



RESTAURANTS – SERVICE TAX VS. SALES TAX

Roti, Kapda aur makan are believed to be the three basic needs of one's life. One of the basic necessities "Roti" has kept many including judiciary, government, tax man, tax practitioners involved.

The state or central govt. are involved in introducing constitutional amendments, drafting and implementing various rules (Rule 2C of valuation rules), declaring service portion in supply of food as "Service" etc, whereas Judiciary is involved in deciding the applicability of sales tax or service tax in a transaction, method of valuation and their appropriateness, interpreting law etc and the tax practitioners are involved in representing the views of taxpayers or government. "Roti" Itself has given livelihood to many.

Background

The issue of taxability on foods and restaurants supplied in hotel came in front of apex court in the case of Associated hotels of India ((A.I.R. 1972 S.C. 1131). In the instant case, Hotel received guests in the hotels where the customers were provided stay along with several other amenities such as food. Guest was charged an all inclusive price and separate item wise bill was not provided.

The court held that the Revenue was not entitled to split up the transaction into two parts, one of service and the other of sale of food stuffs with a view to tax the latter. Mere transfer of properties is not conclusive and does not render the event of such supply and consumption a sale, since there is no intention to sell and purchase. The court added that when the customer uses a fan in the room allotted to him, there is surely no sale of electricity, nor a hire of the fan. Such amenities, including that of meals, are part and parcel of service. The transaction essentially is one of service by the hotelier in the performance of which meals are served as part of and incidental to that service. Accordingly Food served in the hotels as part of stay package was declared as "Service" and no sales tax was chargeable.

It was presumed by the states that the tax was applicable on restaurants and no tax was applicable to supply of food or Drink supplied to person lodged in hotels. However this presumption of the states proved wrong when the apex court in the case of Northern India Caterers (India) Ltd. Vs. Lt. Governor of Delhi (A.I.R. 1978 S.C. 1591) held that **service of** meals whether in a hotel or restaurant does not constitute a sale of food for the purpose of levy of sales tax but must be regarded as the rendering of a service in the satisfaction of a human need or ministering to the bodily want of human beings. It would not make any difference whether the visitor to the restaurant is charged for the meal as a whole or according to each dish separately

Service tax authorities if at all existed at that time would have been very happy with these judgments giving them the scope of levying service tax on the Entire value for food as well stay.



Constitutional amendment

As per the outcome of this Judgment, State legislature was not competent to levy tax on Food stuffs supplied in restaurant or hotels, resulting into loss of revenue to the State exchequer. Government inserted a wider definition of "Sale" in Article 366. Clause 29A in Article 366 was introduced on 2nd February 1983 by 46th constitutional amendment. The amendment provided that "tax on the sale or purchase of goods" includes a tax on the supply of food or any other article for human consumption or any drink (whether or not intoxicating), by way of or as part of any service ,for cash, deferred payment or other valuable consideration. 46th Constitutional amendment nullified the observation of the Supreme Court and authorised the states to levy taxes on the supply of Food or drinks.

Value – Sales tax

Then the question regarding the value on which sales tax can be levied surfaced i.e. whether the tax can only be levied in respect of value of supply involved or on the entire Value. In the case of K. Damodarasamy Naidu & Sons Ltd. vs. State of TN –2000 (117) STC 001 SC (Five Member bench), question posed before the court was whether the Revenue is justified in levying tax on the total turnover without giving due regard to the service portion. **Court in its order held that tax should be levied on the entire value and the price as suggested by petitioner can't be split**. It was held that the tax was on supply of food or drink and it was not relevant that the supply was by way of service or a part of service. The court also cited an example of the patron of fancy restaurant, who orders a plate of cheese sandwiches whose price is shown to be Rs. 50/- on the bill of fare knows very well that the innate cost of the bread, butter, mustard and cheese in the plate is very much less, but he orders it all the same. He pays Rs.50/- for its supply and it is on Rs.50/- that the restaurant owner must be taxed.

Restaurant and service Tax

Origin

Finance Act, 2011 brought the services provided by restaurants having air- conditioned facility and license to serve alcoholic beverages within the ambit of service tax. Post budget conventional clarification issued by TRU stated that the new levy is directed towards high end restaurants providing conditions and ambience in a manner that the service provided may assume predominance over the food and it should not be confused with mere sale of food. The levy is intended to be confined to the value of services contained in the composite contract and shall not cover either the meal portion in the composite contract or mere sale of food by way of pick-up or home delivery, as also goods sold at MRP.

70% abatement was provided and it was clarified that the abatement was meant to separate such portion of the bill as relates to the deemed sale of meals and beverages.



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Post 1st July 2012

"Service" u/s 65B (44), defined for the first time w.e.f 01.07.2012, includes the declared services within its ambit. Declared Services are defined under Section 65B (22) of the Finance Act, 1994 as any activity carried out by a person for another person for consideration and declared as such under Section 66E of the Finance Act, 1994. It means for a service to come under the purview of declared services, it has to satisfy two conditions simultaneously:-

- a) It must be an activity carried out by one person for another person in lieu of consideration and
- b) It must be specified (i.e. declared) under section 66E.

Sec 66E specifies 9 activities as declared services, Service portion in an activity wherein goods, being food or any other article of human consumption or any drink (whether or not intoxicating) is supplied in any manner as a part of the activity is one of them. Thus ambiguity prevailing with regard to taxability of Works contract under service tax has been settled to a greater extent.

As per Sl. no 19 of the mega exemption notification, service provided by the restaurants, food point or mess other than those having the air- condition facility in any part of the establishment, at any time during the year, and (ii) a licence to serve alcoholic beverages was exempted during the period 1st of July 2012 to 1st of April 2013. Thus, All services of AC restaurant having the license to serve liquor were chargeable to service tax.

Post 1st of April, amendment in the exemption notification was introduced and the 2nd condition i.e. license to serve liquor was deleted. Thus all the restaurants having the facility of Air- conditioner is under the service tax ambit.

Valuation

TRU circular issued at the time of imposition of service tax on restaurant had clarified that only the service component is intended to be taxed and accordingly abatement is provided.

Rule 2C of the service tax valuation rules, 2006, subject to sec 67, provides for the valuation of service portion involved in supply of food or any other article of human consumption or any drink in a restaurant or outdoor catering. Service tax is chargeable on 40% of "Total amount" in case of restaurant whereas 60% of "Total amount" is to be offered in case of outdoor catering.



Maintenance of separate records

Unlike works contract, Rule 2C doesn't provide an option of maintaining the separate records for sale as well as service. Rule 2C is subject to Sec 67 which reads as under:-

"in a case where the provision of service is for a consideration in money, be the gross amount charged by the service provider for **such service** provided or to be provided by him"

Only when the amount is not ascertainable under sec 67, valuation rules need to be referred. Sec 67 provides that gross amount charged for such service shall be consideration and if separate records are maintained, amount charged for such service can be determined under sec 67 itself. Hence it appears that the service provider can discharge service tax by maintaining separate records.

Office Canteen

There is confusion whether the canteens at office are restaurants or Outdoor catering? Tax should be discharged at 40% or 60%.

There are basically two models being followed whereas in 1st case, Food is cooked at the premises of the caterer and brought and served to employees in the office canteen whereas in another model , cooking is also done at the office canteen.

Definition of "outdoor caterer" (Existed Prior to 01.07.2012) is as under:-

"Outdoor caterer" means a caterer engaged in providing services in connection with catering at a place other than his own but including a place provided by way of tenancy or otherwise by the person receiving such services.

In both the models, based on the definition of outdoor caterer, it appears that canteen should be classified as "Outdoor catering" and taxes on 60% value should be discharged. A clarification by CBEC may avoid the confusion.

CENVAT

Prior to 01.07.2012, No Credit on Input, Input services, Capital goods was available but the abatement available was on the higher side such as 70% in place of existing 60%. Post 1st of July 2012 CENVAT credit is admissible on Input services, Capital goods and Input except those classifiable under Chapters 1 to 22 of the Central Excise Tariff Act, 1985 (5 of 1986).



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Home delivery and Pick ups

TRU circular dated 28th Feb 2011 issued at the time of introduction of service tax on Restaurant services provided that

"1.1 Restaurants provide a number of services normally in combination with the meal and/or beverage for a consolidated charge. These services relate to the use of restaurant space and furniture, air-conditioning, well-trained waiters, linen, cutlery and crockery, music, live or otherwise, or a dance floor. The customer also has the benefit of personalized service by indicating his preference for certain ingredients e.g. salt, chillies, onion, garlic or oil. The extent and quality of services available in a restaurant is directly reflected in the margin charged over the direct costs. It is thus not uncommon to notice even packaged products being sold at prices far in excess of the MRP"

"1.4 The new levy is directed at services provided by high- end restaurant that are air-conditioned and have license to serve liquor. Such restaurant provides conditions and ambience in a manner that the service provided may assume predominance over the food and it should not be confused with mere sale of food"

"The levy is intended to be confined to the value of services contained in the composite contract and shall not cover either the meal portion in the composite contract or mere sale of food by way of pick-up or home delivery, as also goods sold at MRP"

In case of Home delivery the customer does not use any of these services i.e. Restaurant space, furniture, air-conditioning, well trained waiters, linen, cutlery and crockery, music, live or a dance floor. Further in case of home Deliveries restaurant doesn't provide conditions and ambience in which service provided assumes significance.

Charging the service tax on home deliveries and pick Ups defies the logic forwarded by CBEC while introduction of service tax on services provided by restaurants.

Further "Sale" has not completed upto the delivery of the food. Property of the food remains with the restaurant until the delivery of the product. As per Sec 26 of Sales of Goods act, 1930, the goods remain at the seller's risk until the property therein is transferred to the buyer. If there has been any loss to the food during home delivery, it has to be borne by the restaurant.

States- Taxes on More than 100% value.

Presently VAT is levied and collected by states on 100% value and Service tax is charged on 40% value.

Article 280 of the constitution of India provides for constitution of Finance commission by the President to recommends the distribution between the Union and the States of the net proceeds of taxes which are to be,



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divided between them and the allocation between the States of the respective shares of such proceeds. 13th Finance commission (2009-14) recommended 32% state share in the shareable Central taxes,

States are also getting share of service tax collected on restaurants as the Service tax is part of shareable pool. And effectively State is getting VAT on 100% value + share of service tax on 12.8 % value. States are getting revenue on more than 100% value in case of restaurants.

Sale vs. Service

The controversy on the taxability started with the argument and acceptability by the judiciary that the Food served in a restaurant is a service and sales can't be charged by state legislature.

It may be that there may not have been the need of Constitutional amendment at all if there existed a concept of taxing service at that point of time.

Constitutional amendment deemed the supply of Food or Drinks in restaurants as sale, settling the issue of chargeability of VAT by the state legislature. Post –Constitutional amendment, it can't be argued that the supply of food or drink in restaurant is service and not chargeable to sales tax.

Whether the constitutional amendment has deemed only the supply portion as deemed sale or the entire transaction has been deemed as sale is still a matter of debate.

Honorable Supreme Court in case of BSNL vs. UOI has held that "Of the three types of composite contracts i.e. a works contract, hire purchase contract and catering contract, splitting of the service and supply has been constitutionally permitted in case of works contract and catering contract and no other composite contract has been permitted to split."

In case of Tamil Nadu Kalyana Mandapam Assn. vs. Union of India & Ors. –(2004-TIOL-36-SC-ST), levying of service tax on catering services was challenged on the ground that catering service amounts to a tax on sale or purchase of goods in view of definition of tax on sale or purchase contained in Article 366(29A)(f) of the constitution and levying service tax is beyond the competence of the parliament. The apex court held that Article 366(29A)(f) permits the State to impose a tax on the supply of food and drink by whatever mode it may be made. It does not conceptually or otherwise includes the supply to services within the definition of sale and purchase of goods. It is only supply of food and drinks and other articles for human consumption that is deemed to be a sale or purchase of goods. The court added that the concept of catering admittedly includes the concept of rendering service. The fact that tax on the sale of the goods involved in the said service can be levied does not mean that a service tax cannot be levied on the service aspect of catering.



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In case of INDIAN RAILWAYS CATERING & TOURISM CORPORATION LTD Vs GOVT OF NCT OF DELHI & ORS, Delhi High court held that on board supply of food is a transaction purely of sale of goods and not a composite transaction for sale of goods and rendering of services. VAT is chargeable on the entire amount. The court took the view that the serving of food in the train is altogether different from catering service. Fixed menu by railway board, no choice with passenger, no refund if meal not taken are few of the grounds differentiating it with outdoor catering. The court was not of the view that service tax cannot be levied on outdoor catering, as provided in Section 65(105)(zzt) of Finance Act, 1994. The transaction does not amount to a contract of providing outdoor catering, but, is a transaction of sale of food and beverages.

The above judgment supports the taxability of services separately at least in case of catering contracts. The education Guide issued by CBEC clarifies that service portion in supply of food or drinks has only been declared as service. Clarification on restaurants services is still awaited.

And the journey continues

Recently there have been few judicial pronouncements relating to catering service or restaurants.

Whether Service tax can be levied?

Levy of service tax on air-conditioned restaurants with license to serve alcoholic beverages in 2011-12 Union Budget was challenged by Kerala Classified Hotels and Resorts Association on the ground that centre is transgressing into the item covered under Entry 54 of the state list i.e. taxes on sale or purchase of Goods. Article 366 29 (f) of the Constitution deemed supply of food and drinks in hotels as 'sales.' Further State governments are empowered to collect sales tax on the total value of sales. Single judge bench of Kerala HC held that levying service tax by centre was beyond the legislative competence of parliament as the subject matter is covered under state list.

In a similar case of Indian hotels and restaurant association, constitutional validity of levying service tax was challenged and it was contended that post 46th constitutional amendment, tax to be levied by state is on the supply of food or drink and it is not of relevance that supply is by way of a service or as a part of a service. Honorable Mumbai HC held that the amendment introduced in the constitution must be seen in the context of introduction of such change. The Constitutional amendment was inserted so as to leave no argument that tax on sale or purchase of goods does not include a tax on the supply of goods which may be food or any drink, by way of or as part of any service and it is for that limited purpose. Further it was also added that the Parliament was denuded of its competence to legislate and impose a tax on service provided by an air-conditioned restaurant serving food and drink, under its taxing power, is to do violence to the plain language of the Constitutional provisions, Articles and Entries and it was concluded that service tax or tax on a service, which



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is made taxable by the Finance Act is thus a completely distinct tax. It should not be and cannot be confused leave alone equated with a tax on sale or purchase of goods.

Bombay high court also dissented from Kerala HC for want of categorical finding that Service tax is covered by Entry 54 of the state List. The court also placed a reliance on Supreme Court decision in case of *Tamil Nadu Kalyana Mandapam*.

Value

Currently VAT is charged on 100% value whereas service tax is charged on 40% value in addition of VAT. In many cases, Constitutional validity was challenged but not the dual levy. Bombay HC in case of hotels and restaurant association pointed that the legal competence of the parliament has been challenged and not the double taxation.

Valley Hotels & Resorts filled an application before commissioner, commercial tax requesting him not to charge VAT on 40% amount which has already suffered service tax. The contention was rejected by the commissioner as well as tribunal. Appeal was filled before Uttarakhand HC. HC held that Value Added Tax can be imposed on sale of goods and not on service. The authority competent to impose service tax has also assumed competence to declare what is service. The State has not challenged the same. Therefore where element of service has been so declared and brought under the purview of Service tax vide the notification no. 24/2012, no VAT can be imposed thereon.

Impact

The decision would have impact on valuation on works contract as well. In many cases total duty charged (VAT+ service tax)

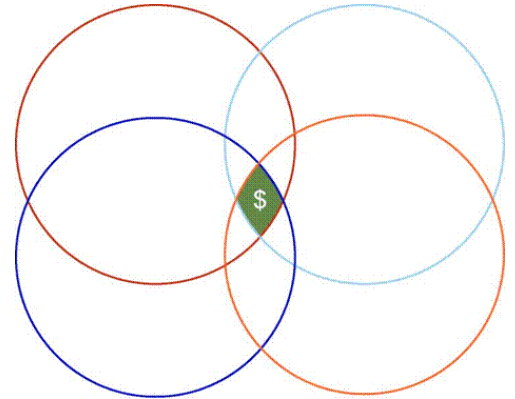
TECHNIQUES IN VALUATION

What is Valuation?

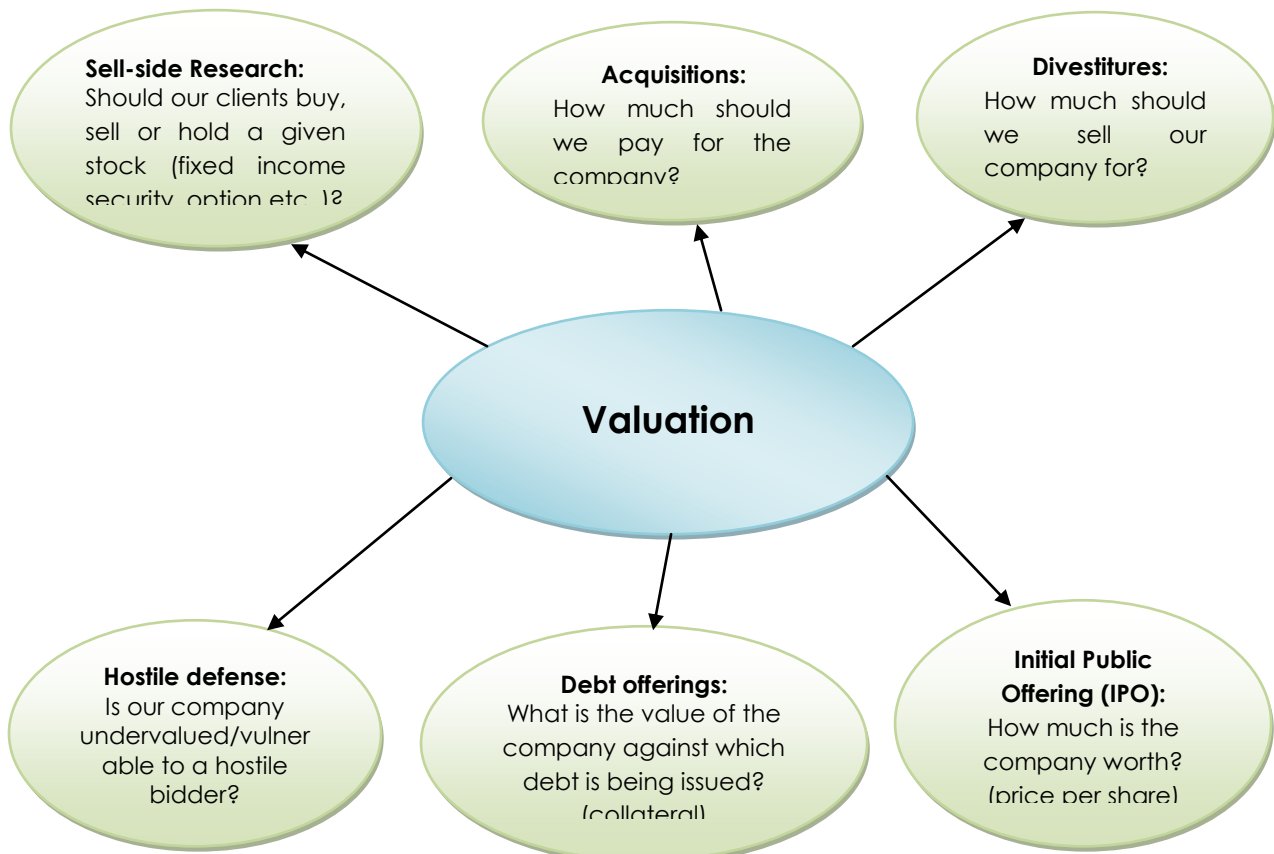
Valuation: Methods of quantifying how much money something should be exchanged for today, considering future benefits.

We will teach 4 valuation methods

- ✦ Trading Comparables
- ✦ Transaction Comparables
- ✦ Sum-of-the-Parts Valuation
- ✦ Discounted Cash Flow Analysis (DCF)



Why is Valuation important?





A. Trading Comparables
Relative Valuation Technique

Agenda

- Multiples: Comparables Trading (transaction comparables will be covered by Mike)
■ Theory: Similar companies (all else equal) should have similar valuations
■ Defining a Peer Group ("similar companies")
■ Picking the right multiples
■ Calculating CLX's multiples
■ Spreading Peer Group multiples
■ Calculating CLX's implied value

First day on the job... (Potential interview question)

- ✦ Your boss thinks shares of Clorox Co. ("CLX") might be a good investment:
✦ She asks you: "How much do you think they are worth?"



- ✦ One common approach is Multiples Based Valuation Technique

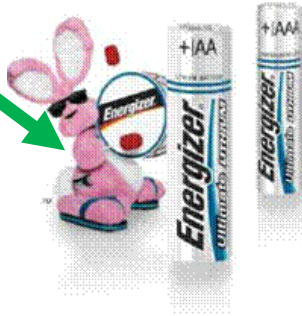
What are multiples?

Example:
Price/Earnings (P/E)
Firm Value/Revenues
Firm Value/EBITDA



"CLX"
₹67 a share

?



"ENR"
₹67 a share



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Earnings per share
₹ 4.24

$₹ 67 / ₹ 4.24 = 15.8x$



Earnings per share
₹ 2.90

$₹ 67 / ₹ 2.90 = 23.1x$

Trading Comparables: The Theory

- Basic Assumption: Similar companies should have similar valuations
- Employing multiples is a **relative valuation** technique

Trading Comparables - Selecting the right peer group

- It is important to select the best peer group possible ("similar companies")
 - How?

| Operational Filters | Financial Filters |
|------------------------|---|
| Industry / Sub-Sectors | Size (e.g. Market Capitalization, Revenue etc..) |
| Product | Profit Margins |
| Markets | Leverage (e.g. Debt/Capital) |
| Customers | Shareholders base (influence of a large shareholders) |
| Seasonality | |
| Cyclicality | |

| Colorox Peer Group | |
|-------------------------|-----------------------------|
| Kraft – "KFT" | Church & Dwight – "CHD" |
| Procter & Gamble – "PG" | Energizer Holdings – "ENR" |
| Colgate – "CL" | Colorox Corporation – "CLX" |
| Kimberly-Clark – "KMB" | |







Next Step: Choosing the right multiples

- It is important to choose the RIGHT multiples

Examples: Multiples

- Price/Earnings
- Firm Value / EBITDA
- P/E to growth
- Price / Cash

- Generally, it is appropriate to use the multiples which are being used in the market.
 - Check sell-side research reports
- It is also important to understand WHY the market is using certain multiples

| Multiple | Pros | Cons |
|---|--|--|
| Firm Value / Subscribers  | <ul style="list-style-type: none"> • Important telecom ratio • Good for more mature situations | <ul style="list-style-type: none"> • Assumes same profitability for all comps • Difficult to use in high growth situations |
| Price/Book Value  | <ul style="list-style-type: none"> • Useful for capital intensive industries and financial institutions • Reflects long-term profitability outlook | <ul style="list-style-type: none"> • Distorted by accounting differences • Need profitability cross-check |
| Firm Value / Sales  | <ul style="list-style-type: none"> • Most often used with high growth companies that do not have earnings | <ul style="list-style-type: none"> • Need profitability cross-check |
| Price / Click Rate (?)  | <ul style="list-style-type: none"> • Useful for companies without revenues or earnings (?) | <ul style="list-style-type: none"> • Is not a good predictor of long-term return to shareholders |

Our Multiples

| | |
|---------------------------------------|--|
| Price/Earnings per share (EPS) | <ul style="list-style-type: none"> ■ Companies have earnings (relatively stable vs -> e.g. tech.) ■ Widely Used (illustration power) ■ Illustrates need for earnings forecasts |
| Firm Value / EBIT | <ul style="list-style-type: none"> ■ Impact of leverage (debt + interest expense) ■ Debt can be good and bad (efficiently used?) ■ Important Distinction: Firm Value vs. Equity Value |
| Firm Value / Revenue | <ul style="list-style-type: none"> ■ High fixed costs + economies of scale <ul style="list-style-type: none"> ■ Small change in sales = Large Change in Earnings ■ Illustrates need for revenues forecasts |

1. Calculate CLX's Price to Earnings Per Share
2. Calculate CLX's Firm Value to EBIT
3. Calculate CLX's Firm Value to Revenue



Our Multiples

| | |
|---------------------------------------|--|
| Price/Earnings per share (EPS) | <ul style="list-style-type: none"> ■ Companies have earnings (relatively stable vs -> e.g. tech.) ■ Widely Used (illustration power) ■ Illustrates need for earnings forecasts |
|---------------------------------------|--|

1. Calculate CLX's Price to Earnings (aggregates)

Price -> Market Capitalization (Price × Shares)
 Yahoo Finance: ₹ 9.5 billion

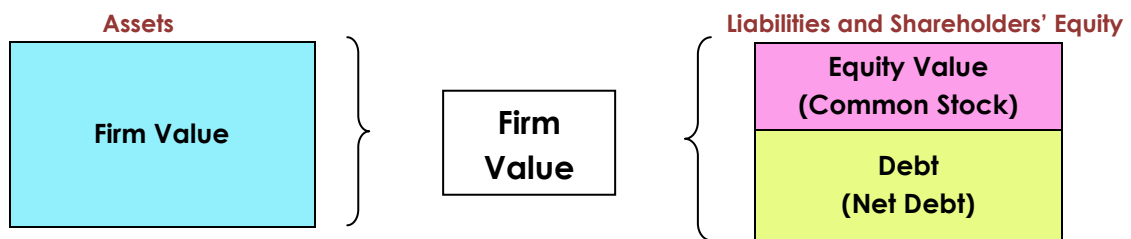
Earnings -> Consensus (average) sell-side estimates – Bloomberg Machine –
 Year –End 2010E: ₹ 600 m

Price to Earnings: ₹ 9500m/ ₹ 600m = 15.8x
 Which is the same as earlier example: ₹ 67/₹ 4.24 = 15.8x

Our Multiples

| | |
|-------------------------|--|
| Firm Value /EBIT | <ul style="list-style-type: none"> ■ Impact of leverage (debt + interest expense) ■ Debt can be good and bad (efficiently used?) ■ Important Distinction: Firm Value vs. Equity Value |
|-------------------------|--|

2. Calculate CLX's Firm Value to EBIT



Net Debt.....

| | |
|------|--|
| Debt | <ul style="list-style-type: none"> ■ Long Term Debt -> ₹ 2151m ■ Current Portion of Long Term Debt -> ₹ 577m ■ Short Term Debt -> ₹ 421m |
| (-) | |
| Cash | <ul style="list-style-type: none"> ■ Cash and Cash Equivalents -> ₹ 206m |

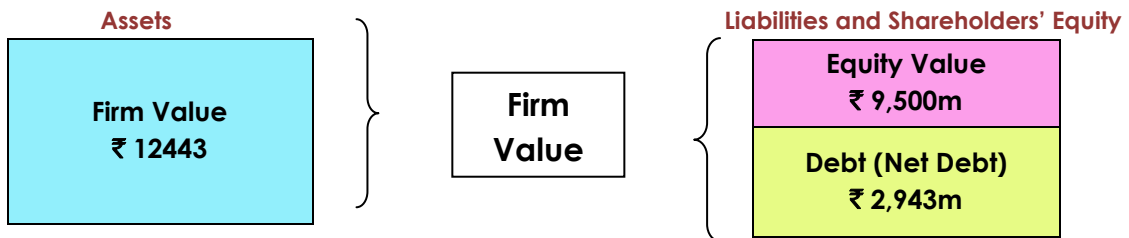
= Net Debt -> ₹ 2,943



Our Multiples

| | |
|--------------------------|--|
| Firm Value / EBIT | <ul style="list-style-type: none"> ■ Impact of leverage (debt + interest expense) ■ Debt can be good and bad (efficiently used?) ■ Important Distinction: Firm Value vs. Equity Value |
|--------------------------|--|

Calculate CLX's Firm Value



Calculate CLX's Firm Value to EBIT

EBIT YE2010E -> Consensus sell-side ₹ 1,305
 FV/EBIT = 9.5x

Our Multiples

| | |
|-----------------------------|--|
| Firm Value / Revenue | <ul style="list-style-type: none"> ■ High fixed costs + economies of scale <ul style="list-style-type: none"> ■ Small change in sales = Large Change in Earnings ■ Illustrates need for revenues forecasts |
|-----------------------------|--|

3. Calculate CLX's Firm Value to Revenue

Why revenue multiple a Firm Value Multiple?

Firm Value -> ₹ 12,443
 Revenue -> Consensus sell-side
 Year End 2010E: ₹ 5,579

Firm Value to Revenue: ₹12,443m/ ₹5,579m = 2.2x

Spreading the Trading Comparables

| Company Set | Equity Value Multiples | Firms Value Multiples | |
|----------------------------|-------------------------------|-----------------------|------------------|
| Company Name | Price/Earning Per Share (EPS) | Firm Value/ Revenues | Firm Value/ EBIT |
| Church & Dwight - "CHD" | 17.55x | 2.10x | 11.36x |
| Colgate-Palmolive - "CL" | 18.23x | 2.56x | 10.77x |
| Kimberly-Clark - "KMB" | 21.00x | 3.30x | 9.74x |
| Energizer Holdings - "ENR" | 17.20x | 3.80x | 10.80x |
| Kraft Foods - "KFT" | 17.43x | 1.80x | 12.82x |
| Procter & Gamble - "PG" | 16.98x | 2.52x | 12.40x |
| Clorox Corp - "CLX" | 15.8x | 2.2x | 9.5x |
| Mean | 18.07x | 2.68x | 11.32x |





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Trading Comparables – Current Price ₹ 67/share “CLX”

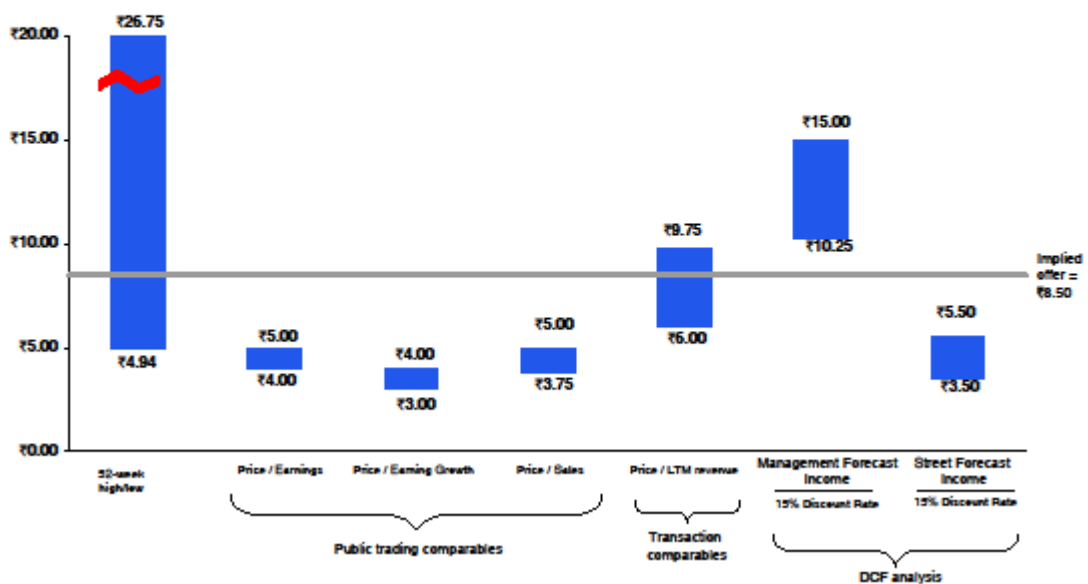
₹ in millions

| Peer Group Mean | 18.1x Price/ Earnings | 2.7x Firm Value/ Revenue | 11.3x Firm Value / EBIT |
|---------------------|--------------------------|-----------------------------|----------------------------|
| “CLX” | ₹600m | ₹5,579 | ₹1,305 |
| Valuation | ₹10,860 Equity Value | ₹15,063 Firm Value | ₹14,746 Firm Value |
| Net Debt | | ₹2,943 | ₹2,943 |
| Equity Value | ₹10,860 | ₹12,120 | ₹11,803 |
| Share Outstanding | 140m | 140M | 140M |
| Implied Value | ₹77.60 | ₹86.57 | ₹84.31 |
| Buy? Sell? Hold? | ? | ? | ? |

Trading Comparables – Valuation Range: ₹ 77 - ₹ 87 per share

The SCIENCE is performing the valuation, the ART is interpreting the results in order to arrive at the “right” price. TECHNOLOGY can help you do this more efficiently.

Implied Price Per Share





B. Transaction Comparables:

Step 1: Locate Comparable Transactions

- Equity research reports
- Merger proxies for similar transactions
 - Fairness opinions of financial advisors disclose the comparable transactions used in their valuations of the target
- Company press releases, shareholder presentations, conference call transcripts and SEC filings
- Bloomberg transaction description (TICKER<EQUITY>CACS) - Click on deal

Step 2: Select Comparable Transactions

- Remember that some transactions are more relevant than others when selecting a range of multiples for a valuation
 - The **situation** surrounding the acquisition is crucial:
 - Bankruptcy-related acquisition

Televisa to Take Stake in Univision

- “Servicing the company's \$ 10 billion debt load left Univision reeling...”
- Televisa is buying into the company at a valuation about **40% below its original takeover price...**”

Source: Wall Street Journal (10/04/2010)

- Hostile transaction
- Recent deals are typically a more accurate reflection of value

(\$ in Millions)

| Date | Target/Acquirer | Transaction Value | EV/LTM Revenue | EV/LTM EBITDA | EV/LTM EBIT |
|-----------------------|-----------------------------------|-------------------|----------------|---------------|-------------|
| 07/12/2010 | Silpada / Avon | \$650 | 2.8x | 10.9x | 11.8x |
| 01/14/2010 | Bare Escentuals / Shiseido | \$1,828 | 3.4x | 11.1x | 12.3x |
| 12/21/2009 | Chattem / Sanofi Aventis | \$2,156 | 4.5x | 13.1x | 13.5x |
| 12/14/2009 | Simple skin care / Alberto Culver | \$396 | 3.7x | 11.0x | 12.0x |
| 12/11/2009 | Ambi Pur (Sara Lee) / P&G | \$470 | 2.6x | 12.5x | 13.5x |
| 5/11/2009 | Edge (SC Johnson) / Energizer | \$275 | 1.8x | 9.2x | 9.8x |
| 4/1/2008 | Orajel / Church & Dwight | \$380 | 3.8x | 13.6x | 15.8x |
| 1/25/2008 | Frederik Fekkai / P&G | \$440 | 3.5x | 16.0x | 17.6x |
| AVERAGE | | \$824 | 3.9x | 11.7x | 12.6x |
| CLX Financials | | | \$6,000 | \$1,500 | \$1,300 |
| Implied Value | | | \$23,200 | \$17,600 | \$16,380 |



C. Sum of the Parts Valuation

Sum of the Parts Valuation Example:

Time Warner, Inc. (TWX)

| Segment | Segment EBITDA | Target EV/EBITDA | Implied Value |
|----------------|----------------|------------------|---------------|
| Movies | \$ 1,500 | 7.0x | \$ 10,500 |
| Cable Networks | \$ 3,900 | 10.0x | \$ 39,000 |
| Publishing | \$ 450 | 5.0x | \$ 2,250 |
| Total | \$ 5,850 | | \$ 51,750 |

Implied EV/EBITDA: 8.8x

- ❖ What is the “**Conglomerate Discount**”?
 - Full value of TWX cannot be realized unless we unlock it
 - Sometimes SOTP does not equal the value whole company
 - $\$51,750 * (90\%) = \$46,675$ (Implied Multiple: 8.0x)

Time Warner, Inc. (TWX) – Spin offs

Cable Spin

“Simpler, Leaner, Better, & More”

- ⌘ “The company will finally, fully separate its cable operations creating a **near-pure content company** enabling **better investors focus.**”

Source: Collins Stewart (30/01/2009)

AOL Spin

“AOL Exit Clarified...”

- ⌘ “Cable networks eventually **become the focus.** Over the long-term, we think **investors will appreciate Time Warner’s leading content centric assets** and **streamlined strategic approach** focused on generating high-quality and popular programming.”

Source: Goldman Sachs (28/05/2009)



D. Discounted Cash Flows- "DCF"

DCF Analysis

Discounted cash flow analysis is based upon the theory that the value of a business is the **sum of its expected future free cash flows, discounted at an appropriate rate.**

- Three key drivers:
 - Free cash flow **projections**
 - Terminal value** at the end of the projection period
 - Discount Rate** (weighted average cost of capital or "WACC")

Free Cash Flow

| Levered Free Cash Flow |
|---------------------------------------|
| EBITDA |
| (-) Interest Expense |
| (-) Capital Expenditures |
| (-) Cash Taxes |
| <u>(-) Changes in Working Capital</u> |
| Levered Free Cash Flow |

| Unlevered Free Cash Flow |
|---------------------------------------|
| EBITDA |
| (-) Capital Expenditures |
| (-) Cash Taxes |
| <u>(-) Changes in Working Capital</u> |
| Unlevered Free Cash Flow |

Let's setup a DCF Model....

Calculating WACC

- $WACC = \left[(r_d \times (1-T)) \times D / (D + E) \right] + \left[r_e \times (E / (D + E)) \right]$
- Let's look at two capital structures: (1) 100% debt. (2) 100% Equity

$$D/(D+E) = 100\% \quad \text{vs.} \quad E/(D+E) = 100\%$$

- There is a cost associated with debt and equity used to fund business initiatives
 - There is a rate charged for debt issued
 - There is a rate charged for equity issued

$$\left[r_d \times D / (D + E) \right] + \left[r_e \times (E / (D + E)) \right]$$

- The rate used for debt should be reduced to account for the tax shield

$$WACC = \left[(r_d \times (1-T)) \times D / (D + E) \right] + \left[r_e \times (E / (D + E)) \right]$$



Cost of Equity – “CAPM”

“CAPM” = Capital Asset Pricing Model

$$R_f + \beta(R_m - R_f)$$

- “The \$10 Question”
- As the perceived risk of a company increases, an equity investor will require a higher rate of return
 - ❖ Risk free rate of return (“ R_f ”) – the minimum return an investor should expect to receive
 - ❖ $R_f + \beta(R_m - R_f)$
 $10\% + (1000\% - 10\%) = 1000\%$
- Treasury securities are a good proxy for R_f
 $3\% + (10\% - 3\%) = 10\%$

Cost of Equity - Beta

Question: If the stock market were to fall 50% next year, would you prefer to have been invested in a mature and stable company or an early stage technology software growth company?

- ⚡ CAPM says an investor should be rewarded more for investing in a stock that fluctuates more with stock market performance
- ⚡ Beta provides a method to estimate the riskiness of a stock with the overall stock market
 - ⚡ Beta of 1.0 is “as risky” as the overall stock market
 - ⚡ Beta of 2.0 should see returns on its equity rise or drop twice as fast as the overall market

$$R_f + \beta (R_m - R_f)$$