Comprehensive Case

M/S DHODA SWEETS

M/s Dhoda Sweets (DS) is a popular confectionary manufacturer in North India. DS has reached its fifth year of trading. It has been successful in developing its business after a slow start. At the end of its fourth year of trading it obtained a new equity capital. Its summarised balance sheet at the end of year 5 is shown in Exhibit 1.

EXHIBIT 1 Dhoda Sweets' Balance Sheet as on March 31, year 200X (Rs '000)

Fixed assets		Rs 1,000
Current assets	Rs 1,500	
Less: Current liabilities	500	
Net current assets		1,000
Total assets		2,000
Share capital (1,00,000 shares × Rs 10)		1,000
Reserves		500
Shareholders funds		1,500
10% Debt		500
Shareholders fund and liabilities		2,000
EAT (tax at 50 per cent)		150

The management of DS is now planning to expand its operations to enter the novelty sweets market. Since they lack the expertise in manufacturing in this segment, instead of setting up a new unit, they propose to acquire a unit in this segment.

Mr Vin Market (Marketing Manager) has been deployed to seek out such a player because of high good connections in the market. He comes out with a lot of options but one company in particular catches his attention. Khemchand Halwaai (KH) is into the manufacturing of novelty sweets with a product range and market which would perfectly complement that of DS's.

The Finance Manager, Mr Money Minded is summoned by Mr Vin Market to help him with the financial aspects.

Mr Money Minded immediately gets on to the job and at first he looks at the balance sheet of KH summarised in Exhibit 2.

EXHIBIT 2 Balance Sheet of KH as on March 31, Year 200X (Rs '000)

Fixed assets		Rs 250
Current assets	Rs 500	
Less: Current liabilities	250	
Net current assets		250
Total assets		500
Share capital (30,000 shares × Rs 10)		300
(*Contd.*)		
Reserves		100
Shareholders funds		400
10% Debt		100
Total liabilities		500
EAT (tax at 50 per cent)	Year 2,001	19
	2,002	22
	2,003	25

Mr Money Minded has estimated that the acquisition will result in some financial synergy. Upon careful deliberations, the management of DS arrives at a conclusion that it can raise the level of efficiency at KH to the level at which it operates. The current levels are summarised in Exhibit 3.

EXHIBIT 3

	DS	*KH*
Return on capital employed (%)	17.50	15
Profit growth rate (%)	20	14
3 years average earning (Rs '000)		
EBT	125	44
EAT	63	22
Earnings per share	1.5	0.833
Market price	18	—
PE ratio (times)	12	—
Dividend per share	0.5	0.5

Mr Money Minded, as a MBA graduate, had studied the following valuation methods:

1. Market valuation
2. Earning capacity
3. Net book value of assets
4. Liquidation

On dwelling deeper the figures that in the absence of market quotation for Ms KH, market valuation is irrelevant. Also, the net book value of assets is irrelevant for a going concern but it can provide a starting point for negotiations. Liquidation value gives distress prices, but they do not involve intangible assets for which DS will have to pay a price.

He also feels that the most appropriate basis for valuation in going concern is the stream of earnings that is being purchased, reflected in the earnings capacity.

Earnings: To get the feel of possible earnings, Mr Money Minded decides to use a range of earnings coming from: (1) Most recent earnings, (2) Average earnings, (3) Earnings increased to reflect DS's return on capital, (4) Projected earnings, and (5) Return on capital required. The respective valuations are summarised in Exhibits 4-11.

EXHIBIT 4 [Valuation 1 (Most Recent Earnings)]

2003 earnings	Rs 0.833
P/E ratio	12
Price per share (Rs 0.833 × 12)	10

EXHIBIT 5 Valuation 2 (Average Earnings)

Average earnings (Rs '000s)	(19 + 22 + 25)/3	22
EPS (average) (Rs)	(Rs 22,000/30,000)	0.73
Price per share (Rs 0.73 × 12)		8.8

EXHIBIT 6 Valuation 3 [Earnings Increased to Reflect DS's Return on Capital (i.e. KH's ROC will be at 17.5%)]

Capital employed (Rs)	Rs 5,00,000
Required ROC (%)	17.5
EBIT	87,500
Interest (0.10 × Rs 1,00,000)	10,000
EBT	77,500
Tax (0.50)	38,750
EAT	38,750
EPS = Rs 38,750/30,000	1.29
Price per share (Rs 1.29 × 12)	15.5

EXHIBIT 7 Valuation 4 (Projected Earnings)

It is unrealistic to believe that KH will grow at the same rate as DS immediately. Hence, 20 per cent is too optimistic but according to Mr Money Minded it provides a ceiling for the bid.

KH's average profit	Rs 22,000
At 20 per cent growth projected profit [(Rs 22,000 (1 + 0.2)]	26,400
New EPS (Rs 26,400/30,000)	0.88
Price per share (Re 0.88 $\times$ 12)	10.6

EXHIBIT 8 Valuation 5 (ROC Required)

DS's ROCE (%)	17.5
DH's EAT	Rs 25,000
Add: Tax	25,000
EBT	50,000
Add: Interest	10,000
EBIT	60,000
DS can pay: (Rs 60,000 $\times$ 100/17.5)	3,43,000
Price per share (Rs 3,43,000/30,000)	11.4

EXHIBIT 9 Valuation 6 (Book Value of Assets)

Net total assets	Rs 5,00,000
Less: Debentures	1,00,000
Net book value	4,00,000
Book value per share (Rs 4,00,000/30,000)	13.3

EXHIBIT 10 Summary of Valuation

Valuation Method	*Share price*
Most recent earnings	Rs 10.00
Average earnings	8.80
Earnings increased to reflect DS's return on capital	15.5
Projected earnings	10.60
ROC required	11.4
Book value of assets	13.30

Now the management of DS has broad parameters to start with the negotiations.

The only valuation which seems out of line to the management is the valuation by 'earnings increased to reflect DS's return on capital' because they could not hope to increase the level of ROC of KH immediately to 17.5 per cent and it would be unreasonable to believe so. Hence, the management of DS will have to pay anywhere from Rs 8.8 per share to Rs 13.3 per share in the negotiations for them to be right to both the companies.