CENTRE FOR FINANCIAL MANAGEMENT

CFM QUARTERLY IN FINANCE

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ARTICLES /CASES

1. A LOT IS HAPPENING OVER A COFFEE..!!!

Kiran Kumar *

Swarup prefers to spend his Sundays as dull as possible. The Sunday of October11th of 2015 was going to be different for him. On any other weekday he would've commenced the day with getting a global market update from the Bloomberg app on his iPad. Being an investment broker for several HNI investors of Equate Advisors,Swarup is a much sought after relationship manager by his clients. His clients feel Swarup is one such adviser, whose stock picks rarely go wrong. His boss at Equate Advisors is generally happy with his performance in terms of delivering numbers and maintaining satisfied customer relations, but, he feels Swarup sometimes contradicts the stock advises of central research team.Swarup argues that's precisely the reason for his success.He does not blindly recommend a stock to his clients, instead, with every such recommendation that comes to him from his research team in Mumbai, he does his own valuation of the stock before he arrives at his conclusion. He strongly believes this always works.

By the time he woke up on this Sunday it was already 9.30 am. He stepped out of his apartment after a short work-out module at the club-house. The generally-residential area that it is, Sahakar Nagar in Bangalore, was semi-urban in landscape. Less than 200 meters from his apartment complex was an outlet of *Café Coffee Day* (popularly called CCD), to which Swarup was a regular visitor. He had an emotional connect with CCD, as most of his successful client meets happen in CCD outlets, thanks to widespread presence across Bangalore; he spends most of his leisure and he feels rejuvenated after every visit in CCD; and more than anything, it is in this CCD that he proposed his girlfriend (and she accepted..!!). Truly a lot happened to Swarup over Coffees in CCD…!!!

He walked into the shop ordered his regular cappuccino with butter cookies and unlocked his iPad screen, while still being amused at the young crowd at the shop already barged in. The *moneycontrol.com* website that he had opened yesterday was still on the first screen. As if it was usual, Swarup reluctantly glanced through news stream, and he found a news item **-** "***Café Coffee Day to go Public***". He also recalled grapevine download from his chitchat with his research team that Equate Advisors are going to recommend CCD for a buy at IPO aggressively. His hot espresso was served and he could just smile at the thought of how hot CCD's IPO going to be. He decided to be better prepared. And this Sunday was to become a working Sunday for him.

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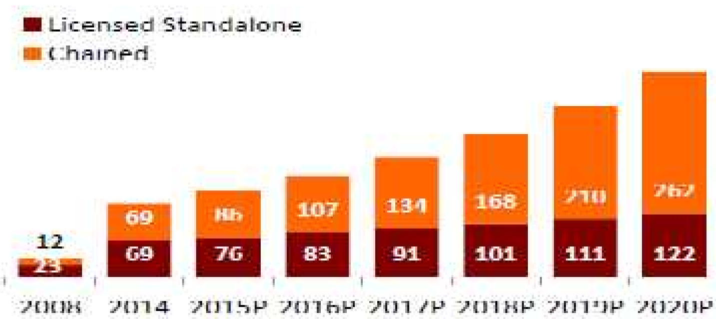
Swarup believes valuing a stock means valuing a business. It's important to understand the fundamental business model of the company. He browsed through the red herring prospectus (RHP) of the company and few websites to gather relevant information and made notes as below, as he usually does:

i. ***Stakeholders***: CCD's parent company Coffee Day Enterprises Limited (CDEL) is held by V G Siddarth-led promoter group upto 93%, whereas private equity firm KKR, Infosys co-founder Nandan Nilekani and Rakesh Jhunjhunwala's Rare Enterprises make it to the list of major shareholders with 3.43%, 1.77% and 0.24% equity stakes respectively.

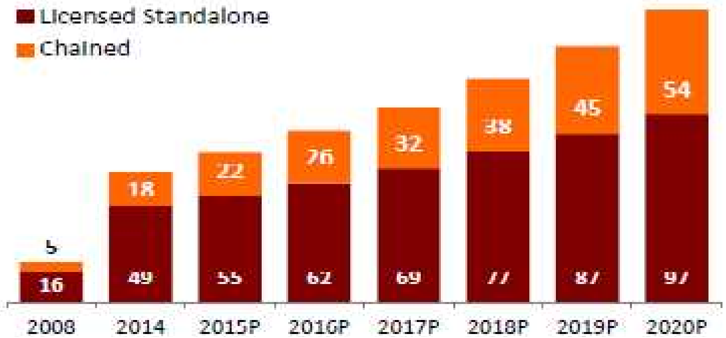
ii. ***Businesses***: CDEL classify themselves into mainly food service market, as their primary business is into coffee products. In addition to having the largest chain of cafés in India, CDEL also operates in procuring, processing and roasting of coffee beans and retailing coffee products across various formats. Their diversification into non-coffee businesses include technology park development, logistics solutions, financial services, Resorts & Hospitality and ownership stakes in IT-ITES companies like MindTree.

iii. ***Environment***: Their claims about the growth in coffee vending business gets justified with the changing consumption pattern of northern and western Indian tea drinking population also preferring to coffee consumption. Added by strong economic and demographic aggregates like increasing percapita income, rising urbanisation, discretionary spending, out-of-home food consumption trends, corporatisation etc., coffee outlets today are in demand more than ever.

Indian QSR (Quick Service Restaurants) market is expected to grow exponentially in the coming years. The same (in Rs. Billion) is shown in the below graph. *(Source: Techopark, March 2015)*



Indian Coffee market's growth is projected as below: *(Source: Techopark, March 2015)*



iv. ***Strengths***: CDEL's strengths are strong home-grown brand, first-mover advantage, substantial market presence, established network of franchises and dealers, multiple consumption points, disorganised competition, scalability of the business, diversified businesses focusing in India growth story and professional management.

v. ***Strategic View***: Currently, CDEL's strategic outlook is to further deepen the existing chain of cafés; increase café revenues by generating higher footfalls and driving increased consumption; leverage brand equity of "Coffee Day" and "Café Coffee Day"; constantly augur product range; and also develop non-coffee business.

vi. ***Financials***: A simplified set of consolidated financial statements for the previous five years were also prepared like this:

Consolidated Multi-Step Income Statement (Simplified)					
					Rs. in millions
Particulars	***For the year ended 31st March***				
	2011	***2012***	***2013***	***2014***	***2015***
Revenue from Operations	10244.04	15652.79	20995.60	22870.08	24793.55
Other Income	725.15	685.92	495.84	657.63	693.60
Total Income	***10969.19***	***16338.71***	***21491.44***	***23527.71***	***25487.15***
Cost of Goods Sold	6727.64	7075.02	7205.34	7076.89	7751.94
Other Expenses	1994.49	2150.65	2355.52	2570.32	2983.10
EBITDA	***2247.06***	***7113.04***	***11930.58***	***13880.50***	***14752.11***
Depreciation	792.45	935.69	1208.55	1540.76	1579.54
EBIT	***1454.61***	***6177.35***	***10722.03***	***12339.74***	***13172.57***

Finance Costs	464.56	431.90	399.80	449.40	554.98
EBT	***990.05***	***5745.45***	***10322.23***	***11890.34***	***12617.59***
Tax Expenses	101.18	104.78	93.55	-1.37	44.46
EAT	***888.87***	***5640.67***	***10228.68***	***11891.71***	***12573.13***

Extracts of Consolidated Balance Sheet					
					Rs. in millions
Particulars	***For the year ended 31st March***				
	2011	***2012***	***2013***	***2014***	***2015***
Non-Current Assets	7384.3	9302.07	10700.71	11251.42	10794.61
Shareholders' Funds	7566.96	7369.69	7344.04	7281.88	7693.05
Interest-bearing Non-Current Borrowings	4355.66	4226.63	3713.46	3937.66	2844.03
Current Assets	7627.30	5860.35	4172.2	3984.27	4546.98
Current Liabilities	2735.78	3076.19	3146.95	3292.07	4092.01
Total Assets	***15011.60***	***15162.42***	***14872.19***	***15235.69***	***15341.59***

Extracts of Cash Flow Statement					
					Rs. in millions
Particulars	***For the year ended 31st March***				
	2011	***2012***	***2013***	***2014***	***2015***
Cash Flows from Operating Activities	103.78	1520.04	1600.01	2304.60	3131.45
Cash Flows from Investing Activities	(2121.22)	(54.01)	(1078.10)	(1492.73)	(1147.97)
Cash Flows from Financing Activities	2646.03	(611.97)	(852.16)	(803.87)	(1354.25)
Purchase of Fixed Assets	(2005.80)	(2689.87)	(2452.10)	(1650.63)	(1460.67)

vii. ***IPO***: The current issue was to raise Rs. 11500 million with a price band of Rs. 316 to Rs. 328 per share using book building process. Currently, the number of shares held by owners is 170,940,744 with a face value of Rs. 10
The issue proceeds are planned to be utilised towards repaying of existing debt to the tune of Rs. 6328 million (in FY16); financing for expansion of coffee business to the tune of Rs. 2875.10 million (in FY16 – Rs. 1241.08 million; in FY17 – Rs. 1634.02 million) and rest to be used for general corporate purposes (evenly in the coming two years)

viii. ***Market & Competition***: Key players in the coffee outlets include Starbucks, Dunkin, CCD, Barista, Cost Coffee and other minor operators. Their respective market shares are given in the below table:

Brand	March 2008	March 2009	March 2010	March 2011	March 2012	March 2013	March 2014	Present Count of
Starbucks	-	-	-	-	2	32	40	64
Dunkin	-	-	-	-	7	20	29	50
Cafe Coffee	700	850	1,020	1,100	1,286	1,454	1,568	1,472
Barista	180	205	220	200	160	180	180	169#
Costa Coffee	41	48	58	75	96	100	100	82
CBTL	1	2	5	13	17	26	26	26

CDEL's competitors include the coffee outlets businesses as above; QSR operators such as McDonalds (WestLife), Dominos (Jubiliant Foodworks) and KFC, Pizza Hut (YUM); food and grocery businesses Nestle and HUL.

Swarup uses ***Enterprise DCF approach*** to arrive at the valuation. He decided to use some modifications in the process, as he normally does and calls it *Midas Touch of Swarup..!!*:

✓ He has decided to use CAPM approach to compute cost of capital. Considering that this company do not have historical data of prices, he wonders how to compute the beta. He has anyways collected below information relating to industry players (those which are listed):

	Jubiliant Foodworks	***Nestle India***	***HUL***
Beta	0.14	0.62	0.11
Debt Equity Ratio	0	0.37	0
Risk-Free Rate = 7.20% (RBI 10-year GOI yield)			
Nifty Monthly Returns annualised for the period 2011-2015 = 14.2%			

- ✓ The marginal tax rate for the corporate is 30%, and Swarup prefers to use this, instead of effective tax rate, which is negative in many years for CDEL

- ✓ He also wants to use a growth rate estimate as below. These rates are based on his discussions with few of his friends in the equity research industry and also few industry experts he keeps interacting on social networking platforms: *From 2016 to 2025 – 17% p.a*; *After 2025 – 3.50% p.a infinitely*. He consciously avoids using the sustainable growth rate as this is the case of IPO, which is expected to be a turnaround event and company's prospects will be way different from its past.
- ✓ He wants to assign weights to cash flows of last five years as below, for forecasting purposes, so that he is giving higher importance to latest cash flows:

	2011	***2012***	***2013***	***2014***	***2015***
Weights	0.10	0.10	0.20	0.30	0.30

- ✓ He decides to compute FCFF first and then reduce the debt component to arrive at FCF for equity shareholders.
- ✓ Swarup also wants to conduct a sensitivity analysis using Monte-Carlo simulation for changes in above growth rates.

Questions:

(1) Discuss the possible valuation biases Swarup is exposed to in valuing CDEL.
(2) How do you compute the beta for an unlisted company?
(3) Compute the post-issue cost of capital for CDEL.
(4) Do you agree with Swarup that sustainable growth rate of past cannot be applied in the case of valuing an IPO?
(5) What will be the projected FCFF for CDEL for the next 10 years and the terminal FCFF?
(6) What will be post-issue intrinsic value per share of CDEL?
(7) Conduct a simulation using MS-Excel for varying rates of growth of next 10 years from 12% to 24% (changing interval of 1%) and terminal growth rate from 0% to 6% (changing interval of 0.50%). What will be the expected post-issue intrinsic value per share of CDEL
(8) Discuss the areas of subjectivity involved in the entire CDEL valuation exercise of Swarup and what other alternatives were skipped in the process.

2. KEY PRINCIPLES OF LONG- TERM INVESTING*

Dr. Prasanna Chandra

According to Saurabh Mukherjea, successful long- term investing depends on:

- Relentless research
- Simple rules of thumb
- A reflective mind

Relentless Research
Successful investors search more widely, dig deeper, and keep an open mind to all ideas. The four broad areas that professional investors focus their research efforts on are:

- Sustainable competitive advantage
- Quality of financial statements
- Competence of promoters
- Integrity of promoters

Sustainable Competitive Advantage The first thing that long- term value investors consider is the sustainable competitive advantage or the strength of the franchise that the company enjoys.

What are the sources of competitive advantage? In his 1993 book, *Foundations of Corporate Success* (published by Oxford University Press), John Kay argues that sustainable competitive advantage can come from two sources: distinctive capabilities and strategic assets. According to Kay, distinctive capabilities are the relationships that a firm has with its customers, suppliers, and employees with cannot be replicated but its competitors. He divides distinctive capabilities into three categories:

- Brands and reputation
- Architecture (network of contracts with various stakeholders)
- Innovation

Compared to distinctive capabilities, strategic assets are easier to identify, as they are more tangible in nature. The most common strategic assets are:

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*This article is based on the book *Gurus of Choas: Modern India's Money Monarchs* written by Saurabh Mukherjea, CEO of the Institutional equities business at Ambit and published by BS books.

- Intellectual property (patents, copyrights, and proprietary knowhow).
- Legal rights (licenses and concessions)
- Captive mines
- Natural monopolies

Quality of Financial Statements Before analysing financial statements, the analyst must have faith in the reliability of financial statements. Assessing the quality of financial statements is tricky. Mukherjea believes that seasoned investors examine the following.

- *Cash conversion ratio* This is measured as cash flows from operations (CFO) divided by operating profits which is referred to as earnings before interest taxes depreciation and amortisation (EBITDA). Higher the CFO/ EBITDA ratio, better the quality of financial statements.
- *The cash tax rate* The cash tax rate is the amount of cash outgo (as per the company's cash flow statement) expressed as a percentage of profit before tax if this ratio is significantly lower than the statutory corporate tax rate (which is presently 34 percent in India) for several years, it can be a matter of concern. Unless the firm is granted tax exemption, this rate should be close to 34 percent.
- *Loans and advances* If the ratio of loans and advances to shareholders' funds is consistently high it may suggested that the company is giving substantial loans to other entities run by the promoters.
- *Reputation of auditors* Since auditors can be manipulated by the management- and there are many examples of this- seasoned investors focus on the quality and reputation of auditors.

Competence of Promoters Since most of the companies in India are managed by promoters, judging management competence is the same as judging promoter competence. What makes a good manager? As Anthony Boulton put it, "It is very difficult to summarise what a makes a good manager and how to assess this in a meeting, but the managements that normally impress me are those that have a detailed knowledge- strategically, operationally, and financially. They tend to be fanatical about the business, working long hours and demanding high performance from their team."

Integrity Of Promoters Promoters can short change minority shareholders in various ways: engage in related party transactions on terms that are unfavourable to the company; merge the listed entity with a family owned company on terms which are tilted in favour of the family owned company; award generous compensation to themselves and their family members; and so on.

To deal with this problem of ‘tunneling’ by the promoters, successful investors scrutinise the track record of the promoters and generally avoid listed companies where promoters have close political connections.

Simple Rules for Successful Investing

Successful long – term investors use a simple set of rules, which in Mukherjea’s words are as follows:

Rule 1 : Only buy a stock if you understand the business model.
Rule 2: Only invest in companies which can generate cash flows and high return on capital employed (ROCE) for long periods of time.
Rule 3: Buy the franchises identified by rule 2 when they are available at prices which build in a ‘margin of safety.”

Reflective Mind

To successfully invest for the long run, one must learn to control the ‘reflexive brain.’ As pointed out by Daniel Kahneman, human beings have a ‘reflexive brain’ that helps in dealing with external stimuli and reacting instinctively in the most effective manner possible and a ‘reflective brain’ that helps in thinking, analysing, and making intelligent decisions. While the reflexive brain has served us well for millions of years, it leads us astray in the modern world, where life is full of complicated problems beyond just immediate physical threats.

In the world of investing, under the influence of reflexive brain which usually dominates the reflective brain investors can fall into the following traps:

Trap 1: What you see is all is (WYSATI)
Trap 2: Anchoring and priming
Trap 3: An aversion to the unfamiliar
Trap 4: Overweighting low probabilities

Successful long –term investors train themselves to avoid these traps. They cultivate the reflective mind so that the investment decisions are not affected by the reflexive mind. More specifically, successful long –term display the following traits:

- Skepticism
- Risk aversion
- Openness of mind
- Patience and preparedness
- Contrarianism.

Is it possible to cultivate the traits required for long- term investment success? Scientific research in neuroscience and psychology suggests that these traits can be acquired even in advanced stages of adulthood provided we are willing to put in the required effort.

3. HOW ECONOMIC THEORY EVOLVED SINCE SAMUELSON'S REVOLUTION

Dr. Prasanna Chandra

In the real world, people display irrationality and limited willpower. But economic theory has progressively endowed economic agents with higher levels of rationality and willpower. This pattern in the evolution of economic theory can be seen by examining the models of consumption function proposed by three eminent economists: John Maynard Keynes, Milton Friedman, and Franco Modigliani.

In his seminal work *The General Theory of Employment, Interest, and Money*, John Maynard Keynes, the most influential economist of the first half of twentieth century, proposed a very simple consumption function. He assumed that if a household received some additional income, it would consume a fixed portion of that additional income- that proportion was termed by Keynes as the marginal propensity to consume (MPC). While Keynes believed that the MPC for a given household was fairly stable if its income did not change dramatically he agreed with Irving Fisher that the MPC varied widely across socioeconomic classes.

A couple of decades later, Milton Friedman, the most influential economist of the second half of the twentieth century, proposed the permanent income hypothesis which assumes that households have the foresight to smooth their consumption over time. In his model, if a family has an MPC of 90 percent and it received a windfall gain of \$ 1000 it would not spend \$ 900 more in the year of windfall. Rather, it would spread out. More specifically, Friedman proposed that households would use a three- year horizon to figure out their permanent income and divide the additional spending evenly over the following three years.

The next level of sophistication was suggested by Franco Modigliani, a Nobel laureate in economics, along with Richard Barro. Instead of looking at one year or three years, Modigliani's model considers an individual's lifetime income and is accordingly called the **life cycle hypothesis.** In his model, an individual would determine when young how much he would smooth his consumption over his lifetime (including the period of retirement), taking into account his bequest plan. Given this lifetime orientation, Modigliani shifted his focus from income to lifetime wealth. Richard Barro goes a step further. He assumes that parents are concerned about the utility of their children and grandchildren and since those descendants in turn will be concerned about their own children and grandchildren, the time horizon of parents will be effectively forever.

B.SNIPPETS

1. Honesty is Important for Value Maximisation

Given the significant erosion in the market capitalisation of British Petroleum (in the wake of oil spills) and Volkswagen (in the wake of emission standards scandal), the stock market is giving its own answer to the question, “Is honesty for suckers?” The verdict is clear: “Honesty is important for companies that want to maximise value over the long run.” While some corporations will get away with cheating, the risk of being caught is always there. Often this risk is just isn’t worth taking, particularly for corporations whose brands’ reputation is a major asset. As Peter Singer put it, “Honesty maximises value over the long term, even if by ‘value’ we mean only the monetary return to shareholders. It is even more obviously true if value includes the sense of satisfaction that all those involved take from their work.”

2. Corporate Governance in China

In the last four decades, China has achieved unprecedented economic growth, which has increased its per capita GDP from one of the lowest in the world, to a level that is in the middle of the international ranks. So far China’s success has come without the development of many of the key institutions such as private property rights, shareholder – oriented corporate governance, and a well- functioning impartial legal systems. China describes its system as “market socialism with Chinese characteristics.” As Randall Morck and Bernard Young put it, “Markets, not decrees, set most prices, while the state, in the form of the Communist Party continues to control the careers of SOEs’ senior executives, regulators, and government officials, and retains ‘options’ to intervene in a large variety of financial and corporate affairs as well as judicial processes and systems.” It seems that unless China develops the missing intuitions, it will be difficult for it achieve the high- income status.

3.A Strategic Alliance of Three Partners

In 2016, Tata Motors, Bharat Forge, and General Dynamics Land Systems (GDLS) of the U.S. signed an agreement for the ministry of defense’s (MoD’s) Future Infantry Combat Vehicle (FICV) Programme….FICV is billed as a project worth $ 11 billion (₹78000 crore). Tata Motors will lead the consortium.

Tata Motors has strengths in design, development, and integration of mobility platforms. Bharat Forge has competence in fighting platforms and manufacturing. General Dynamics has expertise in systems integration.

Commenting on this consortuim, Ravi Pisharody of Tata Motors said, “Defence particularly needs partners with long- term commitments, to see products and solutions through multiple generations of evolution. We three have joined hands for a complete FICV solution for the armed forces.”

4. Brand Valuation

Questions have been raised by lenders on what basis Grant Thorton valued the Kingfisher brand at ₹ 41,00 crore. This is being probed by the Serious Fraud Investigation Office (SFIO).

A Grant Thornton spokesperson said the firm fully stood by its brand valuation report on Kingfisher. He said, “We believe it was appropriate in the context of when it was done and the purpose for which it was done.”

Kingfisher Airlines operating license was suspended in October 2012 by the Directorate General of Civil Aviation.

RBSA advisors, a global valuation and transaction advisory firm, carried out two valuation exercises of KFAL brand in 2013 and 2015. In 2013 the KFA brand was valued at Rs. 200 crore and in 2015 it was valued at Rs. 100 crore.

PART C: WIT AND WIDSOM

1. HUMOUR

- A Congressman said to Horace Greeley one day: “I am a self made man.” “That , Sir,” said Greely, “relieves the almighty of a great responsibility.”
- Bernard Shaw was walking on the ridge of a wheat field. A person came from the other side. Since the ridge was narrow, Bernard Shaw requested him to step down for few seconds. The person replied arrogantly, “I don’t give way to fools.” Bernard Shaw stepped down without protest and said, “But I do.”

2. WISE SAWS

- “A wise man’s question contains half the answer.” IBN Gabirol
- “When love and skill work together expect a masterpiece.” John Ruskin