All these points were taken into consideration while projecting the growth rates over the 10 year period.

2. EBITDA Margins:

EBITDA margins were assumed to be around 25% based on the historical margins and as time goes by the margins would decrease owing to competition Hence

the margins have been decreased by 200 basis points over a 10 year span accordingly.

3. Depreciation & Amortization & Capex:

D&A for a pharma company would be high because of high R&D expenses which are taken as a part of the D&A. They would also require heavy Capex because of high R&D expenses. Hence such high margins were allocated to D&A and Capex.

4. Change in Working Capital:

Increase in Working Capital as a percent of sales taken at has been increased during the downturn cycle as more cash would be tied up because of delayed payments from the customers.

5. Terminal Growth rate:

It is assumed to be 2.5% because though the US and European economies would at 2.5% or less in future and emerging economies growth rates were not considered as Betapharm serves on the western markets.

Table 7 DRL – Betapharm Deal Capitalisation & Valuation Parameters (Perpetuity growth rate analysis).

Perpetuity growth rate (g)	0.025
WACC	0.07
Terminal value of Unlevered Cash flows	25.46937
Implied Terminal Value 2010E	580.1356
Net Present Value of Unlevered FCFs	227.3031
Net Present Value of Terminal Value	294.9115
Implied Enterprise Value (in million)	522.2146

Table 8 DRL – Betapharm Deal Sensitivity Analysis

		Enterprise Value		
		Perpetuity Growth Rate		
WACC	0.08	0.02	0.025	0.03
	0.075	428	447	470
	0.07	456	480	509
		491	522	561

The details of DCF calculations are available with the author.

Table 9

Deal	Actual Deal Value	EV through Valuation	Comments
Tata – Corus	\$12bn	\$4.7bn - \$5.97bn	Overpriced acquisition
Hindalco – Novelis	\$6bn	\$4bn - \$5bn	Overpriced acquisition
Tata Motors – JLR	\$2.3bn	\$1.6bn - \$2.5bn	Fairly valued acquisition
DRL – Betapharm	\$600mn	\$428mn - \$560mn	Overpriced acquisition

One can see that 3 out of the top 4 acquisitions are overpriced. There are many different reasons for the same.

Deal	Reasons for High Acquisition Premium
Tata – Corus	<p>Tata Corus wanted to become one of the largest makers of steel in the world and has acquired Corus which was much bigger than Tata Steel.</p> <p>Desperation to acquire has led to high premium as Tata's wanted to counter the bid offered by CSN. Arcelor mittal also one of the bidders offered and EBITA multiple of 6 and said that anything more than this multiple is overpriced. CSN made a counter bid of EBITDA multiple of 9 and because Tata had to win the deal offered a multiple of 9.5 which was way too high.</p> <p>Lessons to be Learnt: Inorganic growth is fastest medium to grow but should not be at the cost of a heavy price on the Balance Sheet which becomes impossible to recover given the high volatile nature of today's markets.</p> <p>Indian companies should not be desperate to go any extent to acquire in order to become global.</p>
Hindalco – Novelis	<p>Hindalco went for this deal in order to get the technology and technical expertise that Novelis can provide. But Hindalco already had huge debt on its Balance Sheet and further funding the acquisition had increased their liabilities by a greater fold and the situation had become very difficult for Hindalco to recover. Novelis had reported losses in the whole of 2006 and even after the merger the venture did not make any profits in 2008-10 period because of recession</p>

	indicating that aluminum as an industry is very cyclical and the economy also moves in cycles Lessons to be Learnt: Companies should refrain themselves from high acquisitions in case of already existing heavy debts on their Balance Sheet. If the acquisition fails then the amount of already existing heavy debt increases.
Tata Motors – JLR	JLR was a fairly valued acquisition with the acquisition value coming in range of the Valuation through DCF. Tata's recently revered the complete payoff of Tata Motors as they have turned JLR into a profitable venture. When JLR was acquired it was into losses because Ford management did not have proper focus on the JLR segment. Tata Motors had a clear focus and hence were able to turn the tables
DRL – Betapharm	Pharma as an industry has revenues dependent on the blockbuster drugs which the company produces, revenues depend on the patents of the company. Revenues are very high when blockbuster drugs are released otherwise revenues are low when patents get expired. DRL acquired Betapharm as they wanted to become a global player. It would give them access to German markets. Betapharm at that point of time was growing at 24% and DRL assumed that the same growth rates would continue further and paid a heavy premium. After the acquisition Betapharm has grown just over 3% and has become unprofitable for DRL and unable to recover from the premium paid. The reasons could be of recession in 2008 and the Euro crisis. The whole pharmaceutical industry was on a decline. The specialized premium drug market went into negative growth.

CONCLUSION

An acquisition can provide a successful avenue for growth and obtaining competitive advantage. But many acquisitions end up as failures for the buyer. High acquisition premiums are one of the main reasons.

Overpaying for a company is not always immediately clear, nor does it always mean the acquisition will fail. But the more you pay for a company, obviously, the longer it takes to realize the economic benefits. If you consistently overpay for a series of acquisitions, you will systemically destroy shareholder value.

One can avoid the pitfalls of overpaying by developing a thorough understanding of the true worth of the business targeted. The value of a business is theoretically the sum of the net present value of all the future expected free cash flows generated. While it's impossible to truly predict future cash flows, acquirers can do a more thorough job of understanding the target's plans for achieving growth and what really drives value for the business.

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