Equity Valuation

Question

Fasco Ltd. which is specialized in manufacturing of bulk drugs is planning for expansion to handle a new contract which it expects to obtain. Avendus Capital (an investment bank) has approached the company and asked whether the Co. had considered Private Equity financing. In April 2011, the company borrowed ₹ 500 cr. on which interest is paid at 12% p.a. The Company shares are unquoted and it has decided to take your advice in regard to the calculation of value of the Company that could be used in negotiations using the following available information and forecast.

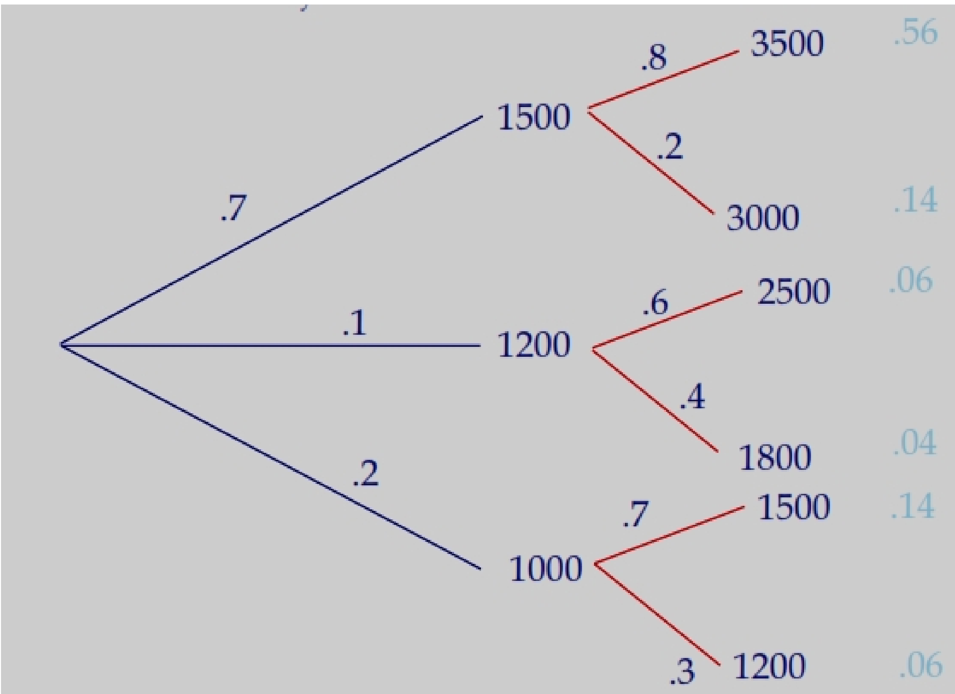
Company's forecast turnover for the year to 31st March, 2012 is ₹ 1500 crore which is mainly dependent on the ability of the Company to obtain the new contract, the chance for which is 70%. Turnover for the following year is dependent to some extent on the outcome of the year to 31st March, 2012. Following are the estimated turnovers and probabilities:

Turnover (₹ in crores)	Year - 2012 Prob.	Turnover (₹ in crores)	Year - 2013 Prob.
1,500	0.7	3,500	0.8
		3,000	0.2
1,200	0.1	2,500	0.6
		1,800	0.4
1,000	0.2	1,500	0.7
		1,200	0.3

Operating costs inclusive of depreciation are expected to be 30% and 35% of turnover respectively for the years 31st March, 2012 and 2013. Tax is to be paid at 40%. It is assumed that profits after interest and taxes are free cash flows. Growth in earnings is expected to be 40% for the years 2014, 2015 and 2016 which will fall to 10% each year after that. Industry average cost of equity is 18%.

Solution

Sales Forecast for the next 2 years is as follows :



Expected Turnover of 2012

= 0.7 × 1500 + 0.1 × 1200 + 0.2 × 1000
= 1050 + 120 + 200 = ₹ 1370 crore

Expected Turnover of 2013

= 0.56 × 3500 + 0.14 × 3000 + 0.06 × 2500 + 0.04 × 1800 + 0.14 × 1500 + 0.06 × 1200
= 1960 + 420 + 150 + 72 + 210 +72
= ₹ 2884 crore

Stage 1 : Explicit forecast period (1st 5 years)

Particulars	1	2	3	4	5
a. Expected Turnover	1370	2884	-	-	-
b. EBIT	959	1875	-	-	-
c. Interest exp (12% of 500)	60	60	60	60	60
d. PBT	899	1815	-	-	-
e. PAT @ 60%	539	1089	1525	2134	2988
i.e. FCFE					
PV @ 18%	457	782	928	1101	1306

So, PV of FCFE for 1st 5 years = ₹ 4574 cr.

Stage 2 : Horizon period (Beyond 5 years)

$FCFE_6 = PAT_6$

$= 2988 \times 1.1 =$ ₹ 3287 crore

Horizon value i.e. $V_5 = \frac{FCFE_6}{Ke - g} = \frac{3287}{0.18 - 0.1} =$ ₹ 41088 crore

PV of $V_5 = \frac{41088}{(1.18)^5} =$ ₹ 17960 crore

$\therefore$ Value of Firms equity = Stage 1 + Stage 2

= 4574 + 17960 = ₹ 22534 crore