Prestige e-Journal of Management and Research
Volume 1, Issue 2(October 2014)
Volume 2, Issue 1(April 2015)
ISSN 2350-1316

SB TECHNOLOGIES: VALUATION OF AN UNLISTED COMPANY

Souvik Banerjee*

SB Technologies (India) Ltd. was set up to provide India based offshore Information Technology (IT) services. It was a unlisted entity. One senior employee was given a stake in the company as part of employee stock option plan(ESOP), with a clause, that the promoter group will buyback his shares at the time of his exit from the company, at a mutually agreed upon price. The moot question was how to value shares of this company.

Keywords: *Information Technology, Financial Valuation, Portfolio Management, Security Analysis*

* Assistant Professor, Acharya Bangalore Business School, Bangalore

INTRODUCTION

SB Technologies (India) Ltd. was set up by Satyendra Bhaduri in the year 1990. This was the time, when India was gradually opening up its economy. At that point of time, he was based in the US, working with one of the Silicon Valley giants. He wanted to do something fruitful as an entrepreneur. The prime motivation was his conviction, that success can truly be achieved by creating wealth in the society, and sharing that wealth with a number of people, by creating jobs.

The prevailing macro-economic conditions also helped in the growth of the company, and it became one of the leading mid-sized IT (Information Technology) company in India. It was headquartered at Bhubaneswar in Orissa and had its software development facilities in Baroda (Gujarat), Indore (Madhya Pradesh) and Mysore (Karnataka). The company used to generate its revenue from 3 segments, namely: Customer Services (CS), Systems Integration (SI) and IT Enabled Services (ITeS).

Customer Services (CS):

The CS Strategic Business Unit (SBU) focused on creating solutions and providing services for the Information Technology (IT) infrastructure requirements, covering infrastructure architecture, design and consulting services; turnkey system integration of large network and data centre infrastructures. Both on-site and remote supports were provided.

Systems Integration (SI):

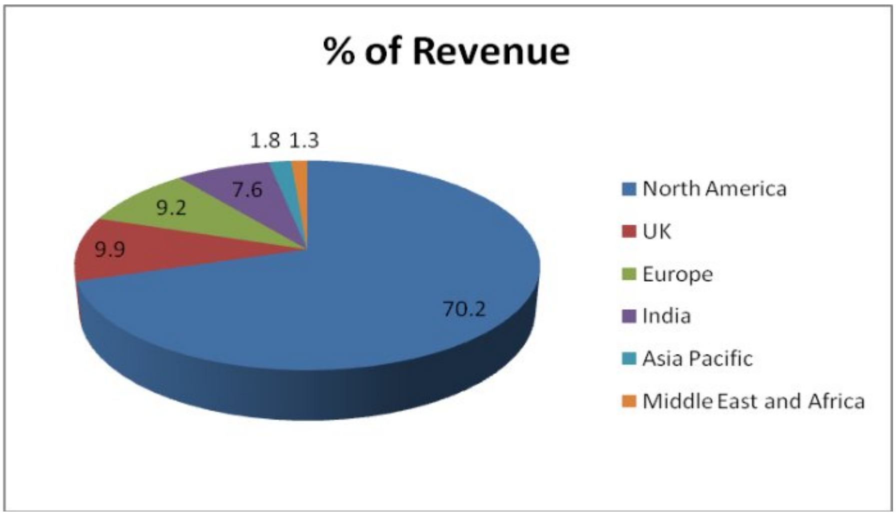
This SBU provided solutions related to embedded systems, software development, software maintenance and support, turnkey project implementation and systems consultancy.

This SBU also focused on emerging areas related to big data and analytics, mobility management and integration and cloud related services.

IT Enabled Services (ITeS):

The ITeS SBU provided a variety of IT enabled Services which include Business Process Outsourcing and Knowledge Process Outsourcing for front end and back office.

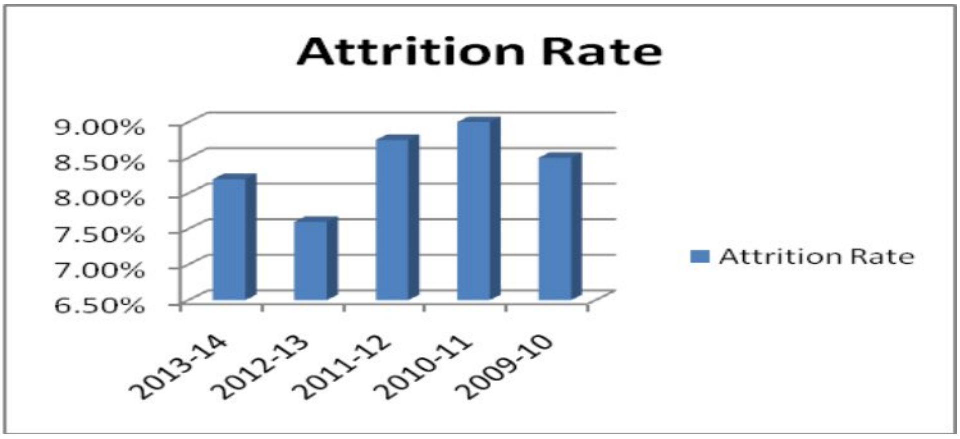
The geographical spread of the revenue was as depicted in the pie-chart.



Geographical Spread of the Revenue for Financial Year 2013-14

Bhaduri was the executive chairman of the company. As part of his management philosophy, the company granted around 5 percent stake in the company among various senior functionaries, starting from the rank of General Manager.

The company also allowed flexi timing and work from home facilities and encouraged both spouses to work in the company. These measures along with, locations of its operations out of big metros kept the attrition level considerably lower for the company, compared to its peers. Attrition rate of the company in the last five financial years are given in the bar-diagram.



Attrition level of the company in the last five financial years

The bulk of the revenue came from travel, tourism and aviation sectors. As the company had domain expertise in these areas, 10 clients ranked among the Fortune 500 companies for the financial year 2013-14.

The promoter of the company along with his family and associates own close to 90% of the unlisted entity. In late 1990s, an US based Private Equity (PE) player took 5% stake in the company.

From the beginning, the promoters were focusing on the marketing function of the company to grow; Vijay Khanna, an alumnus of an Ivy league B-School, and with vast experience in the Information Technology (IT) services sector, joined the company in the year 2000, as Chief Marketing Officer (CMO). To be closer to the clients he was based in San Francisco, the USA. The chairman credits Khanna, as one of the key man for the growth of the company, all these years.

Over the years, he was given 200,000 shares in the company as ESOP (Employees Stock Option Plan). The clause in the ESOP agreement specified that whenever Khanna leaves the company, the promoter has to offer to buy back the shares of this unlisted entity, at a price arrived at mutual agreement. Recently Khanna has resigned and he was serving his notice period. To arrive at the fair price of his stock holding, both the parties agreed to appoint Krishna Chand & Company, a renowned merchant banker. Venkat Sundaram, Associate Vice-President of the firm was entrusted with the job.

Since the company was a unlisted entity, Sundaram wanted to arrive at the fair price through the Free Cash Flow for Equity(FCFE) route. The logic given for this was that the capital expenditure of the company was not much and also, most of the cash flow generated from the operations can be distributed to the equity holders. Further to that, the leverage of the company was stable for last many years, and the growth rate of the company had been stable for at least last 10 years, in terms of revenue and net profit.

The merchant banker was of the view, that the present year's growth in FCFE, could be taken as the average rate of growth, for the years to come.

Sundaram, asked one of his team members to derive the beta of the company. He searched the relevant literature and found that, since this company was unlisted, its annual growth rate of profit after tax (PAT) figure could be used to derive the beta. Regression was done with percentage growth rate of profit (PAT) and Nifty index's yearly return for last 15 years, to derive beta. He showed the result to Sundaram. However, he was not happy, he told a Rs.250 crore company cannot be part of Nifty," you need to rework your math". Then after much deliberation he decided to take broader CNX 500 as the benchmark index. The beta, thus derived stands at 1.1. The company had 105065806 shares outstanding at that point of time.

Questions for Discussion

1. How to value equity of a company based on free cash flow?
2. How to value share price of unlisted companies?
3. What was the value of Khanna's holding, in the company?

Teaching Objectives

This case can be used as part of Financial Valuation or Security Analysis and Portfolio Management Course.

Teaching Notes:

1. Free cash flow to equity (FCFE) is the cash available to stockholders after funding capital requirements and expenses associated with debt financing.
2. FCFE can be calculated in the following way:
   FCFE = Net income (i.e.Profit After Tax) + Noncash charges (like Depreciation) - Working Capital Investment – Fixed Capital investment + Net Borrowing
3. Working capital investment is the change in the working capital accounts, excluding cash and short-term borrowings
4. Value of Equity =($FCFE_1$)/(r-g)
   Where, $FCFE_1$= FCFE(1+g)
   g = Growth Rate in FCFE
   r = Cost of Equity of the Company
5. Cost of equity of the company can be calculated, by using Capital Asset Pricing Model (CAPM). The risk free rate can be taken as 10 years government bond yield.
6. Value of 1 equity share can be calculated, by dividing value of equity with the total number of shares.

Valuation of the company

FCFE Calculation for Financial Year Ending 31st March, 2013 (In Indian Rupee)

Profit After Tax	38,12,80,374
Depreciation	9,89,78,890
Current Asset	1802436178
Current Liability	55,79,45,900
Cash & cash equivalents	65,09,88,345
Short-term borrowings	14,90,33,450
Current Asset without cash and cash equivalents	1,15,14,47,833
Current liability without short term borrowing	40,89,12,450
Working Capital	74,25,35,383
Change in working capital/working capital investment	4,51,25,994
Fixed Asset this financial year	18,79,52,154
Fixed Asset last financial year	17,98,48,712
Fixed Asset Investment(Change in fixed asset with respect to last financial year)	81,03,442
Long term borrowing last financial year	1,50,66,789
Short-term borrowings last financial year	12,70,53,440
Total borrowing last financial year	14,21,20,229
Long term borrowing this financial year	1,49,44,328
Short-term borrowings this financial year	14,90,33,450
Total borrowing this year	16,39,77,778
Net Borrowing	2,18,57,549
FCFE	44,88,87,377

FCFE Calculation for Financial Year Ending 31st March, 2014 (In Indian Rupee)

Profit After Tax	53,19,29,920
Depreciation	10,70,22,315

Current Asset	2,03,35,50,976
Current Liability	54,97,69,603
Cash & cash equivalents	74,90,45,342
Short-term borrowings	15,78,90,212
Current Asset without cash and cash equivalents	1,28,45,05,634
Current liability without short term borrowing	39,18,79,391
Working Capital	89,26,26,243
Change in working capital/working capital investment	15,00,90,860
Fixed Asset this financial year	19,81,79,092
Fixed Asset last financial year	18,79,52,154
Fixed Asset Investment(Change in fixed asset with respect to last financial year)	1,02,26,938
Long term borrowing last financial year	1,49,44,328
Short-term borrowings last financial year	14,90,33,450
Total borrowing last financial year	16,39,77,778
Long term borrowing this financial year	0
Short-term borrowings this financial year	15,78,90,212
Total borrowing this year	15,78,90,212
Net Borrowing	-60,87,566
FCFE	47,25,46,871

g(growth rate in FCFE) =5.27% = 0.052706971

r(cost of equity)=Rf + β(Rm-Rf)(Capital Asset Pricing Model)

Rf=8.5%(10 year's government of India bond yield varies, this figure is taken as the average, as last one year the yield has varied between 8% and 9%)

B=1.1

Rm= 9.26%(CNX 500's, 5 year Compounded Annual Growth Rate-CAGR)

r= 9.336% =0.09336

FCFE1=FCFE(1+g)=47,25,46,871(1+ 0.052706971)= 497453385.3

Total Value of Equity of the company =($FCFE_1$)/(r-g)=Rs.1,223,65,63,881

The company has 105065806 share outstanding

Per share value= 116.4657118

Value of Khanna's Holding(200,000 shares)= Rs.2,32,93,142.36

Key Issues

1. The case deals with Free cash flow to equity (FCFE) approach of equity valuation

2. How to calculate equity holding value got through ESOP(Employee Stock Option Plan) in unlisted companies

References

Khan, M.Y. and Jain, P.K. (2011). *Financial Management-Text, Problems and Cases*, 6th Edition, Tata McGraw-Hill Education Private Limited, New Delhi.

Periasamy, P. (2009). *Financial Management*, 2nd Edition, Tata McGraw-Hill Education Private Limited, New Delhi.

Webliography

Estimating the Cost of Equity for a Private Company' Retrieved from http://pages.stern.nyu.edu/~adamodar/New_Home_Page/valquestions/totalbeta.htm

India Govt Bond Generic Bid Yield 10 Year retrieved from http://www.bloomberg.com/quote/GIND10YR:IND

http://www.nseindia.com/content/indices/ind_cnx_500.pdf

ANNEXURES

Table 1: Statement for Profit and Loss Account (In Indian Rupee)

	Financial Year Ending 31st March, 2014	Financial Year Ending 31st March, 2013
Income		
Revenue from Operations	2,50,57,95,230	2,28,30,67,050

Other Income	10,19,50,320	8,32,40,230
Total Revenue	2,60,77,45,550	2,36,63,07,280
Expenses		
Employee benefit expenses	1,20,18,90,210	1,09,66,88,604
Other Expenses	75,09,22,340	70,66,90,875
Total Expenses	**1,95,28,12,550**	**1,80,33,79,479**
Earnings before interest, tax, depreciation and amortization(EBITDA)	65,49,33,000	56,29,27,801
Finance Costs	50,45,990	90,88,992
Depreciation and Amortization Expense	10,70,22,315	9,89,78,890
Profit Before Tax	54,28,64,695	45,48,59,919
Tax Expense		
Current Tax Expense	7,88,58,780	7,00,79,545
Excess provision for Tax relating to prior years	(9,30,23,455)	
Deferred Tax	2,50,99,450	35,00,000
Net Tax Expense	1,09,34,775	7,35,79,545
Profit After Tax	53,19,29,920	38,12,80,374
Earnings Per Share	5.06	3.63

Table 2: Balance Sheet of the Company (In Indian Rupee)

	As at 31.03.2014	**As at 31.03.2013**	**As at 31.03.2012**
Equity and Liabilities			
Shareholder's Funds			
Share Capital	10,52,33,751	10,52,33,751	10,52,33,751
Reserve and Surplus	295,20,71,354	255,32,34,455	240,67,75,131

ISSN 2350-1316

	3,05,73,05,105	2,65,84,68,206	2,51,20,08,882
Non-Current Liabilities			
Long Term Borrowing		1,49,44,328	1,50,66,789
Long term provisions	5,10,66,320	4,95,05,321	4,55,08,992
	5,10,66,320	6,44,49,649	6,05,75,781
Current Liabilities			
Short-term borrowings	15,78,90,212	14,90,33,450	12,70,53,440
Trade payables	17,61,63,455	22,32,45,761	20,42,45,851
Other current liabilities	5,47,83,494	4,33,23,234	3,61,34,234
Short-term provisions	16,09,32,442	14,23,43,455	12,23,43,455
	54,97,69,603	55,79,45,900	48,97,76,980
Total	**3,65,81,41,028**	**3,28,08,63,755**	**3,06,23,61,643**
Assets			
Non-Current Assets			
Fixed Assets			
Tangible Assets	19,80,66,752	18,72,33,452	17,92,33,998
Intangible Assets	1,12,340	2,00,820	1,98,820
Capital Work in-progress	-	5,17,882	4,15,894
	19,81,79,092	**18,79,52,154**	**17,98,48,712**
Non-current investments	75,34,22,345	65,56,88,091	63,56,67,272
Deferred tax asset	1,95,33,402	2,02,54,098	2,01,68,876
Long-term loans and advances	65,34,55,213	61,45,33,234	59,65,98,294
	1,42,64,10,960	**1,29,04,75,423**	**1,25,24,34,442**
Current Assets			
Current investments	2,17,30,342	2,02,90,454	2,00,98,502
Trade receivables	60,22,34,506	45,67,34,567	44,57,34,802
Cash and cash equivalents	74,90,45,342	65,09,88,345	56,99,45,560
Short-term loans and advances	48,00,99,345	40,56,65,099	33,89,44,343

Other current assets	18,04,41,441	26,87,57,713	25,53,55,282
	2,03,35,50,976	**1,80,24,36,178**	**1,63,00,78,489**
Total	**3,65,81,41,028**	**3,28,08,63,755**	**3,06,23,61,643**