BUSINESS PLANNING

COMMITTEE FOR MEMBERS IN INDUSTRY
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA
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FOREWORD

Business planning is a blueprint to guide the organizational policies and strategies, which are continuously modified as conditions change, new opportunities emerge and threats are faced. It is a litmus test for the business. Setting goals and objectives is one thing, but determining the steps needed to accomplish these goals is quite another. The planning process allows the entrepreneur to determine what might and what might not work. A business plan will lay out a written plan from marketing, financial and operational point of view.

Business planning is important not only for starting a new business but also for many other strategic reasons. It is vital for running a business, whether or not the business needs new investments. Business needs plans to optimize growth and development according to priorities.

A normal business plan includes components such as descriptions of the company, product or service, market, forecasts, management team, and financial analysis and requires investigation, careful assessment of all known factors, and projecting potential results of different options that are open to the company.

In the present business environment, ICAI is playing a crucial role in helping the Chartered Accountants to update their knowledge, skill set, concepts related to every aspect of the business encompassing its marketing, finance, operations, human resource and legal. All these aspects require careful business planning, clear vision, mission and strategy for an organization to emerge successful.

It is really heartening that the Committee for Members in Industry of the Institute of Chartered Accountants of India has come up with this revised edition of the book 'Business Planning'. The book shall provide its readers, valuable insights on management tools used to guide the growth of both startups and existing businesses, to help identify not only strengths of a business, but also areas that need improvement and gaps that need to be filled. I compliment the endeavor of CA. Charanjot Singh Nanda, Chairman, CA. Shyam Lal Agarwal, Vice Chairman and other members of CMII for bringing out this edition.

I am sure that the book would prove to be a value addition to the knowledge base of the readers.

New Delhi
29th June, 2015

CA. Manoj Fadnis
President, ICAI

PREFACE

We've all heard the old adage that failing to plan is planning to fail, and this is true when it comes to business. A business plan is a blueprint to the business's future.

The Business Plan format is a systematic assessment of all the factors critical to the business purpose and goals. In its simplest form, a business plan is a guide—a roadmap for the business that outlines goals and ways to achieve those goals. Often, it involves the use of resources within the company as well as engaging the services of professionals to assist in designing and implementing the plan.

It may seem like a lot of work at the outset, but a well prepared business plan can save time and money in the long run. It not only set the direction for the business but also acts as a reference point for measuring performance. Most importantly, a business plan incorporating a feasibility study will help to determine whether idea is commercially viable and any issues which are needed to address or plan for along the way.

The primary value of the business plan will be to create a written outline that evaluates all aspects of the economic viability of the business venture including a description and analysis of business prospects. Creating a business plan is an essential step for any prudent entrepreneur to take, regardless of the size of the business. The plan will lay out a written plan from a marketing, financial and operational viewpoint.

The Committee for Members in Industry of the Institute of Chartered Accountants of India is committed to update its members with the new areas of the business field and enhance their awareness in topics relevant to the present dynamic business scenario. Bringing out the revised publication 'Business Planning' is aimed at equipping the readers with the comprehensive business planning process and to examine the business idea from different angles which is very important for its existence, sustenance and success.

Someone has rightly remarked,
'Your business, like most things in life, won't look after itself so it's important to spend some time working on the business, not just in it.'

I highly rever the hardwork put in by CA. Anjana Vivek in revising this book for the benefit of the members. I also appreciate the efforts of the entire team of the Committee and the secretariat.

New Delhi
29th June, 2015

CA. Charanjot Singh Nanda
Chairman
Committee for Members in Industry

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CHAPTER 1

Prelude to Planning

Are you planning for the future based on future expectations?
Or
Have you just extrapolated the past experience into the future?

Change is inevitable; change is rapid in this century, more than in any other century that has gone by. Peter Drucker, described as 'the most enduring management thinker of our time' by *Business Week*, has said in his book "*Management Challenges for the 21st Century,"* that one cannot manage change, one can only be ahead of it. In periods of upheavals, such as the one we are living in, change is the norm. He goes on to say that in times of rapid structural change, the only ones who survive are the Change Leaders.

Many of you may have observed this for yourself. Companies which were well known in their fields as little as a decade ago are also grappling with change and the impact on their business. Some of these are new age ventures; some are traditional companies, with a history of having been successful for several decades; others are those who showed great promise a few years ago.

In her book, "*THE SHIFT: The future of work is already here*," Lynda Gratton, Professor at the London Business School, gives an example of how in 2000, she and her colleague, the Late Sumantra Ghoshal, had chosen 4 companies who were leaders and generally admired companies in their respective sectors. The idea was to develop extensive case studies for teaching at the London Business School as well as around the world. The chosen four were the Royal Bank of Scotland, British Petroleum, Goldman Sachs and Nokia. By 2010, three of these companies, excluding Nokia, had fallen significantly in public esteem and were grappling with multiple issues. Subsequently, even Nokia, is off this list of leading companies.

Let us look at an example, closer home in India, of a business sector that is currently taking a leadership position, particularly when it comes to valuations. This is the e-commerce sector. Some experts and finance managers look at the opportunity in addressing the needs of a large untapped market of buyers in the country. These experts are of the view that the digital commerce companies can tap into this market and create enormous value in the coming years. They justify this based on the global experiences, specifically in the US and in China, in the recent past. Such digital commerce companies, typically, have limited physical assets as compared to the more traditional business. A few of these ventures in India have managed to command enormous valuations and raise large sums of money from investors. The investors include Venture Capital Funds (VCs), Hedge Funds, FIIs, Overseas investors, HNIs and some well-known Indian Business leaders and Indian companies.

There is another set of professionals and finance managers who view investment of large sums of capital in such companies with skepticism and distrust. As valuations are increasingly driven by future expectations and intangibles, they feel that such investments are speculative in nature and are not backing true business growth opportunities.

Time will tell whether either of these extreme views is correct and whether there is true value being created for the future or there is a speculation bubble that will burst. Perhaps, the reality is something in-between. A May 2015 article in The New York Times by Conor Dougherty mentions that while some persons are talking about a tech valuation bubble, there are others who say this is not really a bubble; some call it overvaluation and froth.

To create long term value that is sustainable, these companies need to provide profitability in addition to revenue at some point. It is also not easy to predict who would be the leaders in the e-commerce retail space in India and the leading companies of India, say a decade from now. Currently, the assumption is that, to get ahead and stay ahead in this race, huge investments are to be made and that the leaders will be from those companies where such large investments have been made.

The world is getting reset today. Technology has changed the way we work, the way corporates function and also the way we live. For decades, computers were used to communicate and access information. Today we can access much of this information, through our mobile phones. In the days to come many other devices will get connected. There is talk of clothes becoming sensitive to our needs and monitoring our temperature. What was earlier in the realm of science fiction is moving closer to fact than fiction.

Neelima Mahan in an interview with Don Tapscott, a well-known author, consultant and speaker, specializing in business strategy and organizational transformation has touched on some aspects of the role of technology in business and society. In this interview "the digital disruption' published in Live MINT, Don Tapscott speaks of how underlying technology is bringing about profound change to the deep structure and architecture of institutions and his view that the digital economy is the economy.

This ever widening and deepening influence of technology has impacted the way business is done and can grow. Companies that do not have a technology play, whether it is in their core business idea, or in any activity or combination of activities will get left behind. These activities include, but are not limited to operations, human resource management, sales and marketing, communications including through social media etc.

Change in the coming years will be even more rapid. Such rapid change poses a challenge for all. How can a business leader plan and grow the business that not only grows and creates value in the near term, but is sustainable and maintains leadership position over the years? This is not an easy question to answer.

The true leaders will be those who can periodically think through the challenges and opportunities ahead and can strategize to address these. The true leaders will be those who can think through different dimensions of time, i.e. the immediate and near-term, the medium-term and the long-term. For the near-term the focus will be more on the operational, executable business plan and cash flow. For the medium-term, it will be more of a view of trends and maintaining a balance between cash flow and value creation. For the long-term it will require a very different way of thinking, of value and growth and sustainability. It will need a leader to think about what the future could look like and the possibilities and probabilities of where one's business could be in the business landscape at that point in time.

A leader, therefore, will need to think in multiple dimensions of time and will need to periodically flip between all these; in addition to thinking about the multiple dimensions of running a business. In this book, we try to share some tools and techniques that can help finance professionals and business leaders think in these multiple dimensions.

Organizations need to constantly review their business strategy and business models to see that they are not left behind. The term 'Business Model' has gained in popularity over the last few years. A business model addresses how a company operates and functions, sets out its target customers and revenue generation streams and focuses on how it grows and creates value for itself and its various stakeholders. Most importantly, it looks at multiple aspects of a business and addresses financial and non-financial parameters.

For example, if we try to understand who is a customer of Google, is it a paying advertiser or a non-paying user of Gmail and Google search? If Google does not pay attention to the non-paying user, it may not be able to attract a paying user. So the non-paying user also needs to be treated with care. Thus a non-paying user is a customer, but not a direct revenue-stream for the company.

If you are interested in looking at the various ways in which this term Business Model is defined, the 2015 article in the Harvard Business Review by Andrea Ovans, titled "What is a business model?" is worth a read. A list of books and references are provided at the end of this book.

The handbook, "*Business Model Generation,"* written by Alexander Osterwalder & Yves Pigneur, provides a useful tool, the "Business Model Canvas" popularly referred to as the "BMC". This helps analyze and design business models, for a variety of organizations, from idea stage to early stage to large corporates and MNCs. This book itself has been written innovatively; the authors state that this has been co-created by a crowd of 470 practitioners from 45 countries! If you are looking at reviewing and taking stock of your business and your business model, this is a tool that is worth looking at. It is also freely available online.

Business model innovations redefine the way companies run. The change could be in financial aspects with an impact on revenue, costs and cash flow. Non-financial parameters, such as business relationships and customer expectations may also be reset.

Many companies are experimenting with business model changes. A company in India pioneered a different way of paying mall rentals. Instead of paying a fixed amount every month, rent was linked to revenue collections. Thus, in addition to the impact on cash flow management, this helped the company in other ways. The mall owner moved from being a landlord, to a partner, who was also interested in increasing the revenue in the store. Thus, strategically, the business model innovation changed the relationship between the two parties from landlord and tenant, to a more meaningful partnership for mutual benefit. The reader may like to take this as an exercise and view how this could impact the financials of the business, the Profit and Loss Account and Balance Sheet and the accounting impact if any. This could also be done through a scenario analysis, i.e. from low sales to average sales to high sales.

In recent years, some companies have converted capital expenditure costs into payments linked to revenues. This has helped in cash flow management by converting a high one-time cash outflow to periodic flexible cash outflows linked to cash inflows from revenues. Fixed costs for assets have moved into flexible payouts based on revenues. Of course each such change in business model comes with its own set of advantages and risks. Here too the reader may like to analyze the impact on the financials and the non-financial impact, for different scenarios.

There are many such examples of companies that have thought about the future very differently from the way business has been conducted in the past. The leaders of the future will be such companies, who continuously think, innovate, experiment and move on to create value for themselves and society.

Planning for the future needs to take care of multiple factors. Some aspects include the impact of globalization and growth. One need not be an exporter to get impacted by people in other countries. We have many persons from other countries coming in to do business in India. If local firms do not provide quality service and goods, they could very well lose business to people from other countries.

While undertaking an exercise in business planning, attention must also be paid to understanding the impact of business policies on issues that have not been given much thought till now. Companies that succeed may need to closely look at their policies related to the environment, corporate governance and ethics and also understanding the true needs of employees.

Today, we are in an age where information is available at one's finger tips. Whether you like it or not those who want to work with companies will search for information about this on the internet and on social media pages. This leads to a need for greater transparency and disclosure requirements. People are watching and this will keep businesses on their toes.

A customer at an outlet of a leading coffee chain in India was asked to leave after the bill was paid. This customer was offended and immediately sent out a Twitter message

saying that this company was offensive. Within minutes of this posting, the message was re-tweeted to the world at large. The company had to take quick steps for a damage control exercise. They sent out their own Tweets and requested their fans to support them.

This was an eye-opening incident; it forced the management of the company to revisit their policies, particularly those related to store and outlet management. In today's times even one irritated customer can do much damage, with the power of the internet that is available and with social media access.

The leaders of the future have therefore to be much more than efficient in operations. They need to understand the power of the individuals too.

Therefore, if the business planning exercise is done based on past experiences and financial numbers are projected without paying attention to the impact of a rapidly changing world, the exercise may not be meaningful.

So …***Are you planning for the future based on expectations of a dynamic world or have you just extrapolated the past?***

CHAPTER 2

Business Planning and Strategy Formulation

Business planning is a critical function, a continuous function, whatever be the size or nature of the organization. In fact the importance given to it is such that it is said that failing to plan is planning to fail. In this book on business planning, we look at some of the key areas in planning. In this chapter, we look at the various aspects of business planning and business strategy and set the tone for the rest of the book.

All businesses strive to be successful and create value in the long term. Some businesses fail and some succeed. It is easy in hindsight to look back and point out the reasons for failure. The signals of failure which were earlier missed may later appear so obvious. What one would like to do is, plan in advance, so that the chances of failure are minimized.

Paul Light, in his book, *"The Four Pillars of High Performance,"* has tried to extract key traits common to all robust organizations. A robust organization is said to be one that possesses the agility to adjust to changes in the external environment at a moment's notice and the compass needed to maintain a steady fix on its strategic horizons. This is no easy task, on the one hand one attempts to maintain a steady path, on the other hand one needs to be adept at changing. On the face of it, this appears like a contradiction. However, if we look at this closely, we will see that this is just like an equation that needs to be balanced – pictorially we may represent this as follows:

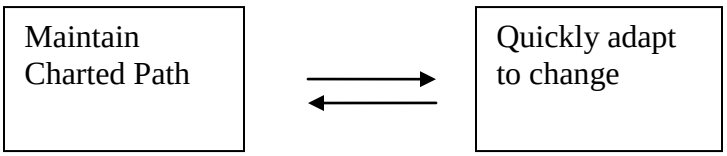

Figure 1: Dynamic business planning

The book, *"The Four Pillars of High Performance,"* is based on reviewing and studying of information resources of The RAND Corporation, which has been an international leader in the study of organizational performance for nearly six decades. An in-depth analysis has been made to understand how one can create and sustain high performance.

The book highlights the fact that we must plan for uncertainty. It states that if there is one thing that is known to RAND researchers, it is the fact that the future is likely to be different from the past and that the key is to plan and prepare for this.

RAND researchers have observed that uncertainty cannot be reduced by merely working hard. At the same time, one cannot just sit back. One needs to get on with business, learning to plan in such a way that includes the expectation of surprises and the need for adaptions. As firms set goals and make choices, they must constantly challenge these very same goals.

So how do you set out to make sure the business you are working with or associating with, is robust? How do you try to make sure the business is sustainable? How can the business create sustainable value? What can set the business apart?

Let us look at two successful enterprises, one Indian and one foreign; Infosys, in India and Microsoft in the US. In the early days of starting their respective enterprises, the entrepreneurs, Bill Gates of Microsoft and Narayana Murthy of Infosys, spent time on the operational day to day management of the business. As the companies became successful and transitioned to a different level, the very same entrepreneurs moved out of the operational role. They identified others who would be responsible for the management and running of the business and they took on the role of the 'Thinkers,' i.e. **Planners**. This is the kind of importance that these successful leaders give to planning.

The thinking exercise is not limited to planning for the next year or three years; it has many components to it. One, there has to be some idea of the overall direction in which the business is headed. The direction for the next year is reasonably clear, but the direction five years ahead is not so clear. The direction 25 years ahead is even less clear. This is particularly so in the modern day world, where emerging technologies are changing the way the world is functioning. Would many of us have had any idea of the impact of technology and the internet on business, 15 years ago?

Often businesses are so focused on attending to their immediate needs and short term requirements that they ignore the long term needs. In Banwarlal Private Limited (BPL), a manufacturing company, there was a strong focus on raising cash to meet the shortfall in working capital. Funds were also required to buy machinery to increase the capacity and grow the business in a competitive environment. The promoters were so focused on raising funds to meet the working capital requirement, that they did not pay attention to the long term export potential. As a result, they did not invest enough time and resource in building up the potential markets in US and in Europe. If they had spent a little more time and done a detailed planning, they could have focused on raising funds for working capital as well as for growth and expansion into foreign markets. They could have looked at options such as taking a loan from the bank or looking for equity investment or perhaps even borrowing overseas. All the energy was instead invested in and focused on raising the funds to meet the immediate requirement, so much so that they neglected to look at the long term picture. In the process the company did not reach its potential; when the economy slowed down they were badly impacted.

CASELET 1: Planning for a venture

Friends, Dinesh, Mukesh and Khan, decided to start a company to sell a product they wanted to develop. They undertook market research and spoke to leading potential customers before they developed their software product. The potential customers unanimously agreed that the idea was good and that they would readily buy such a product if it was available in the market. The developers put their own money into the project and finally in two years time had a developed product which they took to the potential customers. At this point, they were in for a rude shock; the potential buyers said that they did not need such a product. When questioned further, they said that while two years ago, there was a need for such a product, there was no need for it at this point in time.

Thus these persons who had put in a substantial amount of their life savings, failed to convert their idea into a financially viable business. They did not account for the fact that business does not work in a static environment. What is good at one point in time, may be irrelevant or useless at another point in time. One cannot work blindly assuming that the future will be a direct extrapolation of the present.

Q. If you had been one of the promoters, would you have proceeded differently in this matter?

Q. How would you have planned to go ahead with this venture?

Q. What would be your fall back plan if things did not go the way you had envisaged?

END OF CASELET

Management in firms often avoid going through an exercise of rigorous planning, giving the excuse that the future itself is uncertain. In such an unclear scenario, how does one plan, strategise and implement strategies?

The answer to such questions is that, while the future is uncertain, one can think through what could be the possible outcomes if certain steps are taken (or not taken). This is like a student in the 12th standard planning on her future. She may have the options of taking a degree in science, or medicine or law. Ultimately, she will decide on one of these, which may not be the final area of her specialization. Assuming she takes up medicine, she finally may not become a practicing doctor. There are several medical doctors who have gone on to take up the civil services entrance exams or to study for a management degree. However, at the time of deciding on the next step at the 12th standard level, the student has to plan for the immediate next step, keeping some broad-level, long term goal in mind. Thus, while she may not be clear about the final goal, or the goal may change along the way, she will not avoid planning completely.

Business planning helps one think through possible future scenarios. The idea is to put down alternate scenarios and think of what one would do in these alternate scenarios. In one case we can assume that the business does better than expected, in another we have normal expectations and in the third we can take a pessimistic view. More than the scenarios we put down on paper, the planning process is the one which helps us develop better knowledge and understanding of where we are today, why we are there and the alternate options before us.

Scenario analysis also helps chalk out fall back options; how will one react if things go in direction A, B or C? Corrective action can be taken or steps modified/retraced with limited time spent on this.

Strategy and business planning

What is strategy? It is a long term plan of action, designed to achieve a particular goal. Henry Mintzberg, Bruce Ahlstrand and Joseph Lampel in their book, "Strategy Safari," have analysed and looked at different schools of strategy. They state that this is considered to be the high point of managerial activity.

The field of strategic management is one area which has fascinated practicing managers, consultants and academicians. If the business is successful, one would say that the management strategy has worked well. If the company does not do well, it is assumed that management has either failed in having a proper strategy or has failed in implementation of its strategy.

All businesses can benefit from time and effort spent in periodically reviewing their strategy. The degree and details to which the strategy plan is thought through and the implementation plan put in place, may vary.

Strategy may be considered from the overall business perspective. It can also be considered from a functional perspective. The management may have a marketing plan and strategy, they may have a HR strategy, or they may have a financial strategy. These all get captured sometimes in the overall business strategy.

Let us take some examples to understand how funding strategy can impact the overall business strategy. If a company in the manufacturing sector intends to expand its operations and has collateral, it may decide to take a loan for expansion. In such a case, the focus of the business will be to increase the cash flow in the initial stages of expansion. This will enable it to generate sufficient funds to pay the interest charges as well as repay the principal amount.

Many firms in the information technology space in India, do not want to take loans, i.e. they want to be debt free. Their financial plan and strategy is to raise funds in the start up stage from venture capitalists or strategic investors and not from banks or financial institutions. They would rather give a percentage of the equity stake in their company to the investors than take a loan from a bank. This impacts the overall way in which the

business is run. An equity investor looks for different returns as compared to a traditional debt financier. In the case of equity investment by a venture capitalist, the focus is on maximizing the value of the business over a period of time, rather than on increasing the cash flow to service debt in the initial stages.

Within equity investors, angel investors or informal financiers, such as family and friends have different reasons for investing in the firm as compared to strategic and corporate investors or as contrasted to venture capitalists. A company may try to align its style of operations to obtain results which are aligned with the interests of their investors.

Thus a company which has strategic investment will probably work towards producing goods or services that complement and/or supplement the business of the investor. A company which has venture capital investment will aim to grow the equity share value to meet the investor's financial targets. A company which has taken a loan will try to generate sufficient cash flow to make payments to the debtor and so on.

There are a variety of methods in which organizations can approach their strategic planning exercise. In their book, Mintzberg et al., state that there are hundreds of different strategic planning models. They further state that most of these are based on the SWOT model. The SWOT model is a popular tool for many managers. In this the business is analysed in terms of its Strengths (S), Weaknesses (W), Opportunities (O) and Threats (T).

Strategic business planning exercise

The SWOT analysis has the advantage that it considers factors both internal and external to the company. The strength and weakness are factors that depend on the organization structure, the management and other parameters. The opportunities and threats are on account of the external environment, be it the industry scenario, the political scenario or the global economic scenario.

As an exercise those who are preparing the SWOT analysis of their business may also try to identify and look for links between the various components. For example, what is an opportunity because of certain factors today may very well become a threat in the future.

SWOT analysis has its own set of detractors, who feel that the model is not a dynamic one and hence there are some who prefer not to use this method, but try to analyse based on other parameters.

Strategy formulation is an ongoing continuous exercise. A business which has a vision and goal can go much further than one which does not. Another important factor is implementation of strategy. Many Organizations fail, not because they do not think through their strategy, but because they do not think through the steps in implementing their strategy. The strategy and plan for strategy implementation is to be communicated to all employees in the organization and not just remain with the top few members.

The strategy setting and business planning exercise is a continuous one, and cannot be done in a piece meal fashion. This can be represented as follows:

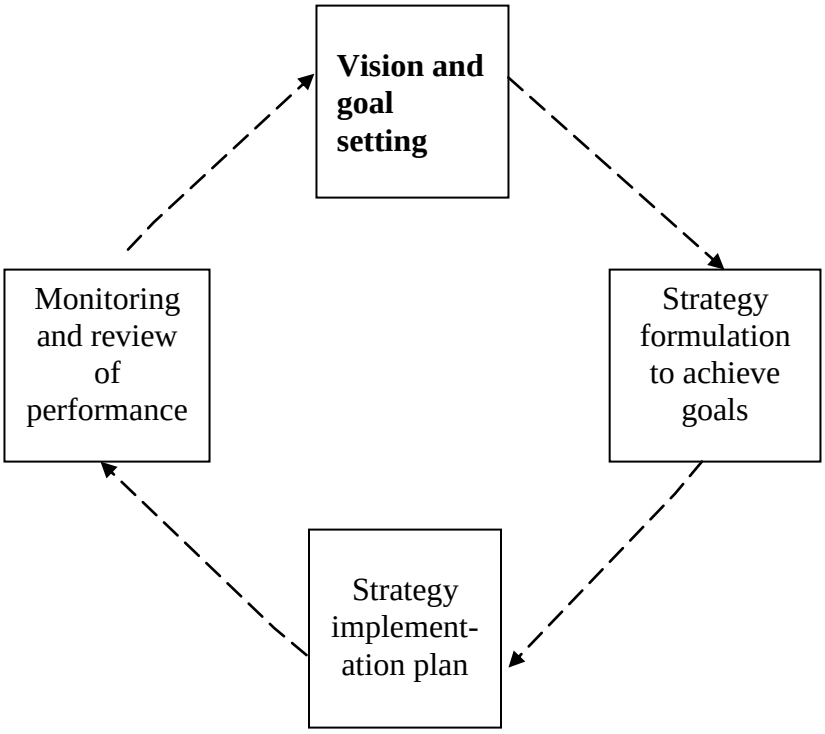

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Figure 2: The strategic business planning and implementation cycle

The strategic business planning exercise has to consider a variety of factors, such as macro level economic indicators, business and political environment, industry and company specific information and the regulatory environment or environments under which the business operates.

Strategic business planning is process whose time has come. In the past, many companies have planned to a limited extent such as in setting out budgets and sales targets. Most businesses have not gone beyond this to actually consider the strategy in depth. Further, many times, Chartered Accountants, have not been privy to such strategic considerations. Even if the have been privy to this, their roles have been typically limited to looking at profitability, financial implications, cash flow, regulatory and tax aspects. Only a few among them have looked at business models, at how future plans will impact the brand image of the company and at value creation in a global business environment.

In the chapters that follow, we look at some key areas where awareness and strategic planning can play a significant role in the future of the business. We also look at some tools and techniques which help in the planning process.

CASELET 2: Strategic planning

NewTech Private Limited (Newtech) is a technology based company, based in Pune. The company has been promoted by Ram Kishore, Kumar R and Sulekha Sharma, who are all technology experts, i.e. they understand the domain and industry in which the company is operating.

Newtech is completing its third year of operations and has about 150 employees on its rolls. There is a lot of potential in the business, so there is a chance of it becoming a globally recognized company. The promoters are technology experts who have held senior positions, so they are in a position to reach out to potential customers and convince them of the quality of their product. On the other hand, there are high risks in implementation and the path to reach the stage of having a robust, high growth, high value business is not so straight. Technology is changing rapidly. Competition is intense as there are other companies, whose founders also have a good academic qualification and good quality work experience.

As they are shortly entering into the fourth year of business, the promoters feel that they need to take stock of the business, the opportunity and the potential they have to make their mark in the world. They are trying to understand what they need to do and do right in order to grow and reach their potential.

Sulekha has recently been introduced to Vinay Rao, the owner of a Pune based strategy consulting firm, B Strat. Vinay's firm specializes in helping companies in Business Planning. Sulekha suggests that Newtech can consider taking the help of B Strat to put together a business plan to achieve significant growth. She says that they need to set out their plan for growth and set a target for themselves, five years from now. Kumar is not enthusiastic about this idea. He feels that the business environment is rapidly changing and so business planning for the future may not be a really meaningful exercise. Ram suggests that they can talk to Vinay and set up a meeting before taking a view.

You are one of the senior consultants of B Strat. You have been given a brief company background and have been informed that the promoters need to be convinced that Business Planning is a meaningful exercise.

Q. How will you convince Newtech promoters that business planning is an important exercise, particularly in a rapidly changing business environment, when what you plan today may not be relevant to business tomorrow?

Q. How would you go about the exercise of business planning in Newtech?

Q. How would you plan to meet the short term and long term needs of the company?

END OF CASELET

CHAPTER 3

The Writing of a Business Plan

Many persons want to write business plans, for a variety of purposes. This may be for internal reference, for raising debt or equity, or to show to a key stakeholder such as a Board Member or an existing investor. The process of planning is the first stage in writing a business plan and is a critical one. Once one's thoughts are in order, writing the plan becomes much easier.

It is often assumed that a strategic business planning exercise automatically will translate into a business plan. This is not necessarily true. An exercise in strategic planning should ideally lead to:

- Long term organizational goals being set and
- An implementation plan for achieving the goals.

Sometimes one may not want to or need to write a detailed business plan. There is often the perception that a third party reading the Plan may adopt or copy the ideas or plans set out. The solution for this is not to avoid writing a Plan, instead one could prepare a business plan with macro level details and avoid disclosing finer details in this if it is shown to an outsider.

Another way to address this concern is to have one business plan to show others and another, more detailed version, for internal use. The detailed plan may have additional chapters or sections, which are disclosed only to select persons. In such situations, it is important to keep a control on the multiple versions and to keep track of what each version contains. If there are updated versions, based on some change in the business model, one will need to keep a close watch on changes made.

The purpose of the plan

At the start it is useful to have some clarity as regards the purpose of the plan. Is it to commit thoughts to paper, or to show a potential equity investor or a potential alliance partner? While it is easier to prepare a single business plan for all purposes, each of these persons will review the plan differently. For example:

- A lender will be looking at financial projections to review profits and cash flow in the business. The interest cover and principal cover will also be viewed.
- A venture capitalist (VC) will be looking at the business plan to see the potential for high growth. The VC may not be concerned about negative cash flow in the early years of the investment and will be interested in exiting from the business in a time frame of about 3 to 7 years and will look for an exit plan in the business plan.
- A potential acquirer will try to understand the synergy of the merged entity and try to see what value can be created from the acquisition.

- A Board Member will focus on growth opportunities, value creation and sustainability.

Getting one's thoughts in order

It is important to spend time in brainstorming with colleagues, advisors, mentors and other knowledgeable persons before putting together a business plan. Questions should be asked, ranging from the business idea, implementation plan to financial projections. Some illustrative questions could be:

- What is the gap in the market the business is attempting to address?
- Is this an existing gap or is the firm trying to create a new market?
- Why would customers buy from the firm? (The answer to this cannot be given at the macro level, one has to closely examine why anyone would really become a customer. One should not just assume that customers will be attracted by superior quality of goods, quick after sales service etc. many persons who have not planned and gone into details find that the plan on paper does not translate into a robust business in reality.)
- How will the product or service be marketed?
- Who are the competitors?
- Is there a good management team in place or are there some vacancies to be filled?
- Who are the external advisors and mentors?
- Who could be a board member?
- What are the requirements for funding?
- How much of the funds will be raised from internal sources and how much from external sources?
- Is the market being targeted in phases or is the company planning to target a big share of the market all at once?

Such questions need to be raised and answers sought before proceeding with the writing of the business plan.

The first steps

When writing a business plan, one must focus on the key areas, such as the business idea, the team, the market and the financials. One must look at the business model of the company as compared to peers and competition. As mentioned in Chapter 1, the Business Model Canvas is a helpful tool to review and take stock of the current business.

Preparation of a SWOT analysis (Strengths, Weaknesses, Opportunities and Threats) does help. This is a simple way of getting one to look closely at the business environment, both internal and external to the firm. Many persons are not keen to prepare the SWOT analysis, because it forces one to look at the negative points about the business. Some persons feel uncomfortable even acknowledging to themselves, that there could be flaws in their plan. They are not keen to expose any flaws to the reader. Others

are of the opinion that setting out weaknesses could invite trouble and could unnecessarily invite negative comments from potential investors. This could, in turn, drive down the valuation of the company. Such a view is short sighted. Investors know that, in a realistic scenario, there will be positive and negative factors. In business, as in life, there are positives and negatives and the business plan has to reflect this reality. A SWOT analysis helps one face the possibility of what could go wrong; it is a tool for planning.

Hence, when starting to prepare a business plan, one needs to first examine and list the business idea, its strengths and constraints. The next step is to think through how one can leverage on the strengths and how one can address the constraints or accept them and plan keeping these in mind.

The structure of the plan

Communication of the core business idea is the key to writing a good business plan. The plan should make sense to the person reading this. Ideas need to be captured in a clear and reader friendly manner.

The elements to be covered in the plan, include inter-alia, the background and history of the business if this is for an existing business, the business idea, the business strategy and implementation plan and most critical details of the promoters of the business and the key management team. The implementation plan should include details about the sales and marketing plan, management team and financials, including the sources of funding, utilization plan, expected revenues, expenses and cash flow. For an existing business, the financials of the past three to five years should be included and key points summarized. The marketing plan and competition analysis must talk about any USP (unique selling proposition) of the firm and the barriers to competition and give details of how the target market is actually going to be addressed. Specific implementations ideas are to be included and explained, since in most cases failure is not on account of a bad idea, it is because of poor implementation.

Due care in writing

Due care is to be taken in writing the plan. Many plans are written without adequate attention being given to consistency in spelling and grammar. This is not appropriate, since the readers of the document may be negatively influenced by a shoddy report. The reader may perceive that one who cannot pay attention to preparing a neat and professional document may bring the same careless attitude to running the business.

In addition to the grammar and content, one must also pay attention to the style of presentation. Formats used throughout the document must be consistent. For example, Chapter 1 may have been written in Arial fonts and Chapter 2 in Times New Roman. This may be because the two chapters have been written by two different persons or have been written at two different times. To avoid such inconsistencies, it is advisable to use a basic

template. Time spent in developing a template in the initial stages is time well spent and may save significant time in the later stages.

Any documents sent to outside parties must be carefully checked and scrutinized for internal inconsistencies and errors. As an example, the financials may have undergone change and the project cost may have been revised from Rs. 50 crores to Rs. 55 crores. If the schedule continues to show Rs. 50 crores as the project cost, the reader will view the proposal unfavorably. A careful reading of the complete draft document checking for inconsistencies would help minimize such issues.

The plan must give details that are necessary and sufficient to be self explanatory. Often there is a temptation to disclose all that one knows, to demonstrate one's knowledge and experience of the business. There is a perception that pages and pages of text demonstrate a great deal of thinking that has gone into planning the business. This is not necessarily true, on the contrary, sometimes; excess information overload can reduce the reader's interest. Similarly using of excessive number of tables and graphs, just to fill up pages may send negative signals that the plan has been prepared to impress the reader. One must, as far as possible, avoid using tables just for the sake of using them; avoid using graphs just to add substance to the plan.

A way that experienced writers use to minimize clutter and information overload in the main report is by moving details of what is not essential to the flow of the main plan, to an annexure. For example, in a manufacturing industry, the brief manufacturing process could be in the main document, while the detailed process chart may be set out in an annexure. Those who are interested and have an understanding of this aspect can read the details in the annexure. At the same time, those who are not interested in these details or those who do not understand these technical aspects can just read the summary process in the main plan.

Prior to preparing the business plan one must think through the business idea and then commit it to paper in a structured manner. The plan should be self-speaking, i.e. there should be minimum requirement for clarification. Attention is to be paid to providing explanations for the abbreviations and technical terms used, if any. Different aspects of the business should be covered in different sections. Pages, graphs, tables and figures used should be numbered. While these may sound like common sense, there are many business plans which are prepared without attention to basic details such as numbering of pages.

The chapters in the plan

Chapters and sections are to be organized with a logical flow. Illustrative sections are:

- Table of contents
- Executive summary
- Sections/chapters, giving information on
    - Company and background information
    - Management team and organization structure

    - Business idea
    - Sales and marketing plan
    - Operating plan
    - Financial details
    - Other information, including assumptions made to be indicated where applicable
- Annexures of key terms, references and other relevant information

The executive summary

An executive summary should convey the key information about the business in a snapshot. Readers look at this summary and if interested in the idea, read the rest of the document in detail. The summary should touch upon information such as the details of the product or service being offered, the people behind the business, the potential market and customers and the implementation plan. The business strategy and the financials would be of interest to the reader and must be communicated clearly.

The business must demonstrate that it is sustainable in the long term. In the short term, the majority of firms need surplus cash and need to be supported till they break even and start generating surplus. The plan must demonstrate the ability to generate sufficient profits to provide a financial return to the investors in the business, as well as to help finance future growth in the enterprise. The executive summary could highlight how value is being created.

Company and background information

A reader would like to understand which industry sector the enterprise operates in, such as in the manufacturing sector, the pharma sector, the information technology (IT) sector or other specific area. Further if the business is in the IT sector, the reader would like to understand whether is it in a niche area or in IT products or in software services. Experienced reviewers would have an understanding of the industry and would get into these specific details. They would have a view on the expected industry and the growth potential.

Other points to be covered in this section are the history of the company, with details of when the business was set up and its evolution over a period of time. If this is a new enterprise, the rationale for starting this business must be set out. One could be setting up a new business for a variety of reasons, such as to fill a perceived gap in the market or because of significant work experience and domain knowledge and the urge to start an entrepreneurial venture or to take advantage of a market opportunity to name a few reasons.

This section should give an overview of the general business environment, the existing or perceived markets, a brief background about the key team and promoters of the business. Other additional information may be provided, in brief, to make this initial section complete.

Management team and organization structure

Readers are most interested in the background of the promoters. In fact, most often, readers of the business plan first look at who is promoting the business and then look at the business idea and financials.

The promoters can make all the difference to a business. If one studies successful companies, one will find that, more often than not, that there are committed, qualified and hardworking persons behind this. Some persons may be lucky and succeed once, but to be consistently successful, one needs to be more than lucky.

Readers are interested in the quality of the team and will look for information about the experience and qualification of the promoters and key team and the organization structure. Key organization HR policies, such as a plan to reward performance with stock options, or giving employees the option of flexible timings can also be mentioned in this section.

Business idea

The core of the business plan is the idea. This section about the idea should demonstrate the plan to convert the idea into a commercially successful business. This should address issues such as business strategy and implementation plan, including inter-alia the vision and mission statements, specifics of the product or service offerings, operational details, any USP and barriers to competition. Other information to be included in this section include items such as details of any in-house technology, process or idea. If some technology is being sourced from a third party, this may be disclosed, including information on any technology transfer through collaboration etc., with the details of alliance partners, current as well as proposed, details of any intellectual property associated with the business and other items which are important and give an idea of the business model.

Sales and marketing plan

This section would set out the target market and market size, either existing or expected. Information about the market research details, if any, profiles of customers, both existing and potential (i.e. pipeline customers), the marketing strategy and pricing strategy should also be detailed.

Many businesses fail in marketing their product(s) and/or service(s). While a product or service may be good, if the target customers are not aware of this or are not addressed, the product or service may not sell. The reader would be interested in understanding the strategy and plan to capture customer interest. In fact these days, even in the case of products, people are marketing an experience. An example is the sale of an apartment which is marketed as a new lifestyle rather than a pure real estate transaction.

Financial details

The financial section should give summary information about the past financials and the future forecast, including key financial statements, i.e. the balance sheet, the profit and loss account and the cash flow statement. Details of contribution from the promoter whether in cash or in kind, details of sources of funds and the plan to utilize them, the breakeven point and the return on investment are other important parameters which will be scrutinized.

There is one view taken by some persons that financial forecasting is a meaningless exercise because the numbers are based on assumptions about the future, which cannot be predicted. While the future is certainly uncertain, the exercise of forecasting is an invaluable one. Going through one cycle of forecasting and then subsequently comparing actual performance with the forecasts, helps one get an in-depth understanding of business.

It is useful to prepare the financial forecast statements on a monthly basis, initially for the first year. This can then be expanded for three to five years as required. If separate divisions are planned, it is advisable to prepare separate statements for the different divisions. For example, if there are two separate offices in India and one in UK, each must have a separate forecast. These should then be consolidated to get overall company statements, month-wise.

Forecasting sales may not be an easy exercise. Revenues depend on a variety of factors, such as viability of product, acceptability of the service provided or product sold, market demand and competitiveness. Sometimes sales are made to alliance partners. In such cases, the sales will depend in turn, on the demand for the partner's products.

Sometimes, it may be easier to start the forecast with the costs, as one would have some idea of the costs involved. While sales are not predictable, costs are generally more predictable. Some costs, such as rent, salary, etc. must be incurred. Other costs, while they are not so predictable, are still to be incurred. These can generally be estimated. In some situations therefore, particularly in new businesses, one can plan for the worst case scenario and work out the expected costs, assuming that there may be no income for some period in the future. This could be a period of one year, two years or even three years. This of course depends on the nature of the product/service being marketed. Some technology projects have a long gestation period, others have returns from year one. Examples of these two extremes are biotechnology projects with very long time to market and consulting companies, which may have sales from day one of the business.

Spreadsheets are useful tools to work with. To the extent possible, use features in the spreadsheet such as formulas and functions - to automatically add, subtract and link sheets. If you create a template of key items, then the numbers get automatically updated in the final statements. For example if you want to check the impact of a salary increase of 20% from 10%, you can have a cell with the salary increase percentage indicated. Just

by changing the number in the cell from 10 to 20, the impact on the salary cost gets reflected. If this is linked to the profit and loss account and the cash flow, these statements will also get automatically updated. The revised numbers can also be linked to the balance sheet. Thus, just by making one change in a cell, a set of updated statements are available for scrutiny.

It is therefore useful to spend some time in the initial stages, building an intelligent spreadsheet. With adequate thought and planning, a good working document can help reduce time spent on manual calculations and can also reduce the possibility of errors. A point to note is that fancy spreadsheet generated numbers are of no use if the underlying assumptions behind them have no foundation. Sometimes promoters do not give sufficient thought as to how they can generate the sales projected and also as to whether they have actually captured all elements of cost. In fact at this stage one should spend time to ensure that, as far as possible, all revenue and expenditure heads are captured. Numbers can then be plugged in and spreadsheets can generate the final statements.

Thought must also be given to the frequency and time frames for which the forecast is being prepared. If possible, these may be on a monthly or quarterly basis for the immediate following year. For later periods, the statements may be prepared on a half yearly or annual basis. The statements may be prepared for three to ten years, depending on the need and requirement.

Data from existing organizations may be analyzed to understand costs, cost structures and to benchmark against. Industry information helps in validating assumptions made. It is important to keep a record of explanations and assumptions made. This helps both for future reference and to bring transparency to the forecasting procedure.

Some examples of data collated and analyzed would be comparable items of expenditure in the industry such as salary, per diem cost on travel, rental costs, telephone, water and electricity charges etc. Understanding the industry cost structures is important. If an average company in the industry has a 20% margin and the business plan indicates a 25% margin in the first year, then perhaps there is something wrong in the forecast. Perhaps the costs have been underestimated; perhaps the revenue has been overstated. In such cases, one needs to take another look at the financials and the assumptions to arrive at the cause for such deviations from normal industry numbers and justify them.

Projections start with revenues, which can come from a variety of sources, such as from services rendered, from products sold, from license fees earned, etc. In all cases, both the volume of sales and the rates assumed will impact the earnings. Assumptions for these along with the expected target customers (e.g. number and details of possible customers) should also be set out.

It is good to have a fair understanding of the expected quality of revenues, in addition to the quantity of revenues. This can be articulated by setting out data and information such as the geography of the revenue, revenue from key customers, revenue from well-known brands, repeat customers etc. As an exercise you can look at articulating the quantity and

quality of revenue of your business. For some additional information on this please refer to the SlideShare page and the presentation made by the author for the Microsoft Ventures Masterclass on Business Models: Growth and Value Creation, slide no. 13. The details of the link are available in the reference section of this book.

Quality of revenue becomes important in a business valuation exercise. A company that is perceived as having a better quality of revenue as compared to a peer, can command higher multiples in valuation, i.e. better quality can command premiums. However this is to be done with care. For more on valuation multiples, discounts and premiums, please refer to Chapter 4 in this book.

Employee costs should be projected keeping in mind the number of employees and their salaries, based not just on their qualifications, but also on their locations. Sometimes employees may be located in different countries and their salaries may have to be benchmarked with the salaries in those countries. This must be factored in and set out in the assumptions along with the expected salary increments over the period of the forecast. Some salary may be linked to equity, some to performance. These must be set out and captured in the Plan document.

All items of cost and expenses in running a business must be captured. These may be estimated based on past experiences and percentages or based on actual expected amounts. In the initial months, these costs will be easier to estimate. As we get into the medium term, trends may be used, based on past experiences and percentages adjusted for expected future changes.

The items in the balance sheet are to be input based on the assumptions made in the profit and loss account. Investment in fixed assets such as land and building owned if any, plant and machinery, computers, furniture and fixtures etc. are based on requirement projected. For example, capital expenditure (capex) is to be calculated based on the area of land purchased, plant and machinery requirement, number of workstations, furniture, research tools and equipment, vehicles etc. which are assumed to be required. Due care should be taken in arriving at the capex as it is closely linked to various phases planned in the project and the numbers must reflect basic assumptions made. For example in some cases 50% of the cost is required to be paid upfront in the form of an advance. This will be reflected as an advance paid in the balance sheet, till such time the item is received and commissioned, when it will move to an asset. Here also as far as possible, spreadsheet links should be used. The debtors on hand, is based on revenues earned and average credit period, which would need to be benchmarked with industry standards.

The cash flow statement should be carefully prepared, based on actual cash expected to be received and paid out, from and to various accounts respectively. Much of these calculations would be made based on industry standards and specific assumptions of the way the business is expected to be run in the future.

Many firms incur product development costs, research costs and other IP (intellectual property) related costs. As far as possible these may also be considered and captured.

There must be consistency across the different statements. For example deposits for premises hired must appear in the balance sheet and the rent in the profit and loss account. During a due diligence review some of these consistency checks are made. These help the reviewer get an understanding of the quality of thought which has gone into preparing the plan.

Other information

A final section in the plan should include information which may be relevant to the business, and not included in the other sections. This may include project time lines, implementation schedule, expected date of commercialization, regulatory environment (for example environmental laws for a pharmaceutical company) etc. Other information such as contact details, references, additional data and statistics, which may be meaningful to a knowledgeable reader, may also be provided as an appendix or annexure.

Alternate scenarios

The future is uncertain. Whatever care one may take, it is difficult to forecast what will happen. There are two common techniques to address such uncertainty. One is to prepare financial forecasts in different scenarios, i.e. an optimistic scenario, a pessimistic scenario and a normal expected scenario. The forecasts in these three situations help one think through a range of possibilities and these get factored into the numbers. To take an example, if an individual who is getting Rs.25 lakhs as salary per annum, has a sudden salary cut to Rs.20 lakhs per annum, the individual will reduce the spending when the income is reduced. Similarly in a business scenario, when revenue and growth is high, the expenses will be higher than when revenue is low.

Financial forecasts are to be prepared to reflect possible scenarios and thinking through these scenarios can help one look closely at the numbers and question assumptions. To illustrate, a business dependent on agricultural produce will be impacted by the monsoon, which is unpredictable. An optimistic scenario may consider a good monsoon while the worst case scenario may assume that the agricultural produce has been impacted because of poor monsoon. To get into the depth of this, one would actually have to consider the impact of the monsoon on both the quality and quantity of the produce. Too much monsoon or rains in the wrong season can also impact the business.

Another tool used to factor uncertainty in the business is to do a sensitivity analysis of key parameters. These parameters include revenue and key items of cost. One example could be studying the impact of a 15% fall in the capacity utilisation which would impact production and therefore the sales of the business. Another example is to study the business and financial impact of an increase in raw material cost due to foreign currency fluctuation.

Impact of changing scenarios

A business plan should specify the impact of changing scenarios. In an existing business in particular, some of these changes can make a significant impact on the way the business needs to be run in the future as compared to the past.

Thus the process of preparing a business plan has to have a logical flow, from idea planning to writing a detailed document. The better the quality of the planning process, the better will be the quality of the business plan.

Quick Reference Tool 1:
A quick guide to the business plan writing process

If you are preparing a business plan:

Spend some time on some analysis before you start

- What is the purpose of the business plan, is it for
    - internal use of management
    - Board member review
    - Bankers and potential lenders
    - Investors (VC/bank/angel investor)
    - For other purpose, e.g. incubation
    - What are the strengths brought to the business
- What are the constraints to either
    - Address or
    - Accept (and work keeping this in mind)

At the starting point

- Put yourself in the reader's place; think about the reader and the message you are trying to convey through the business plan
- Different persons may view the business plan differently, try to understand background and experience of person/group to whom plan is shown
- You may prepare a detailed plan in sections, which may be stand alone and kept for different purposes, i.e. sections for internal use, for investor and for banker
- Keep a track on versions to minimise confusion and possible errors

The business plan

- The document must be self speaking: i.e. minimum clarification must be required from your end (particular attention to be paid to explaining abbreviations/short forms and terms)
- The document must be reader friendly: key information that you want to convey should not be hidden amongst too much details
- Plan on format of report and how data, information, analysis, comments etc. are to be presented

    - Move what is not essential to flow of document to main report
    - Think of content required to capture attention of reader; avoid excessive information overload
- Avoid using graphs for the sake of using graphs; tables for the sake of using tables etc.
- Avoid temptation to disclose all you know and demonstrate your knowledge and experience about the business
- Make attempts to protect your intellectual property if any

Illustrative contents
- Table of contents
- Executive summary
- Sections/chapters/paras
- Summary/conclusion
- Appendix of abbreviations, references, other annexures
- Graphs, tables, figures to be numbered and labeled

Illustrative list of chapters
- Company and background information
- Management team, Organization structure
- Business idea, strategy and implementation plan
- Sales and marketing plan
- Financial details
- Other information such as implementation schedule, statutory environment applicable etc.

Illustrative contents in chapters
- **Company and background information**
    - Background history if existing company; current status
    - Rationale for existing business or new start up
    - General industrial environment of business
    - Brief background of promoters
    - Vision and mission statement
    - Goals and objectives
    - Key business drivers and key constraints; SWOT and business strategy
    - Other key information to make initial background information complete

- **Management team, organization structure**
    - Experience and qualification of promoters and key team
    - Organization structure
    - Any key Organization/HR policies

- **Business idea, strategy and implementation plan, including inter-alia:**
    - Vision, mission
    - Product/service offered
    - Operational details

- USP(unique selling point); barriers to competition
- Details of any in-house technology/process or idea; or source of technology, i.e. technology transfer through collaboration
- Details of alliance partners, current as well as proposed
- Details of any intellectual property associated with the business

- **Sales and marketing plan**
  - Target market size
  - Market research details
  - Customer profiles; existing, potential/pipeline
  - Marketing strategy, including social media marketing strategy if any
  - Pricing strategy

- **Financial details**
  - Past financials: Balance sheet, P&L account and cash flow summary for five year period if available
  - Future forecast – five years in summary (detailed schedules may be in appendix)
  - Details of contribution from promoters (cash/kind)
  - Details of how funds will be raised and utilized
  - Sensitivity analysis for key parameters, e.g. sales variations of + / - 10%
  - Key ratios, break even, project IRR
  - Other information such as quality of key parameters, i.e. revenue based on geography

- **Other information**
  - Time lines, implementation schedule, expected date of commercialization, break even
  - Regulatory environment if applicable, e.g. environmental laws for pharma company
  - Other information which may be relevant to the business
  - Include required references, contact information, data and statistics

Preparing and presenting the business plan

- Presentation is the key
- Capture the reader's interest
- Think through the format of report and how data, information, analysis, comments etc. are to be presented
- Document should be neat and professional, with attention to details such as:
  - format styles, font sizing, colours, header, footer, headings, para alignment, spacing etc.
- Points to consider
  - You must believe in the idea to sell it
  - Homework is to be done before hand, adequate knowledge is required

    - Credibility is important, i.e. if caught with one falsehood, nothing said would be believed
- Updates and changes in business plan
    - If there has been substantial change, update the plan
    - The difficulty is when there are too many versions which are around
    - If there is inconsistency between one plan and the other, this is to be reconciled
    - While the plan is to be updated to reflect reality and changes, too many such changes give wrong signals
- Presentation of business plan in PowerPoint
    - Think through the content and value to listener
    - A master slide can be useful
    - Include page numbers
    - Use clear headers to demonstrate slide topic
    - Avoid clutter (generally not more than 5 points per slide)
    - Pay attention to details: colour combinations, business logo, legibility, consistency of message, etc.

Quick Reference Tool 2:
A quick guide to business forecasting methodology

Financial forecasting summarizes future expectations of:
- Business strategy
- Accounting
- Financial analysis
- There should be a believable story about the future performance of the company. For e.g. "Sales is expected to grow at more than average industry expected rate of growth in this BPO company. This is because of the quality of the management team, the investors and the past track record of the company in getting and retaining customers."

Strategic perspective
- The strategic rationale should be based on careful understanding of
    - the company
    - industry and
    - general economic scenario
- Value is driven by the excess of return over cost of capital over a long period of time. This comes out of competitive advantage, which could be due to:
    - Superior product, service
    - Lower costs
    - Better utilization of assets and capital

SWOT analysis

- Strengths
- Weaknesses
- Opportunities
- Threats

Capture strategy into financial forecasts

- Initially start with profit and loss accounts and balance sheet
- Cash flow can be next derived from these
- Prepare by keeping key ratios and assumptions in mind

Forecasting methodology

- Understand business strategy
- Develop a complete picture
- Develop a complete financial forecast of the BS, P&L and CF statements
- In short term calculate detailed numbers, in the long term summaries trends expected
- Compute sensitivity analysis, for key drivers
- Compute probability scenarios, in the minimum, compute the following scenarios:
    - Normal
    - Optimistic
    - Pessimistic
- Consistency checks
    - key ratios and internal consistency
    - industry parameters
- Cash flow and liquidity
    - How will company raise funds
    - How will funds be utilized
- Verify that the final numbers reflect the overall strategy of business

Starting point

- Make a start
- What are the key drivers of the business – now and in the future?
- What do you think are possible starting points?

Financial forecasts

- Starting point
    - Demand and supply
    - Market size and market share
    - Break even point
    - Growth trends

- In the case of early stage companies which have not yet turned profitable the following are the key drivers of the business forecast for valuation purposes
    - Cash burn

    - Stake that the promoters are willing to offer to the private equity investor/venture capitalist

- Often, demand is the starting point, based on which profit and loss statement is drawn up - demand translates into sales

- Revenues forecast are dependent on industry and business, e.g.
    - Retail industry: based on number of stores, online/offline sales mix
    - ITES: based on number of seats
    - Manufacturing: dependent on product mix

- Expenses are based on level of sales

- Revenue expenses are calculated based on trends as well as requirements

- Revenue expenses to be listed, item by item
    - Key drivers to be identified (e.g. salary – driven by no. of people as well as expected salary costs)
    - Industry benchmarks may be used for cross referencing (variations/deviations are to be justified)

- Capital expenditure (capex) depends on capacity required to generate revenues projected as well as utilization of capacity
    - Based on requirement to reach target revenues
    - Also impacts depreciation & cash flow

- Balance sheet accounts based on expected sales and utilization of assets, company policies (debtors collection period etc)

- Cash flow
    - Based on forecast of balance sheet and profit and loss account
    - Consistency check is important after getting the first set of numbers

In Summary

- Forecasting is the first step of prospective analysis
- It is the start for any valuation process
- The best way to forecast is to do it comprehensively and in detail including all key financial statements
- The forecast must stand up to scrutiny and must be internally consistent

CASELET 3: VIRTUAL GAME: Writing a business plan

This article was originally published by the author on her blog, Entrepreneur's Corner in www.citizenmatters.in

Are you interested in writing a business plan? Is it to show to an investor? If you are planning to write a plan for your business or to help someone or are just curious about the noise made about business plans, here is a game for you to play. A game, where you get to be a virtual entrepreneur, without going into the pain of actually having a real company out there to run. If you are game for this game, think of yourself as an entrepreneur starting or running an existing business and...read on...

First: The background

Before thinking of preparing a business plan ... think through some of the points that are relevant to the plan. List them down. These could be the idea/project that you have in mind or are working on, the team, the potential or existing customers and the operational plan, amongst other things. Pause for a while to understand:

- your strengths
- where you can improve and then
- where you want to go in a few years from today.

Once you have thought through this, please think about what an investor would like to see. Again, if you have a specific investor in mind, understand what this person or persons may be interested in funding. To illustrate, an investor in equity in a company, would look for a multiple financial return, in the normal course of business.

So how is this multiple available? This would be possible if the investor puts money into the company at say Rs.100 per share and is able to sell it in maybe 4-5 years at a multiple of 5 times, 10 times or even more, i.e. at Rs.500 per share, or Rs.1000 or more. To get this multiple, many other factors come into play. The company invested in has to have super growth. To have super growth, the company must have customers who will pay to buy the offerings, whether it is a manufacturing product, a service or anything else. You can think about the other such factors which may enable the company to grow in value over time. These factors may be internal to the company, such as a great team and good idea, or external, such as growth in the economy.

In addition, the investor has to be able to sell the shares, i.e. there have to be buyers for these shares. These buyers could come through the IPO route or as another company buying this and so on. Please think of possible options of exit of the investor, and what could be the possibilities in your case.

If you have a specific investor in mind, think through this carefully. What kind of companies have they invested in? What do you think they will look for? Would they be keen on funding companies in the industry sector in which you operate? Have you seen their website/blog postings and checked with persons who are familiar with their style of

investing? Do your homework adequately and go in prepared for the questions they may ask you.

Writing a business plan is somewhat like writing an exam paper. You prepare, work hard and then commit all your knowledge and hard work to the answer paper. Do you remember taking the 12th standard school leaving exam? While knowing the subject is critical, it is also important to answer the questions well, so that the examiner understands that you have understood the subject well.

Now for the Virtual Business Game...

Three different companies are discussed in brief below. Assume you are an entrepreneur in each of these firms or you are an advisor to the companies. You can pick your role. If you are writing business plans for them, here are some questions to trigger thinking:

- How would you proceed to write the business plan?
- Would the approach to writing the plan and questions asked by you be similar in each of the above cases, or different?
- What are the key points in the business plan in each of these cases?
- In each case, identify what could be a key deal issue.
- Look for both key deal drivers and key deal breaker issues.
- Are they similar or identical in all the three cases?
- Does your business plan address these issues, directly or indirectly?

NOTE:
Deal issues are some key factors which may be the reason why someone may invest or not invest in a company. For example, if there is only one person driving decisions in the company, this could be a deal issue. Investors do not like to risk money in a business with only one key person in the management team.

The three companies:

- Three friends established a company in Bangalore, to work in the areas of IT services. Their company, ThreeForce, was started with Rs.30 lakhs invested in by the promoters, who each had about 12 years of work experience, in India as well as in Europe and US. Midway through the first year of operations, one of the key customers also invested Rs.20 lakhs in the ThreeForce, for a minor stake in the company. Towards the middle of the second year of operations, the promoters decided to go in for a round of private equity investment. The initial funding and the revenue generated was insufficient to achieve the ambitious growth targets they had set for themselves. The promoters decided to approach a venture capitalist or strategic investor for funding.

- Vijaya, Kannan, James and Rehana are good friends from school days. Vijaya, who has completed her MBA and has 2 years of work experience in the IT industry, is currently unemployed. She has two children of school going age.

Kannan is an engineer, who is working in a software company and now wants to start his own business. His wife has a steady job in a multinational company and he is willing to take a risk of losing his steady income. James, an architect is currently managing his own architect's firm. He is interested in exploring the opportunity to develop technology tools for the infrastructure industry. Rehana is a graduate, who has been working in the BPO industry for five years now. She has no family commitments and is comfortable with the job. She is excited at the idea of starting a business with her friends. After a great deal of brainstorming, the four have decided to create a company which will address the technology needs of the infrastructure industry. They have heard that there is a lot of interest in investment in this area and are keen to look for equity investment in the new venture as they do not want to go to a bank and take a loan at this start up stage.

- GooDBuzz Technologies Private Limited was promoted by Amar Ramesh and Rahul Gupta to offer services to the telecom industry. The customers were from India, Europe and Asia. The company received two rounds of financing from a VC in India, who appointed a Board Member to the company. In a Board meeting, the nominee Director of the VC, expressed his view that GoodDBuzz should expand its existing portfolio of offerings by providing services to other industry verticals, as this would help the company grow at a faster pace. The other Board members were also keen to explore this possible opportunity. This however needed additional investment, which the existing promoters and investors could not bring in. The Board members of GooDBuzz were now looking at alternate options before them and how they should proceed. They decided to look for private equity investment in the company.

END OF CASELET

CHAPTER 4

Valuation and Value Creation

Currently most businesses are trying to understand how value is to be created. If we are trying to create sustainable value, we need to look at growth and value of the business from a perspective that is beyond growth of the top-line and the bottom-line of the firm.

Value can be created in many ways. As an organization grows, there are many changes and there needs to be an effective growth strategy to manage these transitions. The business has to gear up for a future which is different, not just because the external environment has changed, but because the firm itself may be radically different.

In this section, we first look at the different ways in which value is measured. Next we look at the emerging aspects of intangible assets (IA) valuation. This is looking at intangibles from the perspective of understanding and managing them in the current day business environment. This chapter does not touch upon the accounting aspects of IA measurement and recording in the financial statements. We also briefly touch upon value creation in a business.

Valuation

Many factors impact valuation. These could be tangible or intangible, real or perceived, internal or external to the firm. This includes the business strategy, business and industrial environment, global economic environment, political environment etc. In the case of a transaction between two or more parties, it may be as linked to the price the buyer is willing to pay for the stake in the company contrasted to the price the seller is willing to sell the stake in the company for.

Valuation is not something that is fixed and constant. It varies, from time to time, depending on the transaction and the need of the buyer or seller. Much of the valuation is because of assumptions about the future of the business, which itself is uncertain.

Aswath Damodaran, in his book, *"Damodaran on Valuation - Security Analysis for Investment and Corporate Finance"*, in fact talks of some myths in valuation. Damodaran gives the reasons for these myths and goes on to explain why these are not true. Three of these myths are listed below:

- Valuation is objective because valuation models are quantitative
- Well done valuation is timeless
- Good valuation provides a precise estimate of the value

Valuation models use data and quantitative information as inputs to arrive at the final valuation numbers. There is, however, room for a subjectivity in these inputs. A variation

of one percent in the discount rate taken in the Discounted Cash Flow (DCF) model can significantly change the valuation. In valuation using a relative method of valuation, selection of different comparable companies, can lead to variation in the input parameters, which in turn impacts the final value arrived at. Selection of comparables is a subjective exercise. Comparables can be selected from companies in the same region, having the same turnover, or similar cost structures. In the case of unlisted companies or companies in an emerging, nascent industry, it is even more difficult to select comparables.

Valuation of a company is undertaken with an eye on the future. We value a company because of its tomorrow, in most cases. This estimate of the future carries its own risk. The valuation models provide for the risk to be built into the numbers in different ways. Some of this is by taking a higher discount factor, by having an appropriate risk premium or by performing a sensitivity analysis by making slight variations in the key value drivers of the enterprise being valued.

In brief, valuation is a perception of the value of a business at some point in time. It depends on the purpose of the valuation; on whether one wants to buy or sell or is looking for equity investors. Bankers value a company differently for lending as compared to a venture capitalist (VC) who is willing to take a higher risk. Both the banker and the VC are interested in financing future operations of the investee company. Both the parties, want to get a financial return from such a transaction. However, both will approach the project with different views. Both value the future of the enterprise differently.

Planning for a valuation

You may be interested in valuing your business prior to an M&A transaction or for investment. How would you plan for this valuation exercise? The practice followed by most enterprises, is to get valuation done externally, by a third party. This is supposed to bring an element of objectivity to the table. In fact third parties are also undertaking valuation for venture capitalists (VCs). Earlier valuation used to be done by the VCs internally, now increasingly some of them are getting third parties to value a potential investee firm.

At the start of any business valuation exercise the business being valued would be studied and industry and market reports obtained. The valuer would also try to select the method that would be most suitable for the business being valued. The difficulty is that there are multiple models to choose from. In addition, some methods can be modified and used with slight variations, depending on the situation and requirement of the valuation. As a result, valuation can often be a complex, time consuming exercise.

Environments impacting valuation

The value of an enterprise depends on a variety of factors, key among them being the industry environment, both in the country or countries of operation, the socio-political environment and the company specific environment.

It is not unusual to find two companies, in the same industry, operating in the same region, with approximately the same number of people, having different values. The difference in the value could be for a variety of reasons. No two businesses are alike, and this is captured in the difference in the valuation. The differences in the two businesses could be due to the experience of the key management team, it could be due to the customers that one company has as compared to the other, or could be due to certain patents or intangible assets held by one company and not held by the other.

Sometimes, this advantage which one company has over the other, maybe be perceived, and may or may not exist in reality. This is because of the intangible "Brand-image," enjoyed by one company as compared to the other. A good valuation model should be able to capture this intangible. For example if a discounted cash flow model is used, the "Brand-image" may be captured by increased future revenues of one company as compared to the other, which will in turn lead to increased cash flow.

To expand this further, let us take an example of two (hypothetical) companies in New Delhi, Naveen Private Limited (Naveen) and Vijay (Vijay) Private Limited. Assume that both are in the same segment of business, with almost identical current year revenues. Further, assume that the key management team of Vijay as compared to Naveen, has more experience and domain knowledge.

It is therefore, not surprising that, in the future, the performance of Vijay is expected to be superior to the performance of Naveen. Of course, this is with the underlying assumption that the two companies are quite similar in all other parameters of measurement currently. These parameters include measurable assets and intangibles.

To sum up, though currently, if measured on current performance, the two companies appear similar, in the future, it is expected that one company will outperform the other. As a result, there will be a difference in the enterprise value, which is based on future expectations, rather than current on performance.

Factors that impact valuation

Prior to an exercise in valuation, the enterprise being valued must be studied in depth. In an existing company, historical data and other information would be reviewed. As mentioned earlier, this would include company specific information, industry related information in the context of the global environment for business.

In a new business, the future expectations from the company and industry would be used as reference points. When a start up is set up to take advantage of emerging opportunities

in a new market, in the initial phase several assumptions and estimates are made regarding the future. Often, in a nascent industry, the initial phase is very volatile. Valuation can reach absurd heights and depths, in these situations. This is what happened in the case of the valuation of the first few so called 'Dotcom' companies. Valuations models were based on a variety of non-standard assumptions. Many companies were valued based on page hits. A multiple was applied for every page hit. Currently, ecommerce companies are commanding huge premiums compared to traditional businesses, so much so that there is a worry about a valuation bubble.

A variety of valuation methods have been used for valuing companies in emerging technology industries. It has been said that some biotech companies have been valued based on the number of PhDs in the company. Many companies are valued at a multiple of revenue, particularly when they are in a growth phase and there is little cash flow or negative cash flow. The earnings based multiple can also be modified further as seen in the example below. The revenue figure which is used as the base number could be the historical average revenue, current year revenue or future expected revenue.

- Historic average of the previous three years: Rs. 80 crores (revenue of preceding three years Rs.55 crores, Rs.80 crores and Rs.105 crores respectively); multiple three:

  Value = Rs. 80*3 = Rs. 240 crores

  (In a further modification, this could be based on the previous year or previous two years' revenue and the multiple would accordingly be different in these cases.)

- Current revenue (actual year to date and forecast for the balance period): Expected to be Rs.125 crores; multiple two:

  Value = Rs. 125*2 = Rs. 250 crores

- Revenue forecast for the following year: Rs. 155 crores; multiple 1.5:

  Value = Rs. 155*1.5 = Rs. 232.5 crores

Thus we can see that the selection of the revenue period and the multiple impacts the value range.

These multiples and revenue numbers would be selected based on review of similar transactions that have taken place in the recent past and review of comparable companies.

Sometimes, instead of revenue multiples, earnings multiples may be used. Revenue multiples would be preferred when the company has limited profits. Earnings and profit multiples would be preferred in more established companies, where the earnings capture the cost structure of the company being valued. Earnings could again be one of the following:

- EBITDA: Earnings before interest, tax, depreciation and amortisation
- EBIT: Earnings before interest and tax

- PBT: Profit before tax
- PAT: Profit after tax

Each of the above has its own advantages and disadvantages. Interested readers can get more information on the applicability of the above in books on valuation, some of which have been mentioned in the reference section at the end of this book.

Valuation models can be broadly classified into three types:

Valuation methods

Cost based **Income based** **Transaction multiple based**

Figure 3: Broad classifications of valuation methods

Sometimes, hybrid models that are a combination of more than one of these methods are used.

Cost based methods

In the cost based method for valuation, assets of a company form the basis for arriving at a final number. Broadly, we can classify this into the following methods:

- Net asset value or book value method
- Replacement cost method
- Liquidation method or break up value method

Net asset value or Book value method

The book value method, takes the value of the assets as per the balance sheet of the company on the date of valuation as the base value. A premium may be assigned to this or the value may be discounted, based on the specific factors of the case in question.

Replacement cost method

In this case the cost of setting up an enterprise similar to the business being valued is considered.

Liquidation method or Break up value method

In the liquidation value method, the value of a business is that amount which is realizable on sale of the enterprise, either as a whole or in parts. Factors such as whether buyers

exist or whether the company is going to be sold piecemeal, are to be considered. Costs of liquidation are to be deducted from the value of the enterprise.

Income based methods

Income based methods are the most widely used. These can be classified into the earnings capitalization method, the discounted cash flow or net present value method and the transactions multiple or the relative multiple method.

Earnings capitalization method or the profit earnings capacity method (PECM)

In this method, the earnings of the company being valued are capitalized at a rate which is considered suitable.

For example assume that Prerana Limited is earning post tax profit of Rs. 30 crores and we would like to capitalize this at 15%. The value of the Prerana Limited under this method is equal to Rs. (30/15%) crores, i.e. Rs. 200 crores. This is a simple method of calculation of the corporate value. The 15% rate here would be based on the standard rate for similar companies in the industry and in the geographical region.

Discounted cash flow method (DCF)

The cash flow model assumes that the enterprise is a going concern and that the value drivers of the company are also the drivers of the cash flow of the company. The business is considered to have different phases in its life cycle. There is an initial growth phase, followed by a steady phase.

The DCF model is a summation of the value of the company in the growth phase and the steady phase. The value in the steady phase is captured as a residual value, based on a mathematical formula. This growth phase, can in turn be further split into two or more phases, with differing growth rates, based on the management perception of the expectations of growth in the future. This is illustrated in the figure below.

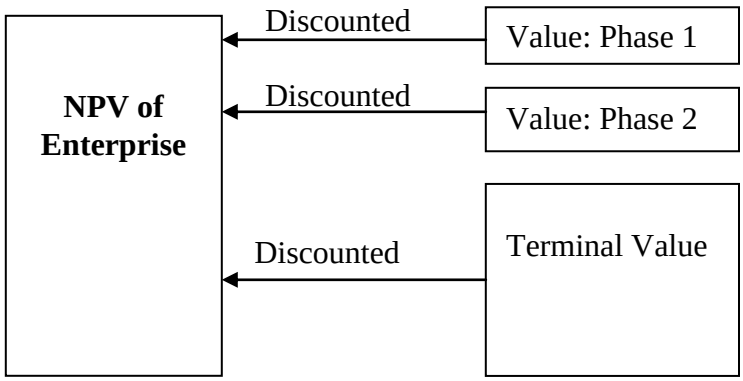


Figure 4: Net present value

Transaction multiples method or relative method

In the transactions multiples method (TMM) or relative method of valuation, the value of a company is calculated based on the values of similar companies. The difficulty is in identifying similar companies. Some common ways of selecting comparable enterprises is by identifying companies by way of size, i.e. in terms of revenues, number of employees etc. The other way is by looking at companies in the same industry, irrespective of the size.

To illustrate this, let us take a company, Pure Services Private Limited (PSPL) with a revenue of Rs. 70 crores in the current year. PSPL expects revenues of Rs. 100 crores in the next year. Some investors are interested in valuing PSPL.

To arrive at the value of PSPL, comparable transactions that have taken place in the past few months in the industry are reviewed. It is observed that the average value of these companies, in the transactions, was between one to two times the forward revenue, i.e. the revenue in the coming year.

PSPL can be valued using a multiple of 1.5, the average, which will lead to a value of Rs. 150 crores. If on the other hand, one feels that PSPL is superior to the other companies being compared to, one could assign a premium to this and increase the multiple to 1.75 and value the company at Rs. 175 crores. The decision of the multiple to use, and the comparable companies selected, alters the value of PSPL and can form the basis of the negotiations in any potential transaction.

The valuation process

The following steps are followed in valuation:

- Data is collected, i.e.
  - Historical information about the company, including financial and non financial
  - Industry specific information, both within the company of operation and the global environment
- Data and information is validated
- Based on the data collected and preliminary analysis, the valuation models are selected
- The business is valued based on the valuation models used and a value range is arrived at, for different scenarios expected in the future (including based on a sensitivity analysis and probable/expected scenarios – as applicable)
- Finally, the value of the enterprise arrived at is reviewed in the overall context of the transaction proposed

The value arrived can become a deal breaker issue if the parties to the transaction have widely differing value ranges. Hence valuation is to be done carefully and with due care and cannot be just a number arrived at using a formula. These stages in the valuation process have been highlighted in the diagram below in the book *"Handbook on Corporate Valuation,"* by Pratap G Subramanyam and Anjana Vivek.

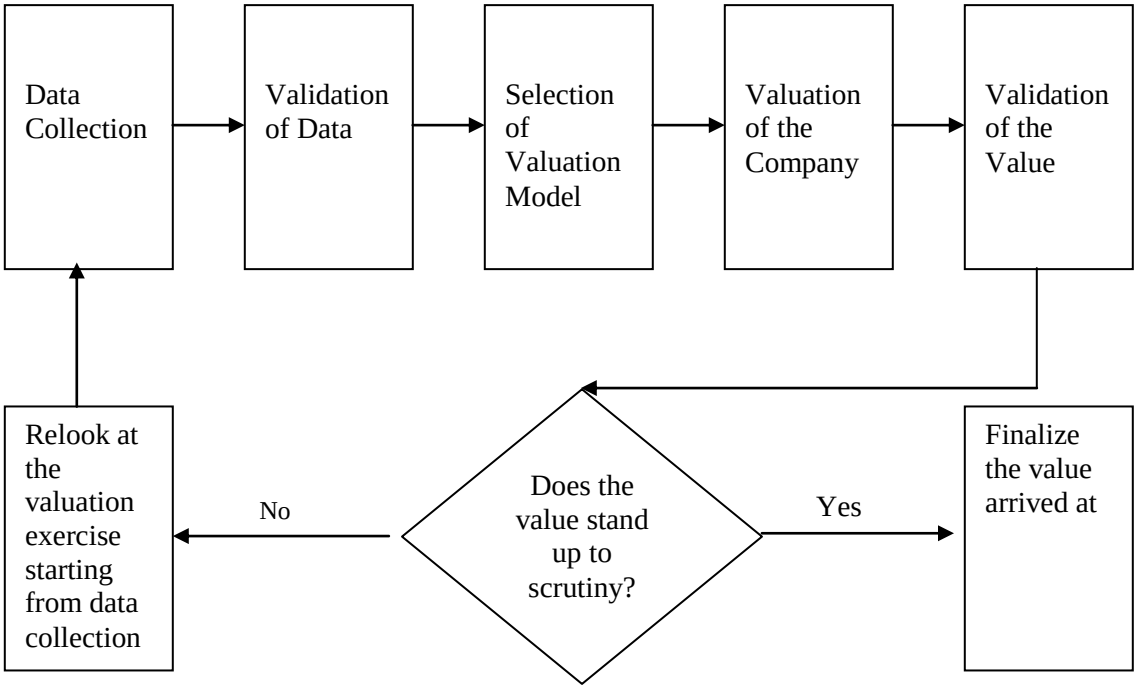


Figure 5: The valuation process

Collection of data

In this stage, one has to review market studies and research reports on the industry and the business environment in which the company is operating. This includes data collection about the future, expected growth in this line of business, expected market share of the company, possible profit margins in the business and competition analysis.

The underlying business strategy is to be understood. Sometimes this strategy may be articulated, sometimes not. Tom Copeland, Tim Koller and Jack Murrin, in their classic book, "Valuation - Measuring and Managing the Value of Companies," explain the importance of developing a strategic perspective and highlight some models for such analysis.

Validation of data

The business forecast needs to be carefully scrutinized. The numbers in the forecast are directly input into the valuation model and hence one needs to understand if these are realistic and achievable.

To illustrate this, let us consider the case of Growth High Private Limited (GHPL), which is expected to have an annual growth rate of 15% for the next 5 years, while the industry growth rate is expected to be 10% in the same period. One needs to understand how and why the rate of growth of GHPL can be so much above the expected industry growth rate. The underlying drivers of superior growth need to be identified. This could be better quality of products, cost efficiency or use of unique technology. In such a scenario, one may also try the following exercise, what would happen to the value of GHPL if the growth rate was reduced to that of the industry, i.e. 10%, or a slightly increased rate of 12%? In essence, deviations from industry average are to be scrutinized very carefully and validated; otherwise, the valuation exercise will not hold credibility.

Selection of valuation model

Typically, one lists out some key approaches for valuation at the start of a valuation exercise, such as the DCF model and market based model. Models which cannot apply in the case under question are rejected. For example, it is difficult to value start ups based on the profit multiple model, since there may be no profits in first few years. Such companies are often valued, based on multiples of their revenue or some other such parameter.

The methods selected must reflect the methods used in the industry, at that point in time. It is preferable to use more than one valuation model. If the value of the company varies with different models used, this may be an indication that the calculations are flawed or that one of the models is not suitable for application in the case under consideration. In such situations, one needs to reexamine the models used and the underlying assumptions and inputs to the models used. The example that follows, illustrates this.

Example

Two companies are to be valued. We try to use the relative method in both cases. In Case A, we find that we can use the relative method for calculating the value of the company, Medcan Private Limited. In Case B, however, we find that the relative method is not appropriate to value PencilPens Private Limited.

Case A

In this example we try to arrive at the value of Medcan Private Limited, based on the enterprise value of three listed companies, Testman Limited, Medlink Limited and CheXup Limited.

Amounts in Rs. crores	Testman Limited	Medlink Limited	CheXup Limited	Average
Enterprise value/sales	1.5	1.2	1.2	1.3
Enterprise value/EBIDTA	18.0	16.0	17.0	17.0
Enterprise value/book value	3.4	2.8	3.1	3.1

Medcan has sales of Rs. 180 crores, EBIDTA of Rs. 14 crores and book value of Rs. 74 crores. What could be its possible value?

Solution:

Application to Medcan Private Limited:

	Medcan P Ltd. Rs. crores	Average of three relative companies	Enterprise value of Medcan Rs. crores
Sales	180	1.3	234.0
EBIDTA	14	17.0	238.0
Book value	74	3.1	229.4

The value range of Medcan is from Rs. 229 crores to Rs. 238 crores, based on the above. In this example, we could use a modified multiple. As an alternate, we could value the company based on the average multiples of Medlink Limited and CheXup Limited only, if we state that Testman Limited is different from the other three companies being compared. Here the justification of the method used needs to be articulated.

Q. What is the alternate value range that you obtain if you do not consider Testman as a comparable company?

Case B

Let us now value PencilPens Private Limited, based on the enterprise value of three listed companies, Papers Limited, Documentation Limited and Printing Limited.

Amounts in Rs. crores	Papers Limited	Documentation Limited	Printing Limited	Average
Enterprise value/sales	1.5	1.8	0.9	1.4
Enterprise value/EBIDTA	14.0	21.0	10.0	15.0
Enterprise value / book value	2.1	3.0	1.8	2.3

PencilPens has sales of Rs. 160 crores, EBIDTA of Rs. 10 crores and book value of Rs. 85 crores. What could be its possible value?

Solution:
Application to PencilPens Private Limited:

	PencilPens P Ltd.	**Average of three relative companies**	**Enterprise value of PencilPens**
	Rs. crores		**Rs. crores**
Sales	160	1.4	224.0
EBIDTA	10	15.0	150.0
Book value	85	2.3	195.5

The value of PencilPens, using this method, ranges from a low of Rs. 150 crores to a high of Rs. 224 crores. We cannot use the relative method for valuation in such a case and have to look for an alternate method or at other comparable companies.

END OF EXAMPLE

The above example was illustrative. The use of the methods of valuation also depends on the nature of the proposed transaction and requirement for this valuation exercise. In an M&A transaction, valuation should reflect synergy expected from the proposed transaction. The choice of valuation model and its application must be done with due care and thought.

Different persons valuing the same company may therefore arrive at different values, based on the models used and the assumptions regarding the possible future scenarios. The differing values become a starting point for the negotiations and deal structuring. Sometimes the value ranges are so different that these make the deal a non-starter.

Valuation of the company

Once the valuation models have been identified, data is input to obtain the value of the company. To reduce the impact of subjectivity in the valuation exercise, different scenarios may be reviewed. Typically, three scenarios are considered, an optimistic, normal and a pessimistic scenario. In the optimistic scenario, both revenues and certain expenses will be on the higher as compared to the other scenarios. In the pessimistic scenario, revenues will be reduced and hence it is natural that some costs would be controlled as the management tries to work with reduced cash flow. This exercise would provide a value range of the company for different levels of performance.

Next, weights are assigned to the different scenarios. These reflect the expectation regarding the probability of each scenario occurring in the future. For example it may be

assumed that values in the three possible scenarios are Rs. 200 crores, Rs. 180 crores and Rs. 150 crores respectively. It may further be assumed, after much deliberation that the probability of each of these scenarios occurring may be 50%, 40% and 10% respectively. The expected value of the company is then calculated as:

Value (expected) = (200*0.5) + (180*0.4) + (150*0.1)
= 100 + 72 + 15
= Rs. 187 crores

The valuation of the company, which is the key objective of this exercise, is to be done carefully. The final valuation of the company or the valuation range has to effectively capture the story behind the enterprise.

Validation of final value

Once we arrive at a value of the company, we need to again raise some questions such as:

- Does the value reflect the position of the company compared to others in the industry and other competing companies?
- Does the value reflect the expected future performance of the company, based on its strategy?
- Does the value reflect the price we want to negotiate for?

There are many factors that affect the value of a company and need to be kept in mind while reviewing the enterprise value arrived at using valuation models. Some of these are:

- Strategic requirements: These can override other considerations. For example, a company in India may be willing to pay a premium to buy a small company in Europe, because it wants quick access to the European markets.
- Demand vs. supply: If there are many bidders for one enterprise, the value of this company will be higher because of the demand from multiple parties.
- Flavour of the season: Sometimes select industries are perceived to be on a growth path. This will in lead to increased values for all companies in the industry.
- Control premium: Investors sometimes want a controlling stake in the company, for which they may be willing to pay a premium.

In addition to the above factors, in certain cases, valuation models may need modification, these include valuations in:

- Mergers and acquisitions
- Investments by venture capitalists or private equity investors
- Valuations in restructuring exercises
- Valuation for Multi-business
- Cross border transactions

- Valuation for an IPO

Illustrative example: Price banding in IPOs *

* *Illustrative example contributed by Pratap Giri S. FCA, ACS*

Unlike valuation of a share for an acquisition, merger or other strategic transaction based purely on fundamentals, IPO pricing follows a mix of fundamental approach and market mechanics. This is because IPOs have to keep in mind the current sentiments in the market, the investors' risk appetite and return expectations and more importantly the marketability of the share and the post-issue liquidity in the market. Therefore, merchant bankers have to delicately balance the pricing with equal weightage to market aspects as to the intrinsic value.

In price banding for a fixed price or a book built offer, merchant bankers rely heavily on the Earning Per Share (EPS) and the Price to Earnings multiple (P/E). These are fine tuned to the financial performance of the company in recent years, the performance to be expected in the immediate future, the EPS and P/E multiple of comparable listed companies and their stock performance and the industry averages. A lot would also depend upon the timing of the public offer. Historically, in good market conditions, IPOs have tended to be aggressively priced such as those of Jet Airways, TCS, ONGC and others. In weak market conditions, generally IPOs are not opened but if they have to, the pricing has to be investor friendly. In retrospect, one can conclude that the IPOs of Maruti Udyog could have been priced higher if it had come in stronger market conditions. It may be argued that in a bullish market, there is always scope for upward movement and therefore the issuer can assume enough upside to the investor. However, in IPO pricing, one cardinal principle is important. The investor should be allowed to make money if the stock has to find sustained support. Therefore, some issues are intentionally priced a bit lower than necessary to provide a psychological edge to the investor. The IPO of Tech Mahindra is a case in point.

In book-built issues, the pricing is a collaborative effort by the issuer and the investor. Therefore, it is believed that it leads to better price discovery, though it has been experienced that in a strong market, even an aggressive floor price does not deter the investor. The Reliance Power (IPO in 2008) is a case in point. Despite the fact that the company does not have any track record, the issue received record subscription despite aggressive pricing. However, the company was made to backtrack due to severe backlash from the media on overpricing the issue. As a measure of recompense, the company declared a bonus issue to all investors in the public offer.

Quick Reference Tool 3:
Special case of valuation: Intangible assets

- Traditional accounting and business models do not readily allow for intangible assets to be valued. However this is one area that cannot be ignored as intangible assets are driving the value of many businesses today.

- In the current business environment, much worth resides in intangibles,
    - Employees
    - Brand value
    - Intellectual property
    - Software in laptops
    - Customer satisfaction etc.

Intangible assets

- Identifiable non-monetary asset
- Without physical substance
- Held for use for production/supply of goods or services or for rental or for administrative purposes
- Asset is a resource
    - Controlled by enterprise
    - Future economic benefits are expected to flow from it to enterprise
- Some assets can be a combination of tangible and intangible
    - Software and hardware
    - Legal document and patent
- Often the intangible asset value exceeds the tangible value in these cases

Intangible Asset (IA) value

- The value of the IA is from
    - Economic benefit provided
    - Specific to business or usage

- May have different aspects; such as
    - Accounting value: value as per books of accounts
    - Economic value: may have value to potential acquirer even though this does not have any value in the financial statements and
    - Technical value: even knowledge that a particular experiment has failed may be useful to a researcher and so this would have technical value but no economic or accounting value.

- Valuation differs for
    - Liquidation
    - Book value

- Banks for lending
- Management control premium
- Partial use of IA
- M&A/LBO/LBI (management buyout, leveraged buyout/buyin)

Some Methods of Valuation:

Historical cost

- Historical and book costs associated can be identified with the IA; direct and indirect costs
- There in subjectivity some areas, for example
  - What is the period for costs should be calculated when the company is very old, e.g. brand value of coca cola (dating to 1817)
  - Which costs are to be considered, which are to be excluded, e.g. advertisement partly relates to current sales and partly to future sales

Replacement cost

- Some IA can be replaced, some cannot
- How do you assign costs for different characteristics, e.g. for a brand – awareness, image, quality of product, superior after sales service , leadership, distribution network etc
- Further there are risk element in replacement of product, hence in practice, uncertainty may lead one to purchase the IA instead of replacing it

Market price related

- It is difficult to get comparable transactions where one can understand the market price (e.g. Used cars have a market price, but IA may not)
- Sometimes multiples may be used such as in M&A enterprise valuation
- It needs to be understood that market price may not necessarily be indicative of value specific to requirement since this may have depended on some strategic rationale
- Market price may be linked to both tangible and intangible assets and it may be difficult to separate and unbundle these values

Potential earnings

- Based on future expectations
- The difficulty is in separating the income associated with the IA on a standalone basis
- Discounts and multiples are difficult to estimate

Excess profits

- Profit from net tangible assets is separated out. For e.g. one may estimate that the difference in price between a generic product and a branded product is indicative of value of the brand. This would then assume that all excess profit is attributable to the brand and not to any other IA, which may not necessarily be the case

Relief from payment

- This assumes that if IA ownership was with another company, royalty would have to be paid for usage of IA
- Value is assumed to be the capitalized value of relief to company

CHAPTER 5

Mergers and acquisitions

Many businesses are looking at growth through the mergers and acquisition (M&A) route. It is often assumed that if one grows through purchase of another business or combines with another entity, the combined new entity will have a lot of advantages. In reality such transactions are not so simple and a successful outcome is not guaranteed. In this chapter we look at the process of the planning in an M&A exercise.

A merger is a combination of two or more enterprises into one company. In acquisitions, one enterprise, or a division of a company is absorbed into another. From a legal standpoint, there are many distinctions between types of mergers and acquisitions. Prior to considering any M&A transaction, one needs to pay adequate attention to the statutory regulations that need to be complied with.

The principal economic reason for a merger is that there is expectation of value creation from the transaction. Historically, there have been many motivations for mergers and acquisitions and many theories have been put forward. The new combined entity could be formed for a variety of reasons, including for either one or more than one of the following: operating synergy, financial synergy, diversification, strategic realignment, tax considerations and market power as stated by Donald DePamphilis in his book, "*Mergers, Acquisitions and other Restructuring Activities.*"

Different types of mergers and acquisitions

Mergers and acquisitions can be of different kinds. Horizontal mergers involve mergers of two or more businesses that compete in the same kind of business activity. Vertical mergers occur between businesses which are in different stages of production operation. In their book, "*Takeovers, Restructuring and Corporate Governance*," Weston, J Fred, Juan A Siu and Brian A Johnson, state that conglomerate mergers are between firms that are working in unrelated activities. Leveraged deals are a category of specialised acquisitions. In leveraged buy outs (LBOs) the acquirers of the company borrow funds to finance the transaction. The borrowed funds are secured against the assets of the company. Typically these acquirers do not have sufficient funds to take over the target company, hence the need for borrowing funds to finance such transactions. The types of M&As detailed above are illustrative and not exhaustive.

The growth of the economy in India in the recent years, has led to many developments. Indian businesses are now competing in a global environment. Many Indian firms are not geared to face such competition. One of the ways to address this competition from firms outside India and reduce imbalance due to sheer size, is by combining more than one business by merging, or by larger businesses in India acquiring smaller businesses. Such inorganic growth can help bring economics of scale to the newly formed entity. Further the merging companies can bring different skill sets and competencies which

complement and supplement each other, to give better returns and facilitate a better growth rate in the merged entity, provided this is done with due thought, care and planning.

Globally, M&A activity has been studied to understand whether the stakeholders have benefited from such deals. A question, which is raised, is whether mergers pay off for the target companies and the acquiring shareholders as well as for society. Many times, M&As fail to meet expectations. Gerhard Picot in his book "*Handbook of international mergers and acquisitions,"* states that in view of the economic significance of increasing transaction numbers and volumes, it is regrettable that more than 50% of such transactions do not bring in the desired increase in values and greater returns on investments. In fact it has been observed that in most cases the shareholders of the selling company benefit at the expense of the shareholders of the purchasing company.

Some of the reasons given for failure of mergers are:

- Overestimation of synergies
- Underestimation of expenses and costs of integration of the two or more different firms
- Over valuing the business by the buyer
- Incomplete or inadequate due diligence

In view of such findings, it becomes important for persons involved in such transactions to proceed with care. A detailed project review, or a due diligence review (DDR) could help understand the finer points and deal issues.

The premise for M&A is to be carefully examined and questions raised not just on financial parameters, but also on soft issues such as cultural fit, impact on customers, etc. before proceeding with such deals.

Due diligence review (DDR) in M&A transactions

Companies merge because of perceived benefits to them, which is expected to lead to increased valuation in the combined entity as compared to the individual separate stand-alone companies. To put this simply, two companies A and B merge to form one company A + B, with the expectation that:

$$\text{Value (A + B)} > \text{Value (A)} + \text{Value (B)}$$

The valuation in such transactions is dependent on a variety of factors. Prior to any M&A transaction, each company projects a valuation, based on historical data, future forecasts, current and expected business environment. The benefits of the deal proposed would also be highlighted.

Each of the parties would review the data provided by the other party to the proposed transaction. Such a review would bring out points, which may impact past historical data or may highlight uncertainties in future forecasts. This can have an impact on the

negotiation and provide a bargaining tool for the reviewer, if done with due care and utilized well.

Valuation is dependent on a variety of aspects, such as technical skills, IT infrastructure, physical infrastructure, financial and accounting and HR organization structure, intangible assets and brand value. These cannot be taken at face value as stated by the parties to the proposed deal, who have to provide variety of data and documents, including inter-alia, historical financial statements, legal documents, records and manuals maintained.

These details are to be reviewed and data to be matched and scrutinized for internal consistency. Documents and manuals are to be studied along with procedures followed by the company. This is to be done with a view to understanding whether what is laid down in the manuals, is actually being practiced by the management. Every projection and forecast made is to be carefully examined. For example, as the sales are projected based on expected markets, the global markets may also need to be examined. The reviewer must look at the total addressable markets (TAM) and study expected trends in the industry to understand the demand for these products/services.

All elements in the projected forecast are to be examined, as the valuation of the business is directly dependent on this. For example, if the promoters of a company being acquired have projected an annual increase in turnover of 25% in the first year and 50% in the next two years, the rationale behind these projections is to be understood. The customer profile and turnover should be computed and examined. Reasons for loss of key customer, if any, are to be looked into. Sales projections are to be cross-checked with other figures such as corresponding increase in say raw material, in labour or salary costs etc.

The impact of the M&A transaction, if it goes through as proposed, is to be factored in. The ability of the proposed combined entity to capture some additional market should be considered. Similarly expenses projected and savings expected because of the proposed transaction are to be studied.

Statements made should be carefully weighed against historical available information. Sales and expenditure should be reviewed against budget and forecasts made in the past. Review of Management Information Statements (MIS) of different periods alongside actual sales, expenses, capital expenditure (Capex) etc. should throw out any sudden deviations from projections, in the past. This will help understand whether or not the company has able to achieve revenues as forecast and the reasons for deviations if any. Another key factor which must be examined is the historical capex and other expenses. These are to be compared with industry standards, to understand whether the company has been prudential in managing its day-to-day operations. This may also give some insight into the cash management approach of the company.

Other elements which are to be considered are the details of compatibility of existing IT systems in the two companies which would be merged, the HR policies, including ESOP

schemes and the manpower skill sets in the two organizations. Employee turnover is to be closely examined and reasons for any deviation from industry standards understood.

Many M&As fail due to poor post merger integration. Issues such as deciding the roles and responsibilities for key individuals are to be carefully thought through. For example two organizations, similar in size and turnover, may consider merging to become a large powerful player. If both organizations have a COO, a CFO and CTO in place, it may be difficult to decide and select the COO, CFO and CTO in the combined business. Further the two organizations may have different structures to manage their day to day administration. In such cases, these differences may come in the way of creating a successful single merged entity which can go on to perform well in the market place. The inherent differences may lead to internal conflict which may take time to be addressed and hence the merged entity may lose out on the market opportunity.

The due diligence exercise therefore cannot just focus on financials and easily measurable parameters, such as turnover and attrition in the two businesses. Some ways of looking at soft issues such as cultural issues may also need to be addressed.

In one case, two companies in the IT Services industry, Timeon Private Limited (TPL) and Pearle Private Limited (PPL) wanted to merge. About two years before the proposed transaction, PPL wanted to close one of its divisions, due to a change in business strategy. It had found a buyer in TPL and the entire division of PPL with 100 persons had been sold to TPL. At the time of the proposed merger, an exercise was taken up to ask these 100 persons their experience in moving from TPL to PPL. On investigation, it was found that within one year of the sale of the division of PPL to TPL, all these 100 persons had left the services of the company. This was a worrying signal for the proposed transaction and was taken up for additional review. On further investigation, it was observed that the work culture in the two organizations were quite different. One organization had a lot of structure and rules and regulations to be observed and the other had a very informal style of working. These differences in working made the employees of the erstwhile division of PPL, uncomfortable in TPL. Thus while prima facie, the two companies appeared to be similar, a detailed review showed another side to the picture. As a result, the two companies decided to partner and work together on assignments, rather than merging into one entity.

Persons conducting the due diligence review therefore need to look into details and take up leads which could help in taking a decision in whether the deal should go through or not. Deal breaker and deal maker issues can come up at any stage of such a review.

Tax, legal and regulatory issues need to be factored into the due diligence review. Other aspects which need to be looked into are the technical feasibility and the commercial viability of the business, post the transaction. The findings of such reviews, keeping in mind the proposed transaction also get factored into the valuation. The points raised provide inputs for negotiation and deal structuring.

M&A transactions and the regulatory environment *

** Sub-section contributed by Pratap Giri S. FCA, ACS*

In India, the M&A activity has shown phenomenal growth in the liberalized era, particularly after the deletion of the restrictive chapters under the MRTP Act. Mergers are not very common as compared to substantial acquisitions, which almost serve the same purpose. However, in India, both horizontal and vertical mergers have taken place.

Currently, M&A activity is still governed by Sections 391-395 of the Companies Act, 1956 since the relevant chapter of the Companies Act 2013 is yet to be notified pending the constitution of the NCLT. The Supreme Court recently cleared the way for the NCLT due to which the new provisions may be notified in due course. Besides the Companies Act, the Competition Act, 2002 is also relevant in the context of larger M&A transactions. Acquisitions in the case of listed companies are governed by the provisions of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 2011 as applicable from time to time. Acquisitions in unlisted companies are largely an unregulated area, except in the area of foreign investment. The current regulatory environment is quite conducive for the M&A activity and one has not seen many complications arising in court hearings under the Companies Act or with SEBI in the case of substantial acquisitions and takeover of listed companies. There have been tax issues arising from indirect acquisitions made by foreign companies in India and the most notable among them is the Vodafone case. It led to a retrospective amendment of the Income Tax Act that created further controversy. M&A is also governed by the relevant provisions of the Foreign Exchange Management Act, 1999 in the matter of foreign shareholding subsequent to the transaction. Similarly, sectoral regulation is also seen in industries such as banking, insurance, telecom and others. The Income Tax Act 1961 also promotes M&A activity providing for carry forward benefits on depreciation and accumulated losses in the case of merger or demerger of companies. This has helped corporate consolidation and restructuring in a big way. Last but not least, the provisions of the new IND-AS 103 Accounting Standard on 'Business Combinations' notified by the MCA for applicability from financial year 2015-16 onwards in a graded way needs to be followed. Therefore, in finding value in a M&A transaction, the regulatory framework in the Indian context should be kept in mind.

The Companies Act connotation of M&A is quite wide and includes all such transactions as would constitute an 'arrangement' as defined in section 390(b). Merger tough not defined specifically, is an arrangement that constitutes an 'amalgamation' of companies under section 394 of the Act. In approving a merger under the proceedings of Company Law, the Courts look into the aspect of 'public interest' which includes the relative shareholder interests, especially if both the companies proposing to merge are listed. In the Indian context, two mergers come to mind that were involved in controversies about the relative valuation of both companies. In the first case which involved the merger of the erstwhile TOMCO with Hindustan Lever Ltd., the merger was eventually put through after the Hon'ble Supreme Court upheld the merger. In the second case involving the

failed merger of the erstwhile Global Trust Bank Ltd (GTB) with UTI Bank Ltd, the merger had to be called off amidst allegations on the overvaluation of the GTB share.

On the aspect of acquisitions, the statutory framework acquired a definitive shape following the introduction of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 2011, popularly known as the 'Takeover Code'. The 2011 Regulations replaced the erstwhile Regulations that were introduced in 1994 and overhauled in 1997. The 1997 amendments were based on the recommendations of the Justice Bhagwati Committee that went into the aspect of acquisition of 'control' as distinguished from acquisition of shares. The new Regulations introduced in 2011 were a result of the Achyutan Committee recommendations. The Code presently provides for a threshold acquisition of shares or control of 25% as the trigger point for a mandatory public offer by the acquirer. The mandatory offer shall be for a minimum of 20% of the issued capital. The Takeover Code has made acquisitions serious business in India and only resourceful and committed acquirers can hope to takeover management of companies and that too in a transparent way.

Ind-AS 103 which is harmonized with the IFR Standards brings in a new era of accounting for M&A transactions with a significant departure from the approach advocated all these years under AS-14. The new standard does not differentiate the accounting treatment for (a) amalgamation in the nature of merger and (b) amalgamation in the nature of purchase. It also does not distinguish between transactions in the nature of an amalgamation and those in the nature of an acquisition. Instead, it focuses on 'control' of a business acquired through by any means whatsoever and prescribes that such business combinations shall be accounted for under the 'acquisition method' as prescribed under the standard.

The standard lays down the following process for such accounting:

- Identifying the acquirer
- Determining the acquisition date
- Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquire,
- Recognizing goodwill or a gain from a bargain purchase.

Quick Reference Tool 4:
A quick guide to M&A and alliance partnerships

Business growth

- Growth can be
  - Organic and
  - Inorganic
- Growth with alliance partners increasing being seen as the way to get ahead of the competition

Growth with alliance partners

- M&As and alliances can be
    - Horizontal
    - Vertical
- Alliances can be in many forms, e.g.
    - Creation of new/different business entities (Through M&A activity, restructuring, part purchase, JVs etc)
    - Informal understandings
    - Relationships with third parties
    - Network associations

Growth with M&A

- Historically many M&As have not proved successful; this could be due to
    - Overestimation of synergies
    - Underestimation of integration issues
    - Incomplete understanding of issues (includes financial, non financial)
    - Incomplete or limited due diligence review

Initial Stage Planning

- Shared Vision and objectives to be set out
- Economic parameters to be factored, i.e. synergy vs. costs
- Legal and statutory issues to be factored
- Structuring issues to be set out
- Personal goals and aspirations of key management and stakeholders to be articulated

Implementation

- Due Diligence to bring out
    - Inputs to deal issues
    - Inputs to valuation
    - Inputs to negotiations
    - Inputs to deal structure
    - Inputs to warranties
    - Inputs to future action plan

- Valuation: to set the price and terms
- Regulatory clearances to be obtained
- Pre deal conditions to be set out and met
- Post deal and integration issues to be set out

Integration

- People issues to be carefully addressed, including but not limited to
    - New appointments
    - Redundancy
    - Job transfers
    - Cultural integration

- Restructuring and divestment to be done with care
- Uniform business systems to be set out
- To manage internal and external communications to
    - Avoid anxiety amongst employees,
    - Keep customers informed
    - Emphasise the positive
- Attempt to realise the synergy expected from transaction

CASELET 4: Value creation in an acquisition

KR Technologies Ltd. (KRTL) is an Indian Company established in 2000 by Karan Kapur, Rita Kohli and Ramesh P. In the year 2013-14, the turnover of the company was Rs. 2500 crores. KRTL also had one subsidiary company Process Experts Private Limited (PEPL), established in April 2006.

In September 2013, the Board of KRTL met to review a proposal to purchase a British BPO Company, John Lenox Ltd. (JLL) for US$25 million. The Board used the opportunity to discuss the future growth plans of the company. The members decided on a strategy to grow inorganically by purchase of some small and medium sized businesses in Europe and USA. The first company to be purchased would be JLL.

KRTL acquired JLL in an all cash deal in April 2014. The expectation was that JLL had many contracts which would now come to KRTL. One of the main customers for JLL was Tristat Technologies and Services (TTS). JLL had a key contract from TTS and expected revenue of US$ 100m from the contract over a three-year period. It was presumed that this contract would be automatically renewed with KRTL.

Subsequent to the deal becoming made public, TTS cancelled its contract for US$ 100m, quoting from a clause in its contract with JLL. The reason given by Rick Smith, COO, TTS, to Karan Kapur, was that TTS was currently outsourcing to two other Indian Companies and one European company. It did not want to have a 3rd Indian Company as a partner. Once JLL was purchased by KRTL, it became viewed as an Indian Company.

KRTL made some changes in the management of JLL, on acquisition of the company. They put a team from India in JLL. The CEO of JLL, William Woods was kept on. William Woods was aware about the transaction, much before the rest of the employees of JLL knew about it. He had indicated to KRTL review team that he did not expect any employee related problem post the deal.

By July 2014, almost 20% of the employees who had been with JLL, left the company. This included some of the senior management and the marketing head.

As a result of all these issues, the Board of KRTL felt that the deal value did not materialize and decided to go slow on its strategy to acquire foreign companies.

Q. Do you think these issues would have been identified if the due diligence had been more carefully/thoroughly done?

Q. What are the key issues that should have been addressed in this DDR in which an Indian company is tying to buy a foreign company?

Q. The Board members felt that the deal value did not immediately materialize. Does the solution lie in avoiding such deals altogether? If not, how should KRTL proceed in the matter?

Q. What can still be done by KRTL to prevent further value loss from this deal?

END OF CASELET

CASELET 5: Proposal for M&A

Gyan Technologies Private Limited (GTPL) was incorporated in January 2013 in Mumbai, India. The company was promoted by Anand Ramesh and Pronoy Bose. These promoters had significant experience in the software industry, in India and in the US, prior to setting up GTPL.

GTPL provided software services mainly in two sectors, BSFI (Banking Services, Finance and Insurance) and telecom. The company targeted customers outside India mainly in Europe and Asia and provided a combination of offshore and onshore services.

The company received two rounds of financing in February 2013 and August 2014, respectively. The initial start up finance of Rs. 10 million was provided by Startups Fund (SF). In August 2014, East Technology Venture Fund (ETVF) committed to invest Rs.100 million in the company. GTPL received 70 million out of these committed funds in August 2014. It was agreed by the interested parties in the deal (GTPL, SF and ETVF) that the balance of Rs.30 million would be invested by ETVF in August 2015. Both SF and ETVF appointed a nominee Director on the Board of GTPL.

At a Board meeting in April 2015, the nominee Director of ETVF expressed his view that GTPL should expand its existing portfolio of offerings by providing services to other industry verticals, such as health care and business automation. This would help the company grow at a faster pace. The other Board members were also keen to explore this possible opportunity and requested the management team of GTPL to examine various options for growth.

In June 2015, ETVF indicated to the promoters of GTPL and to ST that it would not be able to bring in additional committed funds of Rs. 30 million in August 2015. It however would like to continue to keep its existing stake in the company.

The investors in the corpus of ETVF, East West Limited and Markus I Limited had not brought in their contribution and ETVF did not have funds to invest in GTPL at this

point. East West Limited and Markus I Limited had incurred losses in their investments in a couple of portfolio companies in the second quarter of the calendar year 2015.

ETVF then placed a new option before the GTPL Board. ETVF had an existing investment in Healthsoft Private Limited (HPL). HPL focused on providing a range of services to the health care industry. HPL had initially started operations as a medical transcriptions company and now was trying to expand into providing other software services to this industry sector. The management of HPL was also exploring the option of expanding their business and provide additional other IT enabled services.

The expected turnover of HPL for the calendar year 2015 was Rs. 200 million. The projected turnover for the same period for GTPL was 250 million. In terms of number of people, HPL had 140 employees as compared to 225 employees at GTPL.

ETVF proposed that GTPL could consider the option of merging with HPL. This would be a strategic growth option that would lead to inorganic growth of the two companies.

The Board members of GTPL were now looking at alternate options before them and how they should proceed.

Q. You are an advisor to Gyan. What would you advise them to do?

Q. How would you ask them to proceed?

Q. What are the challenges in the proposed transaction?

Q. What could be the possible synergies in such a deal?

Q. What are the preliminary questions that GTPL should put to ETVF and HPPL to get more information about the advantages and disadvantages of this option to merge?

Q. In the situation above an investor has backed out from a commitment. What are the concerns that need to be addressed by the different stakeholders? What are the red flags and signals that the advisor needs to bring to the notice of the promoters?

END OF CASELET

CHAPTER 6

The Due Diligence Review Process

The due diligence review process is a very important tool for planning. The findings from such an exercise help in decision making, whether the due diligence review is for an investment, a proposed transaction or just to get an understanding of an organization status at a point in time. Currently, a great deal of attention is being paid to the due diligence review process. In this chapter we take a look at this important process in decision making and strategic business planning.

Illustrative example: Due diligence in public offers *

* *Illustrative example contributed by Pratap Giri S. FCA, ACS*

The three main areas where due diligence has acquired tremendous significance in recent times are (a) Public Offers, (b) Mergers and Acquisitions and (c) Private Equity and Venture Capital investments. In the case of public offers, due diligence is a statutory requirement under the Issue of Capital and Disclosure Requirements Regulations (ICDR Regulations) of SEBI. In the other two areas mentioned above, due diligence is conducted voluntarily by the acquirers since there has to be a proper verification of the business and financial affairs of the company in question.

Due diligence has now acquired the dimensions of a full blown audit of the company's financial accounting records, a secretarial audit of compliances and an assessment of the company's financial forecast all rolled into one. So it would not be correct to assume that a due diligence review is a limited review. On the contrary, it has to throw up not only issues that are in question as of date but issues for the future as well. There is a close linkage between due diligence and valuation too as more often than not, the agreed valuation goes through iterations based on the issues thrown up by the due diligence review.

The responsibility of due diligence in public offers has been thrust upon the merchant bankers managing the issue (known as lead managers). If there are multiple lead managers, the lead manager in charge of preparation of the offer document has to file the required due diligence certificates.

There is a four stage due diligence required to be performed by merchant bankers in public offers. The first stage is extremely important. At this stage, the lead manager has to conduct the due diligence and file a due diligence certificate with the SEBI along with the draft prospectus (also known as a red herring prospectus in a book built issue). In the case of a debenture issue, there is an additional due diligence certificate to be issued by the debenture trustee appointed for the issue. The first stage is essentially to ensure that there has been a proper verification of all facts and inspection of documentary evidence by the lead manager of all the disclosures made in the offer document. It is also to ensure

that the lead manager has taken adequate care to ensure statutory compliance by the company and the lead manager with regard to the issue.

At the second stage, the lead manager has to certify the second due diligence certificate to SEBI just before filing of the final offer document with the Registrar of Companies to ensure inter alia, that the final offer document is in conformity with SEBI requirements if any.

At the third stage, a due diligence certificate has to be filed before opening of the issue certifying that no corrective action needs to be taken or that amendments have been issued to the offer document after issue of the same. A fourth certificate is to be filed after the opening of the issue but before its closure stating among others that adequate disclosure requirements have been met.

Quick Reference Tool 5:
A summary of the due diligence review process

Due diligence is:

- A detailed review
- May or may not be a statutory requirement
- Conducted with a specific objective in mind
- Driven by the a transaction or proposed transaction

Undertaken for:

- M&A / demerger / reconstruction
- Private equity investment
- Lending by institution
- Completion of a deal
- Vendor side analysis
- Special/limited area review
- Fund utilization review

By whom is this undertaken

- By the 'Buy side,"
    - Prior to a proposed transaction for M&A
    - Prior to a proposed transaction for VC/ private equity investment
    - Post transaction
- By the "sell side," prior to approaching a possible investor or attempting for a strategic or private placement

Due diligence approach

- Investigative: to ascertain if data and facts presented reflect a true picture To "Trust but verify"

- Analysis of information provided
- To go to root of issue and not stop at the surface level

Due diligence helps to

- Take informed decisions as more information is available
- Understand possible risk elements in a transaction to minimise these risks by addressing them
- Flag deal issues (deal breaker and deal maker issues)
- Provide inputs for valuation and negotiations
- Plan for the future course of action, from before the deal to post the deal

Due diligence depends on the

- Industry: the review for a manufacturing company is different from that for a software services company
- Stage of the company: the review for an existing company is different from that for an early stage company
- Nature of transaction: the issues for an M&A transaction will be different from the issues in venture capital investment
- Scope of review: Sometimes the scope is defined and focused and may need only a limited review

Areas of Due diligence: DDR can be for a variety of areas and could be financial as well as non financial for example:

- Accounting and Financial
- Tax Issues
- Legal
- Business
- HR
- Technical
- Funding utilization
- IP and Intangible Assets related

Illustrative elements in a financial review

- Financial Statements and schedules
- Assets/liabilities/income/expenses/ cashflow
- Forecasts and financial models
- Auditors reports, internal (MIS) reports
- Shareholding pattern
- Financial strengths, weakness
- Funding plan and investment plan
- Inputs to valuation
- Inputs to negotiation
- Inputs to deal issues

- Inputs to deal terms and conditions, for e.g. Representations, warranties etc. linked to potential future liabilities

Illustrative elements in a legal review
- Contracts
- Agreements
- Impact of regulations on transactions
- Titled and deeds
- Warranties and indemnities
- IP issues

Illustrative elements in a business review
- Business and economic environment
- Business strategy
- Business model
- Marketing and sales strategy
- Business strengths, weakness
- Infrastructure
- SWOT
- Value drivers of business
- Key constraints
- Competitive advantages, USP

Due diligence methodology
- To consider the transaction drivers
- To focus on key issues
- To be timely

Due diligence output
- To address requirement of transaction
- To highlight the risks and possible deal issues
- To address issues that impact valuation
- To highlight concerns which need to be addressed, some prior to the proposed transaction and others post transaction

Quick Reference Tool 6:
Illustrative list of information required during a due diligence review

During a due diligence review, the reviewer looks at various aspects of the project in detail. In addition to looking at the business plan there is a great deal of information required. The following list is a sample of some of the things that could be reviewed.

Executive Summary of project

This should, typically not be more than 2-3 pages. This will highlight the following:

- Brief details of the promoters and the key management team.
- The product and/or service being offered by the company.
- The total addressable market (TAM) and the market barriers to the project.
- Financial details including the project cost, the funds tied up till the date of the plan and the total funds requirement of the project including key financial forecasts.

Company and Background Information

This would give details of the company which requires finance including its various business activities, general industry outlook, profiles of key persons and shareholders in the company. The following list is indicative of the information which should be provided:

- Memorandum and articles of association along with printed literature including brochures about the company and its products and/or services.
- Company history and details of related companies, if any, achievements of the company and its various business activities.
- Detailed profiles of promoters and key management team with their role in the activities of the company.
- List of Board members, major shareholders, including institutional investors, angel investors, NRIs, foreign investors. The promoters' contribution (both cash and kind to be separately indicated) is also to be shown.
- General industry outlook and prospects for the business as perceived by the management.
- Advantage and disadvantage of current location of business.
- Current status of the business.
- Name of bankers, auditors, legal advisors and key consultants of the company.

Human Resource

It is now widely being recognised that human resource is the key resource of any Organizations. Investors are interested in looking at how the management has planned to address the various issues in this area: They would generally like to see information on the following:

- Organization chart with number of employees and future plans to hire more employees.
- Details of skills required to manage and operate the business and whether such skills are available in house or whether this would be outsourced.
- Deficiencies in the team existing and plan to overcome this deficiency.
- Details of salary levels for various employees.
- Details of employee stock option plans (ESOPs) and other schemes which are existing or planned.

- Details of any employee motivation schemes, cash and kind that are planned, if any. This may be in the form of ongoing training programmes, bonus payments or could take more innovative forms.

Product/service information and operational details

The product or process should be described in detail to help the potential investor understand the business and the business environment. Some points which should be covered are:

- Details of product range/process/service provided by company.
- Market and target customers, for each product.
- Features of the project which give it an edge over competition, including technology edge, if any, may be highlighted, giving impact on the project, i.e. whether it makes the product cost effective or solves existing problems or results in a superior product etc.
- Whether there are any market trends or changes which will affect the project, either positively or negatively.
- Whether there are any barriers to prevent others from using or developing the project technology.
- Details of any technology developed in-house, explaining how it has been developed and stage of development, i.e. whether it is at the pilot stage or is ready to commercialise and whether additional development cost is to be incurred.
- Information about any patentable technology. If any patent is held or is applied for, details may be provided. If technology used is owned by others, it may be indicated whether the company has the right to use the same.
- Details of any intellectual property rights associated with the project.
- If technology is sourced from outside with collaboration, details of any Memorandum of Understanding (MoU) entered into or Agreement signed for the same. Preferably copies of these documents may be provided. Further additional information may be provided on

⇒ information on the collaborators providing the technology may be provided, with justification for their selection and information on others who could have supplied the same or similar know-how.

⇒ details of any buy back arrangement, i.e. whether there is a firm commitment to buy back or whether any buy back is it conditional.

⇒ whether upgrade of technology is automatically being provided, or whether additional payments have to be made.

⇒ whether the technology provider is at liberty to sell the technology to others companies in India and/or globally and whether the same being sold to others.

- Details of any future development plans for the project.
- Details of major suppliers of raw material for the project.
- Whether key equipment will be bought or leased, and details of the suppliers.

Sales and marketing

There is no use having the best product in the world, if there is no one willing or able to buy it, whatever be the reason, whether it is related to price or requirement of the buyer or anything else. Information about potential or existing customers is to be given in the plan, including:

- Market survey details, if available, giving details of how market has been defined, in terms of area, type of customers, price range, etc .
- List of customers, potential, existing and why they prefer or will prefer the company's product to others.
- Details of other competitors, existing, potential or possibilities of others entering the field and strategies to address competition from them, whether in terms of price, quality, features, service etc.
- Projections for the next few years, preferably for five years, at least for three years.
- Sales and marketing strategy, will sales be through agents, direct, online sales, licensed to others etc. Method followed for any overseas sales. Details of any firm tie-ups may be indicated.
- Marketing Plan, advertisement plan whether hoardings, TV, print media or online social media or a combination of various methods are to be used.
- Whether warranty is being provided and if this is built in with pricing and costs; how post sales issues are to be handled.
- Details of how the product is being manufactured, in-house or contracted or a combination.

Financial information

Financial information provided is reviewed very carefully during the due diligence process. The investor will ultimately want a return on the investment and will therefore look closely at the funds brought in, to be brought in; the funds spent and to be spent. The following is a brief outline of the financial information to be provided by the promoter:

- Annual audited accounts for five years for existing companies (sometimes, investors may just look at the previous three years statements or less), along with the cash flow statements.
- Details of initial promoters contribution, whether cash or kind.
- Details of project cost proposed, sources and utilisation of funds.
- Firm commitments for finances at the time of preparing the business plan.
- Details of debt financiers and bankers providing any working capital.
- Projections for the next five years with justification for assumptions made.
- Sensitivity analysis to be done for key elements, such as drop in sales, increase in raw material cost or salary cost. Worst case scenario is to be indicated.
- Key ratios, break-even details and IRR of the project
- Valuation, valuation methods and justification for inputs to valuation.

Other information

Promoters may like to give some other information which is not included in the above sections. Some of these other items which are to be included in a business plan are:

- The time schedule for completion of the project, estimated dates of commercialisation and break-even.
- Project implementation schedule, preferably in the form of a chart such as a bar chart.
- Details of any statutory compliances that have to be met and the status of clearances to be obtained from Government Authorities. This may even be in the form of a checklist.
- Details of whether any promoter, shareholder or officer has been involved in any legal or criminal proceeding.
- SWOT (Strength, Weakness, Opportunities, Threats) analysis of the project.

CASELET 6: Preparing for a due diligence review

Wave Tech Private Limited (WAVE) was established in April 2014, in Bangalore, India, to work in the areas of embedded systems in wireless technologies. Wave was set up with the objective to develop its own products for licensing to OEMs.

The company was promoted by three individuals, Mukund Desai, Venkatesh K and T Isaac. Prior to starting Wave, these promoters, each had about 15 years of work experience, in India as well as in the US. Their areas of expertise included software development, embedded systems and design and development of electronic design automation.

The promoters invested Rs.15 lakhs each of their personal funds in the company, for equal stakes in the equity of the company. Mukund was appointed the CEO, Venkatesh the COO and T Isaac, the CTO of Wave.

At the time of starting the company, the promoters envisaged that the product development stage would take about 14 months, and that the prototype of their initial product would be ready for sale in Q4 in the calendar year 2015. In the initial period, Wave also intended to supplement its cash inflows with some revenues from services, both offshore and onshore.

In July 2015, Wave received seed financing from Infotech Services Private Limited (ISPL), an unlisted IT services company, which wanted to enter the IT products market. ISPL committed Rs. 2 crores towards the initial product development costs for the first two years of operations of Wave. This amount was committed to be paid in half yearly installments of Rs.50 lakhs each. ISPL also committed to outsource some of its contracts to Wave. Wave received Rs.50 lakhs in two installments from ISPL in July 2014 and January 2015 respectively.

By the end of the calendar year 2014, Wave had grown in size. The company had a full time CFO, Amit Vyas, who was in charge of all financial operations and reported directly to the CEO.

In April 2015, the company received an advance of USD 10,000, from Ramon Inc. Wave was to supply its first prototype to Ramon for testing by December 2015. There was a clause in the contract between Ramon and Wave, where Ramon had the option to convert the advance paid by it into equity shares, in case Wave did not deliver the prototype on schedule.

In May 2015, Wave was about 3 months behind schedule in product development. At the same time, ISPL indicated to Wave that it would not be in a position to release Rs. 50 lakhs due in July 2015.

The CEO of ISPL, Karim Khan, explained that his company had suffered many setbacks in its own business. Karim Khan also communicated to Wave that ISPL might not be able to outsource any Software Service business to them.

Wave was now in a difficult financial position. The company urgently needed funds to continue the product development activities. The promoters decided to approach a venture capitalist or strategic investor for funding. At the same time, they were approached by a leading wireless technology company WITEC who wanted to acquire them and wanted to buy out the other investors.

Q. How should the promoters proceed in this matter?

Q. What are the advantages and disadvantages if they get acquired by WITEC?

Q. Is any preparation required from their side, prior to meeting the potential investors? If yes, how should they get ready for this and the expected due diligence?

END OF CASELET

CHAPTER 7

Negotiations

Negotiations are an important part of any business. What one gets out of a business transaction, ultimately depends on negotiation skills, whether it is purchasing a company, a machine, or stationery item. Negotiation skills and techniques therefore should be carefully studied and worked upon. One needs to prepare and plan for this critical element in creating and running a successful business.

In this chapter we look at some of the points to be considered when planning to negotiate. At the end there is an exercise which forms the basis of a negotiating role play. To run this role play, participants need to prepare for possible valuations on both sides of the negotiating table, i.e. as potential sellers and buyers.

Prior to a negotiation, a detailed background check and planning is most helpful. It is difficult to be 'over prepared,' when it comes to negotiating for a business.

Often when one enters into a negotiation, price is the key and sometimes the only deal driver. One may not pay heed to the fact that, if successful, the negotiation could be the starting point of a relationship. For example, if a company is getting acquired by another, the negotiations regarding the transaction price and deal structuring are just the initial points in the expected relationship between the two parties involved. If one of the parties perceives that they have not been fairly treated by the other, this will affect the long term relationship after the transaction is completed. This perception of fairness is the key. So not only must you try to be fair in negotiations, you must also convey and communicate this to the party on the other side.

This may seem like a contradiction. After all, when one is negotiating, one wants to get the best deal for oneself. So in such a situation, how can you consider giving in to certain demands of the other side, in the interests of fairness? This is where the planning comes in useful. In negotiations for an M&A transaction, it is expected that there will be additional value creation due to the synergies in the proposed deal. This value creation should be shared between the two parties. If all, or the majority, of value expected to be created, is going to one of the parties alone, then this will not be a fair deal. This can lead to conflict between the team members of the two firms in the future. In fact, this is almost a sure recipe for distrust and discomfort between the parties on the opposite sides of the negotiating table.

Example: Sample list of items to consider prior to negotiations in a proposed deal

Prior to negotiations, it is important to be prepared with the following:

- What you want from the deal
- Deal maker issues

- Deal breaker issues
- What is the point where you are prepared to walk away from the deal
- The other party's interests in the proposed transaction, try to put yourself in the other party's shoes
- The alternate ways in which the deal can be structured, i.e. in terms of a combination of:
    - Cash
    - Stock
    - Deferred and/or performance based

- Checklist of the factors you consider important, prior to the negotiations
-
- Consider factors which may be relevant to transaction, either in terms of the valuation, deal structuring and/or which may need to be factored in the legal documentation such as warranties and representations
-
- Decide on the team members who will negotiate
- Who will be the key negotiator
- Will you plan to have different persons handling specific questions
- Will you have your advisors with you to participate in the negotiations
-
- Decide on the negotiating strategy you want to adopt, thinking through the following questions can help
    - What are the questions you plan to ask, how will you formulate questions, you need to mind your language
    - What are the expected questions and how you can answer them
    - How will you prepare to listen to the other team, listen to both the articulated demands and the unarticulated ones
    - How will you plan to handle potential breakdown situations if negotiations are reaching a stalemate
    - How will you pay attention to the deal motivation issues, which may or may not be articulated
    - Prepare with a role play, this is most useful.

The role play illustrated in the caselet below has translated into some successful outcomes for the participants. In one case, a woman entrepreneur in a family business played this game on a weekday and on the Saturday following she was at the negotiating table to sell a division of the family business. Her target was to get Rs. X crores for this unit sale. She realized Rs.2X crores as the sale price. She said that this role play had helped her prepare and plan for the division sale and hence she was successful in the negotiations.

CASELET 7: ROLE PLAY – An exercise in valuation and negotiation

The exercise below is an illustrative one which covers valuation, negotiations and deal structuring. This is based on a case which has been successfully played out in the Indian

Institute of Management Bangalore, by the author, in class room sessions in executive education programmes.

1. Sheba, Gaurav and Khan are running a BPO, SGR Pvt. Ltd., started in Year 1 (Y1), in Bangalore and are having discussions with a VC fund, who is a potential investor in the company, to raise USD 2 million funding.
2. The revenue expected in the calendar Year 4 , from 4 verticals is USD 4 million and the percentage share of revenue from these verticals is expected to be as follows
    - Finance - 30%
    - Telecom - 30%
    - Auto - 20%
    - Health - 20%

3. In Year 5 and Year 6, it is expected that there will be growth at 100% in all verticals. In Year 7 and Year 8, it is expected that there will be growth of 50% in the finance vertical and the other verticals are expected to grow at 20%

ASSIGNMENT:

- Prepare the revenue forecast for SGR Pvt. Ltd., based on the above information for Year 4 – Year 8
- Consider a pessimistic and optimistic scenario for the forecast, to help you get a better understanding of possibilities in the future
- Arrive at a value range for years 3 & 5
- You may use the following procedure to arrive at a valuation range for the company and prepare for negotiations:
    - Study companies in the industry, select your sample companies for comparison
    - Calculate expected typical margins and hence expected EBIDTA, PAT, in the future, in the years under consideration, in this industry
    - Factor in the expected impact of the global market scenario on this industry in general and on this company in particular
    - Arrive at expected PE ratios and price to sales ratios, in the market expected in 3 years, in 5 years
    - Arrive at a suitable multiples for SGR Pvt. Ltd.; discounting for illiquidity, size and any other factor you consider suitable

- Have a plan for structuring the deal

ROLE PLAY: PREPARE TO NEGOTIATE

One group of persons can prepare as the key negotiating team for SGR and one team can prepare as the VC fund, i.e. the potential investor in the business. The two sides can negotiate and either close the deal or walk away from the deal. The deal can be structured as a mix of initial payment or deferred payment or convertible instrument, if so desired.

ROLE PLAY LEARNINGS:
Negotiating Insights: From IIMB's MPWE Programme

This is an extract from an article, originally published in the blog, Entrepreneur's Corner in www.citizenmatters.in

Background: In the last week of sessions of the MPWE 2009 at IIMB (Management Programme for Women Entrepreneurs) we had a negotiations role play for purchase/sale of a business. The participants were divided into 8 teams, 4 representing the buy side and 4 the sell side. We therefore had 4 sets of negotiations. The learnings of this are shared here.

Rules: The rules were simple; a one page sheet of the case was given to the participants with a background of the company being sold as well as a sample set of companies. This was to help them arrive at a valuation range, prior to the negotiations. The groups were also given initial preparation time to plan and decide on their negotiation strategy. The 8 teams were instructed that they had to close the deal within the given time. They were also told that they had to really feel the part of the buyer/seller side and had to get into the role. The idea was to simulate a real life situation in a limited time period.

Analysis: It was interesting to see the different permutations and combinations that came up regarding the sale price and deal structuring and the post deal plan. Three deals were struck, and the fourth set could not agree to a deal price in the time available. There were variations in the negotiating strategies and the deal price, however, some points were common across the eight groups and below are the key takeaways:

- The fact that different persons negotiated differently came across very clearly. Some teams were able to take leading positions early on in the game, because of the way they took control over the whole process.
- Negotiations are the starting point, many times if the deal goes through; the two sides have to work together in the future. It is therefore important to avoid getting into personal traits and offensive or overly aggressive stances. It helps if the two parties realize that they should not perceive this as a battle with two opposing sides, but rather as a joint work to come to some agreement which is seen as fair to both.
- Ultimately, the teams are made up of individuals who may be sensitive to different things. Negotiators need to be aware of the signals sent out by individuals.

Negotiations is about understanding or attempting to understand the needs of different people, in your team as well as in the team on the other side.

- If team members of one group disagree in the meeting or give conflicting views, this can lead the other party to suppose that there is some problem to be addressed and can directly impact valuation and deal structuring. Thus teams need to be careful about what messages they are giving out, in their words as well as in their actions.
- Sometimes, giving the other party a few options helps. Some examples: taking a certain percentage upfront for a certain value, taking some money now and some later, an option of keeping a board position, or an option to change the management of the company such as the CEO and CFO.
- Sometimes news flashes about the business and industry are received and can change the whole tone of the negotiations. In the role play, there were two interruptions which announced some changes in the business and environment. These influenced the negotiators and the deal structuring changed as a result. For example, at one point, the buyers were given a message about a rumour that there could be a disagreement in the key team of the sellers. As a result, in one deal, the buyers decided to bring in a change of management and a part of the deal money was brought in as a severance package to the CEO of the selling company.
- The side that was more prepared came out of the deal stronger. They went prepared not just with a valuation range, but also with a list of questions and answers to questions that they could be asked. These related to the company, the business and industry environment and the future plans post the deal, if it did go through.
- Despite this being a simulation, for a period of time, participants actually felt that they were buying or selling a business and they felt pleased when the deal was finalized. This is of course to the credit of all participants who went into this role play with all seriousness and the outcome showed this. Many times, human emotion influences us to work towards deal closure, even though the financial aspects may not be very favorable. We need to be conscious of our emotions in addition to the financial and business aspects.
- One of our participants summed up this set of sessions very nicely. She said, prior to this exercise, I thought I could just value my company and go out and raise funding for this, by offering an equity stake at a certain price. I now realize it is not like say ...one trying to sell something at a certain price point. There are many dimensions to sale/purchase of a business and negotiations play a key role in the price we can get.

Summary and takeaway: The participants opined that these learnings and negotiating insights could help them, not only in instances where they had to sell a stake in their company or raise capital, but also in other negotiations such as transacting with a customer or a buyer. Hence in real life also, practicing with a role play prior to a negotiation would be helpful.

Quick Reference Tool 7:
Valuation and negotiation: Five points to note

Here are some aspects on valuation and negotiation which can help you get a better deal price, whether it is for M&A or VC or for strategic investment. This was originally published in a LinkedIn post.

1. Valuation is
2. Art and Science

a. Subjective and Objective

There is a math to valuation, there are business models which are captured in financial models and spread sheets. There is scenario analysis and sensitivity analysis. There are premiums and discounts assigned to multiple factors. This objective math is impacted by subjectivity of the person(s) doing the calculation, for example, if you are an unlisted company, is the discount factor 50% or 80% or somewhere in-between? Should you take a multiple of 9 times revenue or 10 times ... why 9, why not 10? The mistake made sometimes is that it is assumed that because there is a calculation, the number is correct.

3. Calculated value is discounted or goes at a premium, based on

a. Deal Rationale from sellers perspective
b. Deal Rationale from buyers perspective

Try to get the underlying rationale from the opposite side of the table. For example, if you want to buy, try to understand why the seller wants to sell, the true reason, not just the stated reason. This will help you in negotiating a better deal, in terms of price and value ... And … may also get you more favourable deal terms.

Zane, CEO of Tan, a large company wants to buy out another large company, Zooz. On the face of it, it appears that Zane wants this deal for professional reasons, such as the fact that Zooz can be a great fit to Tan's line of business and can help Tan address a set of international customers who are now not buying from Tan. However, the real motivator for Zane to close this deal is quite different; he wants to show (off) to his alumni network that he is heading one of the largest global companies. The acquisition is a means to achieve this personal ambition of his. So sometimes the deal rationale is visible, sometimes not.

4. Valuation is impacted by

a. Due diligence findings

Tainak wants to sell his house. While the house has been recently painted and is reasonably well maintained, the front lawn has a tap that is leaking. The tap could be

fixed by a washer at almost zero cost, but Tainak does not do this, thinking that this is only a washer and that the rest of the house is fine. However, the potential buyer looks at this differently and sees this as a possible signal that maybe… just maybe... the house is not so well maintained. On the day the buyer visits, the water has been leaking and the lawn is slushy in the corner near the tap. In the negotiations and price finalization this one point helps the buyer push down the sale price by thousands. In business too due diligence findings can be hooks, to negotiate with and lower the price.

5. Valuation can be impacted by

a. Deal structuring

Deals can be based on a mix of stock and cash, or linked to performance in the future. Sometimes if the buyer and seller perceive the future growth plans differently, these differences can be set out in a financial model and the deal can be structured based on how the future plays out in reality.

6. Negotiations impact value, these include

a. Strength of position from which negotiation is done

b. Skill and talent of negotiator

c. Hard work and preparation

d. Unbundling of deal issues; i.e. setting out and contrasting between deal breaker issues and other points

e. Role playing and scenario planning of alternate situations in advance

f. Negotiation style

Negotiations can significantly impact the deal value and the way the deal is structured. It helps to analyse why the other party to the deal, wants the deal. It also helps to plan through the negotiations strategy in advance.

APPENDIX I

* CASE STUDY: Business Plan Preparation

** Case Study contributed by Ketoki Basu, FCA*

Comp Xpert India Private Limited, a training institute was set up in Bangalore on February 14, 2010. The promoters of the company, two brothers, Anil and Sunil are both technocrats. Anil is an engineering graduate in Computer Science with nearly 2 decades of experience in large corporate houses. Sunil the younger brother of Anil, graduated in Electronics and Telecommunications 2 years after Anil. Sunil thereafter completed a degree in Management before pursuing a career in management consultancy.

Anil and Sunil resigned from their respective jobs and started Comp Xpert in 2010. They equally contributed to the initial share capital of Rs. 15 lakhs. The operations of the company commenced from June 2010. The first academic year started from July 2010. The institute offered courses in:

- Web development and design (WDD)
- Security and Networking and (S&N)
- Multimedia (MLT)

In the first year, the company operated from a residential house with about 5 students in each of the above courses. They handpicked quality faculty for the courses. The course was designed by Anil.

The school became popular in a short span of time and in about 5 years the company had 50 students in each of the courses. The company was willing to add new centres but ensured the batch size was restricted to 10 per class. The centres were housed in about 2500 sq. ft. of space with a classroom each for the each of the 3 streams. In 5 years the company was operating 5 centres with 15 classrooms; i.e. there were three class rooms per centre.

Over the years, the company realized that there was a huge demand for the course, the business was profitable but to expand strategically the company had to:

- Expand the number of centres to accommodate more students
- Update its course each year
- Purchase/build its own centres

During May 2015, the company was approached by an angel investor. The angel had been following the company and was keen to take up a stake in the company. The angel investor is from the IT education field and had operated a large institution pan India on a franchise mode. He wanted to look at the business plan and financials to understand the valuation of the company. Further if he did invest in the company, he wanted a fair idea

of the prospects of exiting the company in terms of buy back of shares by promoters, sale to strategic investor or initial public offering.

The Directors requested the Chief Financial Officer to prepare the business plan of the company. As a starting point the financial plan was prepared. The sequence in which the financial plan was prepared is explained below.

Financial Plan

Step 1

1. With a fair idea of the vision of the company, the market potential and demand for the course, the number of students expected in future years was projected. A summary of the students for the future years was projected as follows:

	Year 1	**Year 2**	**Year 3**
	No. of students	**No. of students**	**No. of students**
WDD	200	350	500
S&N	200	350	500
MLT	200	350	500
Total	**600**	**1,050**	**1,500**

2. Having completed the student projections, classrooms and centres were projected for the next 3 years as follows:

	Year 1		**Year 2**		**Year 3**	
	Classrooms	**Centres**	**Classrooms**	**Centres**	**Classrooms**	**Centres**
WDD	20	20	35	35	50	50
S&N	20	20	35	35	50	50
MLT	20	20	35	35	50	50
Total	**60**	**20**	**105**	**35**	**150**	**50**

3. The annual fees per student in each course were expected to be Rs. 3 lakhs per annum payable in 3 equal installments on specified dates in June, October and February. With increase in costs was projected that such fees were to be escalated by about 10% per annum.

Step 2

4. The Directors, the Chief Financial Officer (CFO), a Manager overseeing the operations at the 5 centres and an office representative cum receptionist at each

centre were the ones in the company's payroll. Besides this there were 3 trainers at each centre.

5. With expansion it was envisaged that the number of managers had to be stepped up. It was decided to keep the optimum number of centres under a manager at 5. The revised salary for the different levels employees and the annual increment were decided as follows:

	Salary per month-INR	**Annual Increment**
Director	1,00,000	12%
Trainer	60,000	12%
CFO	50,000	12%
Manager	35,000	12%
Office Representative	8,000	12%

Step 3

6. The capital expenditure requirement had to be estimated next. The addition of assets were based on estimates that were as follows:

   - Furniture- As per the current company practice, Rs. 7,000 worth of furniture was purchase per student and Rs. 8,000 for each manager. Each centre required additional furnishing amounting to Rs. 10,000. It was decided to retain the practice. Furniture costs are expected to go up by about 20% each year.

   - Cost of equipment per classroom in each centre was estimated at Rs. 450,000. This was based on the current levels of equipment in each classroom. Such equipment being subject to high degree of change in technology, was estimated to be replaced every 2.5 years. Equipment costs are expected to increase by about 10% each year.

7. The company's long term vision for expansion was to utilize surplus funds for acquiring new premises for centres. During the previous year, the company had from its surplus cash, purchased space to run a centre. This strategy of purchasing space for centres would result in reduction of monthly rentals and rental deposit.

8. With the influx of new students, additional funding and generation of surplus the company targeted purchasing 5 centres' space in Year 1, 20 centres in Year 2 and another 24 in Year 3.

9. With 50 centres in place in Bangalore the company would then contemplate expansion to other cities.

10. Expansion to other cities could perhaps be considered at a later stage using the franchise route. However, at this stage, expansion beyond 50 centres was not being considered and did not form part of its current business plan.

Step 4

11. The other expenses were estimated as follows:

Type of expenses	INR		Escalation
Course material	1,00,000	per student/yr.	8%
Rent	50,000	per centre	8%
Advertisement p.a.	12,00,000		100%
Electricity	3,000	per centre	10%
Water	1,500	per centre	10%
Repairs	1,000	per centre	10%
Housekeeping	2,500	per centre	10%
Security	10,000	per centre	10%
Printing & Stationery	2,000	per centre	10%
Postage & Courier	2,500	per centre	10%
Local Conveyance	3,000	per centre	5%
Travel	20,000		10%
Communication charges	5,000	per centre	5%
Website maintenance	30,000		5%
Legal p.a.	60,000		5%
Audit p.a.	3,00,000		10%
Office Expenses	3,000	per centre	10%

- For the rented premises a one-time refundable deposit amounting to Rs. 5 lakhs per centre would be payable. It was assumed that rental deposit will not escalate and the company would negotiate to pay the same amount each time. Rent is paid in advance at the beginning of the month for the month.

- Insurance on assets were expected to be about 1% of the WDV of the assets.

12. Though fees were payable on specified 3 installment dates, it was observed that there was a considerable amount of delay in receipt of fees. Eventually however all students paid up. This was ensured as pass certificates were not released to defaulters. This aspect had to be factored in the financial plan. Based on this information, the sundry debtors were estimated.

13. Course material supplied to students would be at cost and purchased at the start of the financial year.

Step 5

14. The CFO then constructed the monthly Balance Sheet, Profit & Loss account and Cash flow statement for the 3 years.

Step 6

15. These statements were then consolidated on an annual basis. The annual Balance Sheet appeared as follows:

Balance Sheet *INR In lakhs*

Period	Year 1	Year 2	Year 3
EQUITY & LIABILITIES			
Shareholders' Funds			
Share Capital	590.0	1,740.0	3,590.0
Reserves & Surplus	279.0	816.9	1,691.1
Money Received against Share Warrants			
	869.0	**2,556.9**	**5,281.1**
Share Application Money pending allotment			
Non Current Liabilities			
Current Liabilities			
Short-Term Borrowings			
Accounts Payables	3.4	6.5	10.3
Short-Term Provisions			
	3.4	**6.5**	**10.3**
TOTAL	**872.4**	**2,563.4**	**5,291.4**
ASSETS			
Non Current Assets			
FIXED ASSETS			
Tangible Assets	596.3	1,927.2	3,693.9
Intangible Assets			
	596.3	**1,927.2**	**3,693.9**
Non Current Investments			
Other Non-Current Assets-Rent Deposit	95.0	145.0	120.0
	95.0	**145.0**	**120.0**
Current Assets			
Current Investments			
Inventories			
Accounts Receivables	150.0	462.0	1,452.0
Cash and Cash Equivalents	31.1	29.2	25.5
Other Current Assets			
	181.1	**491.2**	**1,477.5**
TOTAL	**872.4**	**2,563.4**	**5,291.4**

16. From the estimates the company was expected to record a turnover of INR 18 crores in Year 1. This was expected to touch INR 34.65 crores in the second year and INR 54.45 crores thereafter. The projected Statement of Profit & Loss for 3 years:

Statement of Profit and Loss *INR In lakhs*

Period	Year 1	Year 2	Year 3
INCOME			
WDD	600.0	1,155.0	1,815.0
S&N	600.0	1,155.0	1,815.0
MLT	600.0	1,155.0	1,815.0
Revenue from operations	**1,800.0**	**3,465.0**	**5,445.0**
Other Income			
Total Revenue	**1,800.0**	**3,465.0**	**5,445.0**
EXPENSES			
Cost of Materials Consumed	600.0	1,134.0	1,749.6
Purchases of Stock-in-Trade			
Changes in Inventories of Finished Goods, Work-in-Progress & Stock-in-Trade			
Employee Benefits Expense	498.0	950.9	1,505.3
Finance Costs			
Depreciation & Amortization Expense	97.0	181.7	352.9
Other Expenses	222.0	394.8	500.4
Total Expenses	**1,416.9**	**2,661.4**	**4,108.1**
PROFIT BEFORE EXCEPTIONAL & EXTRAORDINARY ITEMS AND TAX	**383.1**	**803.6**	**1,336.9**
Exceptional Items			
PROFIT BEFORE EXTRAORDINARY ITEMS AND TAX	**383.1**	**803.6**	**1,336.9**
Extraordinary Items			
PROFIT BEFORE TAX	**383.1**	**803.6**	**1,336.9**
Tax Expense	126.6	265.7	462.7
PROFIT/ (LOSS) FOR THE PERIOD FROM CONTINUING OPERATIONS	**256.4**	**537.9**	**874.2**
PROFIT/ (LOSS) FOR THE PERIOD FROM DISCONTINUING OPERATIONS			
Tax Expense of Discontinuing Operations			
PROFIT/ (LOSS) FOR THE PERIOD FROM DISCONTINUING OPERATIONS (After Tax)			
PROFIT/ (LOSS) FOR THE PERIOD	**256.4**	**537.9**	**874.2**

17. The Cash flow statement was prepared for 3 years. While the business was profitable, funding was envisaged from the perspective of the company building its own centres. The angel investor was looking at the initial funding requirement at this point. It was envisaged that depending on the growth, the company could also look at approaching a Venture Capital Fund at the next stage. Further, there could also be an option of taking a franchise route. However the projections initially prepared did not consider any franchise option

Cash Flow Statement *INR In lakhs*

Period	Year 1	Year 2	Year 3
Net Profit before exceptional items and tax	**383.1**	**803.6**	**1,336.9**
Adjustment for:			
Depreciation & amortization expense	97.0	181.7	352.9
Finance costs			
Operating profit before working capital changes	**480.0**	**985.3**	**1,689.8**
Adjustment for:			
Inventories			
Accounts receivables	-112.5	-312.0	-990.0
Short term loans & advances, Other current assets			
Accounts payables, Other current liabilities	2.6	3.1	3.7
Short term provisions			
Cash generated from operations	**370.1**	**676.5**	**703.5**
Income tax paid (net of refunds)	-126.6	-265.7	-462.7
Cash flow before exceptional items	**243.4**	**410.8**	**240.8**
Exceptional items			
Net cash from operating activities (A)	**243.4**	**410.8**	**240.8**
Cash Flow from Investing activities			
Purchase/sale of fixed assets	-626.2	-1,512.6	-2,119.6
Other Non-Current Assets-Rent Deposit	-70.0	-50.0	25.0
Investments made			
Sale of investments			
Interest received			
Dividend received			
Net cash used in investing activities (B)	**-696.2**	**-1,562.6**	**-2,094.6**
Cash Flow from financing activities			
Issue of share capital	475.0	1,150.0	1,850.0
Proceeds/(Repayment) of loans			
Finance costs			
Payment of dividend			
Net cash from/ used in financing activities (C)	**475.0**	**1,150.0**	**1,850.0**
Net (decrease)/increase in cash & cash equivalents (A+B+C)	**22.2**	**-1.9**	**-3.8**
Cash & cash equivalents as at the beginning of the year	8.9	31.1	29.2
Cash & cash equivalents as at the end of the year	**31.1**	**29.2**	**25.5**

The Directors and the CFO finalized the financial plan which was to be shown to any potential investor.

Business Plan

Having finalized the projections, the CFO had to put together the plans of the founders in terms of vision, mission and other business parameters as a narrative report. The procedure followed was to break up the report into relevant chapters which were to focus on key areas of interest to a prospective investor.

Executive Summary

A summary of Comp Xperts in a few sentences was mentioned. The chapter was written to give the investor an idea of the business. The presentation and choice of words was such as to increase his appetite for further information about Comp Xperts.

Company and background information

The details of the structure of the company and when it was set up was stated. The history of Comp Xpert and how it had evolved over the years was briefly mentioned here, keeping in mind that an investor would like to understand and have information about the industry sector, why the company was founded any anything else that was special about the company.

Management and organization

Investors are keen to know the background of the promoters. This gives them an idea as to whether the company has the right people behind it to make it successful. The detailed resumes of Anil and Sunil were given in this Chapter. The resumes were projected in such a way so as to show the value such promoters were bringing to the company.

Comp Xperts has a large pool of technical advisors. These consist of both industry experts as well as those with a good track record in academics. The background of such experts was brought out. The organization structure was explained in detail. Under this chapter Comp Xperts' SWOT analysis was also presented.

Products and services

The offerings of a business have to be set out. The details of the courses offered and the duration of the course was explained. It was also explained why such courses were popular.

The aspect of the Directors getting personally involved in the course design and handpicking the faculty was an important issue to be highlighted. The special features of these courses offered by Comp Xperts and what makes it different from others offered in the country was also pointed out.

Marketing plan

The Directors provided the data on the market survey carried out by a professional agency for the company. The report clearly explained the market gap and Comp Xperts potential share in future. It was explained that in the next 3 years the company had plans to expand to 50 centres in Bangalore only. The potential to expand to other cities was highlighted from the market survey data but it was mentioned that the same would be taken up after 3 years.

Location

The flagship centre and the location of future centres in the next 3 years were mentioned here. The logic behind choosing such locations was also explained.

Competition

The competition in the market both domestic and global is of importance to an investor. This helps them to determine the entry barriers. Comp Xperts' competitors both in India and overseas were pointed out in this chapter. The features of each competitor were also explained clearly. The differentiator in terms of each course was highlighted.

Strategy

Here, the following were explained in detail:

- Value proposition of Comp Xperts
- Comp Xperts' competitive edge over others
- Sales strategy and
- Pricing strategy
- Financials

The annual Balance Sheet, Profit & Loss account and Cash flow statements were explained. The CFO added some graphs to explain sales increase and expense trends. The salient ratios were also calculated and explained here.

Summary

Having completed the Business Plan, Sunil was able to translate the same into a crisp presentation for the investor pitch. Further, the exercise of preparing the business plan with detailed financials, paved the way to work out the valuation of the company. This would help the company when it came to negotiating with the any potential investor.

While the company did realize that it had the potential to grow, it had not actively tried to plan this expansion. The directors decided that while the angel investor had proactively approached them, they would seriously consider approaching other investors should there be a shortfall in their fund requirement.

The directors also decided to approach an expert to advise them on the proposed transaction.

Questions for case analysis:

I. Assume the company has approached you for assistance in this matter. The questions below would need to be addressed by you so that you can provide quality inputs to the founders.

- What would be your recommendations regarding the Business Plan that has been prepared?
- How would you advise the directors to prepare for the negotiations with the potential investor?
- How should they prepare for due diligence that the investor is likely to suggest?
- It appears that the company can also go to VCs and other early stage investors. Can you do your homework on the requirement, review the projections with care and suggest any alternate funding strategy? Do you think that debt funding is a better option for the company at this stage?
- What are the other options that you can suggest for growth and value creation?

II. Assume the investor has approached you for assistance in this matter. The company has provided you the Business Plan and the Financial Plan as prepared above.

- Would you accept the Business Plan that has been prepared? Would you accept the financials as they are or would you like to make any adjustments/modifications? Why? Are these modifications related to assumptions made or in the financial model or strategy related?
- Would the nature of the modification/adjustments made by you if any in the Business and Financial Plan, impact the approach taken to negotiate?
- What are the deal issues that you would flag off, i.e. reasons for the deal to go through and not go through?
- Is there any other suggestion that you would like to give to a potential investor in this company?
- What are the ways in which an investor can add value and protect this investment if made?

APPENDIX II

* CASE STUDY: Business Plan Review

** Case Study contributed by Rajnish Singh, Director, VentureBean Consulting Pvt. Ltd.*

Executive summary

Ripple Industries Pvt. Ltd. (RIPL), incorporated in 2001, promoted by K Govind and family, is a leading manufacturer of coolant pumps in India. These pumps are used in the manufacture of machine tools. For most of the pumps manufactured by the company, it also manufactures the paired motors in-house. In addition to coolant pumps, RIPL also manufactures refueling pumps and electric motors. The Company also manufactures alternators stator windings (auto-electrical) for KRENT, a multi-national company based on designs provided by KRENT.

The Company has also set up exclusive facilities for assembly of windings to a couple of companies on contract basis. The Company currently operated out of 4 facilities in Bangalore.

The company is an ISO 9001:2008 certified entity and the products are CE Marked, making the pumps acceptable in the worldwide market. RIPL has a well-established quality system to ensure that each pump is tested with a computerized system to ensure that every product is quality certified. RIPL maintains the data of 10 years of products manufactured, which establishes a good traceability of custom-made products.

For the year ended March 31, 20X5, the Company achieved a Total Income (TI) of Rs. 3340.2 lacs, on which it made an Earning Before Interest and Depreciation (EBIDA) of Rs. 304.6 lacs, a profit before tax (PBT) of Rs. 174.0 lacs and a profit after tax (PAT) of Rs. 116.4 lacs. For the same year ended March 31, 20X5, the net cash accruals of the company was Rs. 181.4 lacs.

For the year ending March 31, Y1, the Company is expected to achieve a Total Income (TI) of Rs. 3400.0 lacs, on which it is expected to generate an EBIDA of Rs. 243.0 lacs, a profit before tax (PBT) of Rs. 130.7 lacs and a profit after tax (PAT) of Rs. 87.6 lacs. For the same year ending March 31, Y1, the net cash accruals of the company is expected to be Rs. 152.4 lacs.

The Company is facing severe space constraints at its facilities and is unable to increase its production. The Company has taken possession of about 85,000 sq. ft. of land 80 kms from its current facilities and proposes to expand its manufacturing facilities by setting up a machine shop and shift its existing machine shop to this new facility during Y2. Subsequently, RIPL proposes to shift the pump assembly operations to the new facility in

the coming years. The total cost of construction of the necessary infrastructure to shift the Machine Shop, shift the existing machines and purchase a new CNC machine, is estimated at Rs. 420.0 lacs. The Company proposes to complete the relocation activities by March 31, Y2.

The Company has been approached by Zimmer Technocast Pvt Ltd (ZTPL), which has facilities for manufacture of 100 MT of Ferrous castings to takeover of its foundry. ZTPL is promoted by four first generation entrepreneurs, and the foundry has been in operation since 2008. For the year ending March 31, Y1, ZTPL is expected to achieve a Total Income (TI) of Rs. 805.0 lacs, on which it is expected to generate an EBIDA of Rs. 74.3 lacs, a profit before tax (PBT) of Rs. 18.8 lacs and a profit after tax (PAT) of Rs. 12.6 lacs. For the same year ending March 31, Y1, the net cash accruals of ZTPL is expected to be Rs. 37.6 lacs. RIPL is keen to buy the foundry business of ZTPL, together with all the associated assets, as it would be able to source its entire casting requirements on-house, thereby reducing the risk of quality, price and timely delivery as compared to the current purchase structure where it has to depend on a large number of suppliers to purchase the required castings for its pumps and motor assemblies. The total cost of the transaction is estimated at Rs. 500.0 lacs. This transaction is expected to be completed by June 30, Y2. In addition, the Company would incur costs for refurbishment of certain machines and buildings to the extent of Rs. 30.0 lacs during Y2. After stabilizing the operations of the foundry, the Company plans to install an additional line at ZTPL facilities during Y3, which will enable it to increase its sales by about Rs. 1000.0 lacs in a couple of years.

With the addition of new facilities and purchase of the foundry business from ZTPL, the Company is expected to achieve a turnover of Rs. 7509.5 lacs by Y7, on which it is expected to generate an EBIDA of Rs. 765.8 lacs, a PAT of Rs. 321.1 lacs and net cash accruals of Rs. 482.0 lacs.

To meet a part of the cost of the expansion project and purchase of the assets of ZTPL, the Company is planning to raise a term loan of Rs. 715.0 lacs from banks. In addition, the Company plans to increase its bank borrowing for working capital by another Rs. 300.0 lacs to meet its increased working capital requirements.

Company profile

The company has been in the production of coolant pumps and electric motors since incorporation. Today the Company is a market leader in this segment with a dominant 70% market share in the coolant pump market. Almost 90% of the coolant pumps are supplied with electric motors manufactured by the Company in-house. In addition to coolant pumps, RIPL also manufactures oil skimmers, refueling pumps and electric motors. The Company is currently developing solar pumps. In the year 2005, the Company introduced high-pressure pumps in India. The Company also entered into an agreement with ZAND to sell its pumps in India. In 2007, the Company introduced the high-pressure screw pumps. Today, the Company has the entire range of coolant pumps in the market.

The Company currently operates out of 1 owned premise of about 30,000 sq. ft. land area and about 15,000 sq. ft. of built-up area. In addition, the Company has taken 3 premises on lease, close to its owned premise, with 20000 sq. ft. of built-up area.

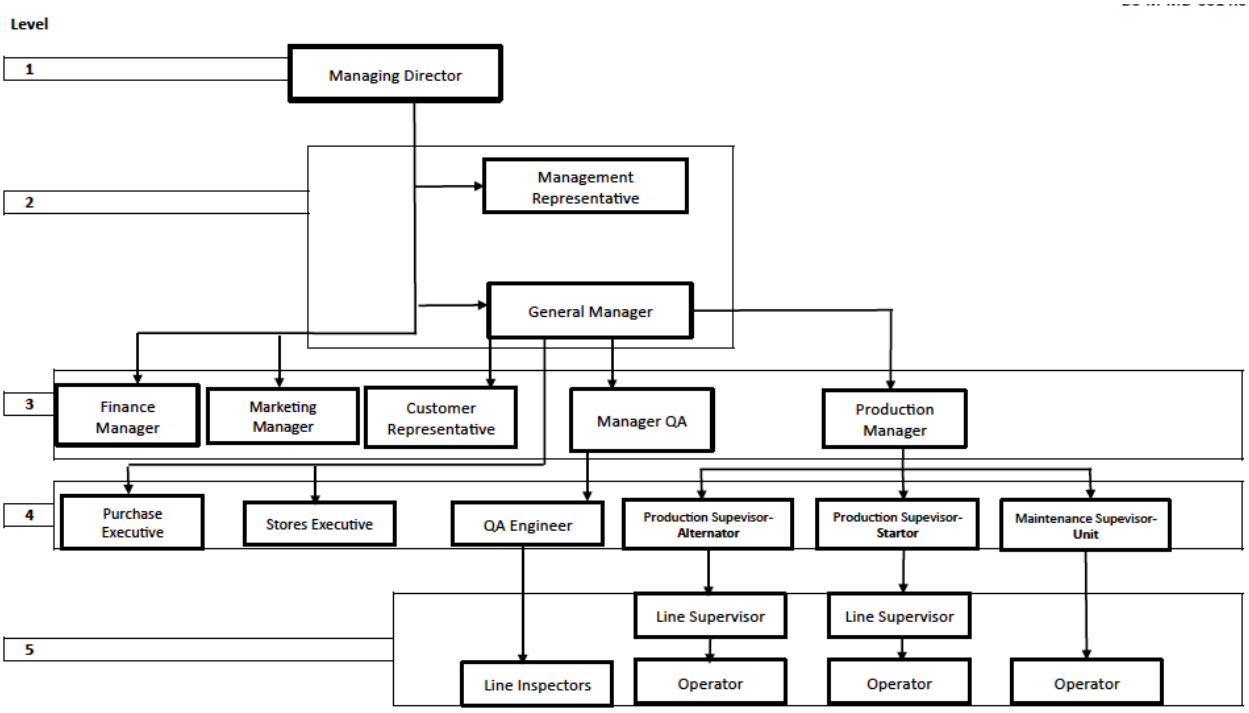
The Company had facilities for machining castings, motor windings, winding varnishing, assembly of pumps and motors. During 20X5, the Company set up a 30 MT non-ferrous foundry to develop non-ferrous parts required for the pumps being developed for exports market. The Company has been successful in developing the heat exchange pump in collaboration with ZAND. The first batch of these pumps have been supplied to ZAND for overseas and Indian users, who are getting the same tested by their customers. Over the next few years, these pumps are expected to generate significant exports volumes. Company was awarded the Best Vendor by KRENT and appreciated for continuous and timely delivery by its largest customer of coolant pumps.

Shareholding and organization structure

RIPL is currently managed by Mr. Kumar (son of Mr. K Govind), who is the Managing Director of the Company. Other Directors are Mr. K. Govind, Mrs. Vidya and Mrs. Veena. RIPL is currently 100% owned by the family. The details of current shareholding pattern of RIPL are given in Annexure A.

Organization Structure

RIPL has a well-defined and lean Organization structure as given below.



Mr. Kumar is supported by an experienced team in each of the roles above.

Financial Performance of RIPL

The financial performance of RIPL for the 5-year period ended March 31, 20X5, was as given below.

(Rs. in lacs)

Year ended March 31,	**20X1**	**20X2**	**20X3**	**20X4**	**20X5**
INCOME					
Sales					
- Domestic	1450.6	1483.4	2366	3118.4	3278.7
- Exports			2.1	2.9	7.4
Other Operating Rev			34	39.3	36.1
Total Sales	***1450.6***	***1483.4***	***2402.1***	***3160.6***	***3322.2***
Packing and Forwarding	5.4	5.2	8.9	11.4	12.2
Other Income	5.0	1.1	4.6	9.1	5.8
Total Other Income	***10.4***	***6.3***	***13.5***	***20.5***	***18.0***
Total Income (TI)	**1461.0**	**1489.7**	**2415.6**	**3181.1**	**3340.2**
EXPENDITURE					
Material Consumed	909.0	984.1	1588.7	2213.0	2232.0
Changes In Inventory	5.7	-2.2	0.2	-3.7	5.6
Employee Cost	158.4	170.7	283.2	351.6	402.3
Manufacturing Expenses	55.9	65.2	101.0	138.9	132.7
Sales & Marketing Expenses	62.0	63.1	97.2	111.9	114.4
Admin Expenses	74.6	71.9	80.6	80.4	83.6
Repairs & Maintenance	25.8	17.9	36.4	44.4	65.0
Total Expenses	**1291.4**	**1370.7**	**2187.3**	**2936.5**	**3035.6**
EBIDA	**169.6**	**119.0**	**228.3**	**244.6**	**304.6**
% EBIDA to TI	**12%**	**8%**	**9%**	**8%**	**9%**
Interest on Loan	19.5	31.3	39.5	53.2	55.4
Depreciation	35.4	39.8	41.6	60.7	75.2
Profit Before Tax (PBT)	**114.7**	**47.9**	**147.2**	**130.7**	**174.0**
Tax	41.9	11.5	49	43.3	57.6
Profit After Tax (PAT)	**72.8**	**36.4**	**98.2**	**87.4**	**116.4**
Dividend		1.5	5.9	5.9	8.8
Tax on proposed dividend		0.2	1	1	1.4
Net cash accruals	**106.7**	**70.3**	**133.9**	**142.2**	**181.4**
Return on Equity	**24%**	**10%**	**22%**	**17%**	**19%**
Return on Total Cap. Employed	**22%**	**13%**	**21%**	**17%**	**21%**

The Company's turnover has more than doubled during the 5-year period ended March 31, 20X5. However, the TI of the Company has been relatively flat during the last year, on account of slow down in the automotive industry and hence resultant impact on the machine tools industry. Although, the sales of coolant pumps declined during the last year, the Company has been able to maintain its TI on account of increase of sales to some key suppliers. The EBIDA of the Company has been varying between 8% and 9% during the 4-year period ended March 31, 20X5.

During the year ended March 31, 20X5, the Company earned a PAT of Rs. 116.4 lacs. During the same year the Company declared a dividend on its equity share capital of Rs. 8.8 lacs (60%) and earned a net cash accruals of Rs. 181.4 lacs.

The Balance Sheet Statement of the Company for the 5-year period ended March 31, 20X5, was as given below.

(Rs. in lacs)

Year ended March 31,	**20X1**	**20X2**	**20X3**	**20X4**	**20X5**
LIABILITIES					
Equity Share Capital	4.7	14.7	14.7	14.7	14.7
Reserves & Surplus	301.3	332.6	424.3	504.8	610.9
Net Worth	**306.0**	**347.3**	**439.0**	**519.5**	**625.6**
Long Term Borrowings-Banks	35.3	126.4	108.8	128.5	112.6
Working Capital Borrowings-Banks	16.7	-12.6	-22	38.7	14.8
Loans From Directors	120.5	123.4	148.8	174.4	156.6
Deferred Tax Liability	5.9	9.6	13.2	17.2	24.8
Current Liabilities					
Trade Payables	162	253.6	339	494.8	436.1
Statutory Dues	7.4	12.5	16.8	23.0	21.4
Advance from Customers	6.4	5.4	10	13.7	5.6
Others	4.7	6.8	1.7	3.1	4.9
Provisions	92.3	12.8	52.3	46.1	61.2
Total Current Liabilities	**272.8**	**291.1**	**419.8**	**580.7**	**529.2**
Total Liabilities	**757.2**	**885.2**	**1107.6**	**1459.0**	**1463.6**
ASSETS					
Fixed Assets					
Gross Block	391.1	441.6	671.2	862.3	990.6
Less : Depreciation	176.9	216.4	257.5	308.8	384.0
Net Block	***214.2***	***225.2***	***413.7***	***553.5***	***606.6***
Current Assets					
Inventory	31.8	42.2	44.7	50.0	38.5
Receivables	350.6	382.4	557.0	662.9	628.3
Advances to Suppliers	4.1	3.7	11.2	13.3	9.1

Staff Advances				4.6	1.8
Balance with Statutory Authorities	18.8	142.3	41.7	43.2	44.3
Cash & Bank Balance	16.7	40.5	23.6	101.6	97.8
Deposits	28.5	28.9	15.1	29.0	31.8
Others	92.5	20	0.6	0.9	5.4
Total Current Assets	***543***	***660***	***693.9***	***905.5***	***857.0***
Total Assets	**757.2**	**885.2**	**1107.6**	**1459.0**	**1463.6**

Year ended March 31,	**2009**	**2010**	**2011**	**2012**	**2013**
CR	**1.99**	**2.27**	**1.65**	**1.56**	**1.62**
TD/E Ratio	**0.56**	**0.68**	**0.54**	**0.66**	**0.45**
LTD/E Ratio	**0.1**	**0.4**	**0.2**	**0.2**	**0.2**
FAC ratio	**6.1**	**1.8**	**3.8**	**4.3**	**5.4**

During the year ended March 31, 20X5, the Company added Rs. 128.3 lacs to its gross block by adding CNC machine and stator winding machine and the Net Worth of the Company was Rs. 625.6 lacs. As on the same date, the Company had outstanding Term Loans of Rs. 112.6 lacs and Bank Borrowings of Rs. 14.8 lacs (against sanctioned limits of Rs. 75.0 lacs). RIPL had inventory of Rs. 38.5 lacs (6 days of annual raw material consumption), outstanding receivables of Rs. 628.4 lacs (70 days of annual sales) and trade payables of Rs. 436.1 lacs (71 days of annual raw material consumption).

As on March 31, 20X5, the Company has relatively low debt outstanding from Bank. As on the same date, the Company had unsecured loans from promoters of Rs. 156.6 lacs. The unsecured loans from promoters carry interest rate of 14% and are repayable as required by the promoter. However, the Promoters are willing to sub-ordinate their loans if required. The Current Ratio, Total Debt to Equity Ratio, Long Term Debt to Equity Ratio and Fixed Asset Coverage Ratio were all within acceptable limits.

Current performance

Performance of RIPL for the 10-month period following March 31st, 20X5 and for estimated performance for the full Y1 is given below:

(Rs. in lacs)

	10 months	**Y1**
Sales	2731.2	3430.0
Other Income	7.5	20.0
Total Income (TI)	**2738.7**	**3450.0**
Change in Inventory	-6.9	
Raw Material	1826.2	2298.1
Employee Cost	354.9	428.8

Manufacturing Expns	87.1	137.2
Selling Expns	84.2	102.9
Admin	188.2	171.5
Repairs	40	68.6
Total	2573.8	3207.1
EBIDTA	***164.9***	***243.0***
% EBIDA to TI	***6%***	***7%***
Interest	12.8	37.3
Depreciation	0	75.0
PBT	**152.1**	**130.7**
Tax	0	43.1
PAT	**152.1**	**87.6**
Net Cash Accruals		152.6

The %EBIDA to TI for the 10-month period is lower at 6% on account of increase in Employee costs and cost of Raw Materials. However, for the full year the margin is expected to marginally improve to 7% on account of better absorption of costs on over a larger turnover.

During Y1, the dependence on coolant pumps has reduced by 2%, which has been taken up by sales to other leading suppliers.

Proposal Details

A. Expansion Scheme

RIPL currently operates out of 4 premises in Bangalore. The Company has no space in its current premises to increase production beyond the current levels. The Company has not been able to take on new works from KRENT on account of this. In view of the above, the Company proposes to expand its manufacturing facilities by setting up another unit, about 80 kms from the current facilities.

The company has already purchased about 85,000 sq. ft. of land for Rs. 124.0 lacs. As per the Agreement with of purchase from the State Body, once about 40 % of the land is covered by facilities by the Company, the Sale Deed will be executed in favour of the Company.

RIPL proposes to immediately construct a building of 20,000 sq. ft. to house its machine shop and an office block of 3500 sq. ft. at the new premise. On completion of the buildings, the entire machine shop would be relocated to the new facility. In addition, the Company proposes to purchase a new CNC machine to be installed here. The building construction is expected to commence from Y2 and the buildings are expected to be ready and the machine shop is expected to be relocated by end Y2 itself. The operations are expected to commence from April 1, Y3.

The total cost of the expansion scheme is expected to be Rs. 420.0 lacs as detailed below:

Cost of the Expansion Scheme

(Rs. in lacs)

	Area (Sq. Ft.)	**Y2**
Buildings		
- Machine Shop	20,000	260.0
- Office Block	3,500	60.0
Plant & Machinery		
- CNC M/c	1 No.	100.0
Total		**420.0**

Means of Financing

The above cost of the Expansion Scheme is proposed to be financed as below:

(Rs. In lacs)

Term Loans	315.0
Internal Accruals	105.0
Total	**420.0**

B. Purchase of Assets of Zimmer Technocast Pvt Ltd

Zimmer Technocast Pvt Ltd (ZTPL) is in the manufacture of ferrous castings. ZTPL has a foundry of 100 MT capacity, together with allied facilities in Karnataka.

ZTPL is promoted by the Partners of Zimmer Foundry and Proprietor of Sri Lakshmi Foundry. The promoters hold almost 75% of the paid-up capital of ZTPL. The details of the promoters of ZTPL is below:

Name	**Age**	**Qualification**
Mr. Rama Rao	69 Yrs	Metallurgical Engineer
Mr. Venkatesh	64 Yrs	Mechanical Engineer
Mr. Ganesh	57 Yrs	Commerce Graduate
Mr. Mangalam	74 Yrs	Mechanical Engineer and Foundry Technologist

The Promoters of ZTPL are in the field of castings manufacture from 1960s and have an excellent reputation in developing and manufacturing ferrous castings used in the general

engineering, machine building, earth moving, construction and mining and mineral dressing industries.

ZTPL started commercial production in the year 2008 and started making profits from the very first year of operations. During the last few years the foundry has established a good reputation for itself and earned "Best Vendor", "Green Channel supply partners' award" as well as Self Certification status from almost all its customers'. The unit is also accredited with ISO 9000:2008.

At present, the foundry, after standardising its operation, is ready to expand the production capacity with additional balancing facilities. This requires infusion of further funding. But the current promoters are not in a position to bring in the additional investment. Also, in consideration of their age and health conditions they are unable to devote their full time for managing the unit. Their children are also are not willing to take over the company as they are employed in good positions and few have settled abroad. Some of them are also requesting their parents to come and stay with them and or join them abroad.

In view of the above situation, the current promoters of ZTPL are exploring opportunities to sell ZTPL. RIPL has been approached by ZTPL to take of the foundry of ZTPL. Considering that about 30% of ZTPL's production can be consumed in-house by RIPL and also that ZTPL has established a good base of customers that account for nearly 70% of its capacity, RIPL is keen to buy the foundry business of ZTPL together with all its assets.

RIPL has already entered into an MOU with ZTPL for this transaction. It is expected that the transaction will be completed in Y2.

Financial Performance of ZTPL

The financial performance of ZTPL for the 5-year period ended March 31, 2013, is below.

(Rs. in lacs)

Year ended March 31,	**20X1**	**20X2**	**20X3**	**20X4**	**20X5**
INCOME					
Sales					
- Domestic	180.0	433.9	642.9	777.5	685.9
- Exports	0.0	0.0	0.0	0.0	0.0
Other Operating Rev	21.9	21.3	4.6	15.1	13.8
Total Sales	***201.9***	***455.2***	***647.5***	***792.6***	***699.7***
Total Other Income	***0.4***	***0.5***	***1.0***	***1.3***	***1.4***
Total Income (TI)	**202.3**	**455.7**	**648.5**	**793.9**	**701.1**
EXPENDITURE					

Material Consumed	129.4	258.8	385.6	475.2	394.8
Changes In Inventory	-2.4	-5.7	0.0	-5.4	-13.5
Employee Cost	10.9	22.3	37.9	59.3	61.9
Manufacturing Expenses	30.1	71.9	109.5	122.1	123.0
Sales & Marketing Expenses	1.8	5.5	8.8	12.9	13.9
Admin Expenses	6.8	26.9	27.4	31.4	37.1
Repairs & Maintenance	2.6	7.0	16.5	16.3	14.4
Total Expenses	**179.2**	**386.7**	**585.7**	**711.8**	**631.6**
EBIDA	**23.1**	**69.0**	**62.8**	**82.1**	**69.5**
% EBIDA to TI	**11%**	**15%**	**10%**	**10%**	**10%**
Interest on Loan	21.9	28.4	32.9	36.8	36.1
Depreciation	24.0	28.8	28.7	27.5	25.9
PBT	**-22.8**	**11.8**	**1.2**	**17.8**	**7.5**
Tax	6.5	-1.9	-1.4	1.1	4.8
PAT	**-29.3**	**13.7**	**2.6**	**16.7**	**2.7**
Dividend	0	0	0	0	0
Tax on proposed dividend	0	0	0	0	0
Net cash accruals	**-5.3**	**42.5**	**31.3**	**44.2**	**28.6**
Return on Equity	**-151%**	**41%**	**7%**	**30%**	**4%**
Return on Total Cap. Employed	**8%**	**20%**	**15%**	**20%**	**15%**

ZTPL saw a reduction in its sales during FY 20X4-X5, on account of Slow down in the market and also due to the stoppage in off-take by a leading customer. The EBIDA margin of ZTPL has been consistent around 10% for the 3-year period ended March 31, 2013. The Balance Sheet Statements of ZTPL for the 5-year period ended March 31, 20X5, are below:

(Rs. in lacs)

	20X1	**20X2**	**20X3**	**20X4**	**20X5**
LIABILITIES					
Equity Share Capital	49	49	49	49.0	49.0
Reserves & Surplus	-29.6	-15.9	-13.3	5.8	16.0
Net Worth	**19.4**	**33.1**	**35.7**	**54.8**	**65.0**
Long Term Borrowings-Banks	113.6	103.1	91	43.5	19.5
Working Cap. Borrowings-Banks	62.2	52.5	91.1	89.7	97.3
Loans From Directors	49	75.5	81.5	83.5	83.5
Deferred Tax Liability	6.5	4.5	3	2.7	3.1
Current Liabilities					
Trade Payables	43.8	57.8	102.6	111.2	143.9

Statutory Dues	0.8	1.1	1.8	2.0	5.9
Others	10.9	5.7	12.4	31.0	34.8
Provisions		3.5	0.2		
Total Current Liabilities	**55.5**	**68.1**	**117**	**144.2**	**184.6**
Total Liabilities	**306.2**	**336.8**	**419.3**	**418.4**	**453.0**
ASSETS					
Fixed Assets					
Gross Block	203.8	222.6	238.4	274.6	284.5
Less : Depreciation	24	52.8	81.6	109.1	135.0
Net Block	***179.8***	***169.8***	***163.3***	***165.5***	***149.5***
Current Assets					
Inventory	36.4	56	75.5	82.8	110.3
Receivables	74.0	90.1	138.2	146.9	149.7
Cash & Bank Balance	0.3	6.4	26.1	0.4	25.0
Loans and Advances	14.2	13.1	15.2	22.2	15.1
Others	1.8	1.4	1	1.0	3.4
Total Current Assets	***126.4***	***167***	***256***	***252.9***	***303.5***
Total Assets	**306.2**	**336.8**	**419.3**	**418.4**	**453.0**

CR	**2.28**	**2.45**	**2.19**	**1.75**	**1.64**
TD/E Ratio	**11.59**	**6.98**	**7.38**	**3.95**	**3.08**
LTD/E Ratio	**5.9**	**3.1**	**2.5**	**0.8**	**0.3**
FAC ratio	**1.6**	**1.6**	**1.8**	**3.8**	**7.7**

As on March 31, 20X5, ZTPL had inventory of Rs. 110.3 lacs (106 days of annual raw material consumption), outstanding receivables of Rs. 149.7 lacs (78 days of annual sales) and trade payables of Rs. 143.9 lacs (138 days of annual raw material consumption).

The performance of ZTPL for the 9-month period in Y1 and for estimated performance for the full Y1 is given below:

(Rs. in lacs)

	9 month period in Y1	**Y1**
Sales	589.8	803.0
Other Income	0	2.0
Total Income (TI)	**589.8**	**805.0**
Change in Inventory	5.4	
RM	320.9	441.7
Employee Cost	94	72.3

Manufacturing Expn	81.9	144.5
Selling Expns	1.0	16.1
Admin	36.6	40.2
Repairs	1.3	16.1
Total	541.1	730.7
EBIDA	**48.7**	**74.3**
% EBIDA to TI	**8.3%**	**9%**
Interest	24.1	30.5
Depreciation	14.0	25.0
PBT	**10.6**	**18.8**
Tax	0.8	6.2
PAT	**9.9**	**12.6**
Net Cash Accruals		37.6

Performance Improvement Plan for ZTPL

Subsequent to the take over of the business of ZTPL, RIPL proposed to take the following steps to improve the performance of ZTPL:

1. Currently, ZTPL is able to utilize about 60-70% of its casting capacity. RIPL requires about 40T of ferrous casting every year and by shifting this business to ZTPL, the capacity utilization of ZTPL would go up to nearly 100%, thereby enabling ZTPL to better absorb its fixed cost and hence result in improved margins.
2. Many processes like mould handling, sand handling and scrap handling are done manually in ZTPL. By incorporating some basic modification handling processes for these can be made easier, resulting in less fatigue to workmen, who can be used for other process works.
3. ZTPL gets much of the fettling activities done through contract work, which results in high labour and transportation cost. RIPL plans to reduce some of this.
4. ZTPL's rejection rates are currently between 8-12%. RIPL proposes to reduce the rejection rates to 5-7% by close monitoring of process and quality control.
5. At present, ZTPL manufactures only large castings. RIPL plans to effectively utilize the molding machines and increase production by about 5-10%, with some minor modifications.

In addition to the improvement in performance of ZTPL, RIPL believes that it can re-engineer some processes and design, thereby reducing its raw material requirements and costs by about 3-5%, which will improve RIPL margins.

In the coming years, as ZTPL has sufficient land and other support facilities, RIPL plans to install additional production lines and increase the capacity of ZTPL.

Cost of Transaction

The total cost of the assets purchase of ZTPL, together with the cost of refurbishment, is estimated at Rs. 530.0 lacs, as detailed below.

(Rs. in lacs)

Asset Purchase	
Land	120.0
Building	180.0
Plant & Machinery	100.0
Others	100.0
Total	**500.0**
Refurbishment	
- Building	15.0
- Machinery	15.0
Total refurbishment	**30.0**
Total	**530.0**

Means of Finance

The above cost of the purchase of ZTPL assets is proposed to be financed as below:

(Rs. In lacs)

Term Loans	400.0
Internal Accruals	80.0
Unsecured loans - Promoters	50.0
Total	**530.0**

Sales and Marketing Arrangements

RIPL has a large network of customers for coolant pumps. Some of its largest customers for coolant pumps and their share of the total sales are given below:

Anz Designers Group	6%
Barb Grz	4%
Kane Automation	4%
Fabricators & Traders	4%
Designer Engineers	1%

The client base for coolant pumps are well diversified and RIPL is not heavily depended on any single customer. RIPL normally works on an order base manufacturing process

for every customer. However, as a part of its inventory, it does carry certain inventory for standard coolant pumps.

The largest component in any coolant pump is copper (for motor winding). RIPL has a method of revising its prices every month in case the price of copper fluctuates significantly.

Financial Projections of RIPL

A summary of the financial projections for RIPL, for the 7-year period ending is given below.

(Rs. in lacs)

Year ending March 31,	**Y1**	**Y2**	**Y3**	**Y4**	**Y5**	**Y6**	**Y7**
INCOME							
Sales	3400.0	4251.4	5023.9	6023.9	6752.4	7090.0	7444.5
Other Operating Rev	30.0	39.8	43.0	43.0	43.0	43.0	43.0
Total Sales	***3430.0***	***4291.1***	***5066.9***	***6066.9***	***6795.4***	***7133.0***	***7487.5***
Total Other Income	20.0	21.5	22.0	22.0	22.0	22.0	22.0
Total Income (TI)	**3450.0**	**4312.6**	**5088.9**	**6088.9**	**6817.4**	**7155.0**	**7509.5**
EXPENDITURE							
Material Consumed	2298.1	2792.1	3237.8	3842.8	4268.6	4480.7	4703.4
Employee Cost	428.8	512.2	599.5	707.0	780.6	819.4	860.1
Manufacturing Expenses	137.2	268.4	338.0	448.0	547.2	574.4	602.9
Sales & Marketing Expenses	102.9	121.8	142.3	167.3	184.2	193.3	203.0
Admin Expenses	171.5	135.6	152.0	182.0	203.9	214.0	224.6
Repairs & Maintenance	68.6	85.8	101.3	121.3	135.9	142.7	149.8
Total Expenses	**3207.1**	**3916.0**	**4571.1**	**5468.6**	**6120.4**	**6424.4**	**6743.7**
EBIDA	**243.0**	**396.6**	**517.9**	**620.4**	**697.1**	**730.6**	**765.8**
% EBIDA to TI	**7%**	**9%**	**10%**	**10%**	**10%**	**10%**	**10%**
Interest on Loan	37.3	114.7	203.4	192.6	164.6	136.6	108.6
Depreciation	75.0	148.0	178.0	178.0	178.0	178.0	178.0
PBT	**130.7**	**134.0**	**136.4**	**249.7**	**354.4**	**416.0**	**479.2**
Tax	43.1	44.2	45.0	82.4	117.0	137.3	158.1
PAT	**87.6**	**89.8**	**91.4**	**167.3**	**237.5**	**278.7**	**321.1**
Dividend	8.8	8.8	8.8	14.7	14.7	14.7	14.7
Tax on proposed dividend	1.4	1.4	1.4	2.4	2.4	2.4	2.4
Retained Earnings	77.4	79.6	81.2	150.3	220.4	261.7	304.0
Net cash accruals	**152.4**	**227.6**	**259.2**	**328.3**	**398.4**	**439.7**	**482.0**
Return on Equity	**12%**	**11%**	**10%**	**16%**	**19%**	**19%**	**18%**

Return on Total Cap. Employed	**17%**	**14%**	**17%**	**19%**	**21%**	**21%**	**20%**
DSCR	**2.3**	**2.5**	**2.5**	**1.7**	**2.1**	**2.3**	**2.7**

By Y7, the Total Income (TI) of RIPL is expected to reach about Rs.7509.5 lacs, on which it is expected to make an EBIDA of Rs. 765.8 lacs, PAT of Rs. 321.1 lacs and net cash accruals of Rs. 482.0 lacs. RIPL is expected to improve its ROE to 18% by Y7 and ROCE to 20%. The Company is expected to main very healthy Debt-Equity Ratio and Debt Service Coverage Ratio during this period. The Balance Sheet Statements are projected to be as below:

(Rs. in lacs)

Year ending March 31,	**Y1**	**Y2**	**Y3**	**Y4**	**Y5**	**Y6**	**Y7**
Liabilities							
Equity Share Capital	14.7	14.7	14.7	14.7	14.7	14.7	14.7
Reserves & Surplus	698.5	778.0	859.2	1009.5	1229.9	1491.6	1795.6
Bank - Term Loans Existing	45.4						
Bank-Term Loan ZTPL Assets		400.0	400.0	300.0	200.0	100.0	
Bank-Term Loans-New Facility		315.0	315.0	240.0	165.0	90.0	15.0
Bank - Working Capital Loans	4.8	304.8	344.8	344.8	344.8	344.8	344.8
Unsecured Loans-promoters	131.6	231.6	231.6	231.6	231.6	231.6	231.6
Deferred Tax Liability	24.8	24.8	24.8	24.8	24.8	24.8	24.8
Trade Payables	440.7	654.2	720.1	887.2	1020.2	1070.8	1124.1
Other Current Liabilities	31.9	31.9	31.9	31.9	31.9	31.9	31.9
Provisions	43.1	54.4	55.2	99.5	134.0	154.3	175.2
Total	**1435.5**	**2809.4**	**2997.3**	**3184.0**	**3396.9**	**3554.5**	**3757.7**
Assets							
Gross Fixed Assets	990.6	1940.6	2240.6	2240.6	2240.6	2240.6	2240.6
Less : depreciation	459	607.0	785.0	963.0	1141.0	1319.0	1497.0
Net Fixed Assets	531.6	1333.6	1455.6	1277.6	1099.6	921.6	743.6
Investments		190.0	190.0	190.0	190.0	190.0	190.0
Inventory	44.1	193.5	206.3	292.5	375.3	394.0	413.5
Receivables	652.1	883.8	989.6	1195.1	1348.6	1416.0	1486.8
Loans and Advances	142.4	142.4	142.4	142.4	142.4	142.4	142.4
Cash and Bank Balances	65.286	66.1	13.4	86.4	241.0	490.5	781.4
Total	**1435.5**	**2809.4**	**2997.3**	**3184.0**	**3396.9**	**3554.5**	**3757.7**

CR	**1.8**	**1.7**	**1.7**	**1.7**	**1.8**	**1.9**	**2.1**

TD/E Ratio	**0.1**	**1.3**	**1.2**	**0.9**	**0.6**	**0.4**	**0.2**
LTD/E Ratio	**0.1**	**0.9**	**0.8**	**0.5**	**0.3**	**0.1**	**0.0**
FAC ratio	**11.7**	**1.9**	**2.0**	**2.4**	**3.0**	**4.9**	**49.6**

The Net Worth of RIPL is expected to increase to Rs. 1810.3 lacs by Y7. The term loans of Rs. 715.0 lacs that RIPL proposes to borrow to meet a part of the Expansion Scheme and Purchase of Assets of ZTPL, is scheduled to be fully repaid by then.
During Y2, RIPL is expected to increase its bank borrowings for working capital by an additional Rs. 300.0 lacs, to meet its increase working capital requirements.
The Current Ratio and Fixed Asset Coverage Ratio of RIPL are expected to be within acceptable norms during this period.

ANNEXURE I

Ripple Industries Private Limited

Company profile

Date of Incorporation	**:**	
Location	**:**	1. ----- Bangalore 2. ----- Bangalore Rural District.
Products	**:**	Coolant Pumps and motors Oil Skimmers Re-fuelling Pumps Auto-electrical Contract manufacturing

Board of Directors

Name	Age (Yrs)	
Mr. K Govind	78	Director
Mrs. Vidya	67	Director
Mr. Kumar	45	Managing Director
Mrs. Veena	40	Director

Shareholding pattern

Name	% Holding
Mr. K Govind	3.03
Mrs. Vidya	3.34
Mr. Kumar	46.63
Mrs. Veena	46.37
Ms. Deepa	0.61
Mr. Krishna	0.03

Assumptions for Financial Projections for RIPL

1. The sales estimates for RIPL for Y1 are based on the sales achieved for the first ten months in this year and expected business for the two months of February and March Y1.
2. Annual growth of 5% is assumed in the sales for RIPL every year, except for Y3 and Y4, where incremental sales of Rs. 500.0 lacs is assumed every year on account of new business from KRENT.
3. Raw Material for RIPL has been assumed at 67% of Sales for Y1 and Y2, and 66% thereafter, on account of better management of cost of raw material with ZTPL supplying castings.
4. Manpower cost for RIPL has been assumed at 12.5% of Sales based on historical data.
5. Manufacturing expenses for RIPL has been assumed at 4% of Sales based on historical data.
6. Sales and Marketing expenses for RIPL has been assumed at 3% of Sales based on historical data.
7. Administrative expenses for RIPL have been assumed at 5% of Sales based on historical data.
8. Repairs and Maintenance expenses for RIPL has been assumed at 2% of Sales based on historical data.
9. The sales estimates for ZTPL for Y1 are based on the sales achieved for the first 9 months of the year and expected business for next 3 months.
10. Annual growth of 15% is assumed in the sales for ZTPL from Y2 for every year and 5% thereafter, except for Y4 and Y5, where incremental sales of Rs. 500.0 lacs is assumed every year on account of additional business with increase in production.
11. Raw Material for ZTPL has been assumed at 55% of Sales based on historical performance.
12. Manpower cost for ZTPL has been assumed at 9% of Sales based on historical data.
13. Manufacturing expenses for ZTPL has been assumed at 18% of Sales based on historical data.
14. Sales and Marketing expenses for ZTPL has been assumed at 2% of Sales based on historical data.
15. Administrative expenses for ZTPL have been assumed at 5% of Sales for Y1, thereby reducing to 4% of Sales for Y215 and 3% of Sales thereafter, on account of better absorption of fixed coast over increased sales.
16. Repairs and Maintenance expenses for ZTPL has been assumed at 2% of Sales based on historical data.
17. Depreciation on fixed assets are assumed on SLM based on the depreciation rates provided by Company's Act.
18. Income Tax has been assumed at 33% of the PBT.
19. New term loan of Rs. 715.0 lacs proposed to be borrowed by RIPL is scheduled to be repaid in 48 monthly installments, the last one in March Y7.

Questions for case analysis:

I. Mr. Kumar, MD, RIPL has had some second thoughts about the plan to takeover ZTPL. He has approached you, a Chartered Accountant, for advice and assistance in this matter, He has shared this business plan extract with you.

- How would you proceed in this matter? What are the key questions you would ask Mr. Kumar?
- What would be your recommendations regarding the Business Plan that has been prepared?
- How would you advise the directors to prepare for the negotiations with the Zimmer Technocast Pvt Ltd., whether they decide to go ahead with this deal or not? Prepare a list of key due diligence questions to be asked.
- What are the other options that you can suggest for growth and value creation of this company, after looking at their plans for the next 7 years?

II. You are an equity investor, interested in funding growth companies in the manufacturing sector in India.

- How will you view this business plan, particularly when there are two aspects to it, an acquisition as well as an organic expansion plan?
- What are the key questions that you will have for the two companies? Prepare a list of Preliminary Due Diligence questions to ask.

II. You are bank manager who has been approached by Mr. Kumar for funding the growth plans.

- Will you view this proposal favorably? If yes, why, if no why not?
- What are the key questions that you will have? Prepare a list of initial questions that you will need answers to.
- Set out a list of information that is to be provided by Mr. Kumar for your review.

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