

Hammer & Jason Limited

Business Valuation & Assessment of an Acquisition Offer

ACS
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Disclaimer:

This is a sample report created by using a fictitious businesses as an example. The purpose is to demonstrate the quality of ACS reports. This sample must not be used as a guidance for any investment decisions.

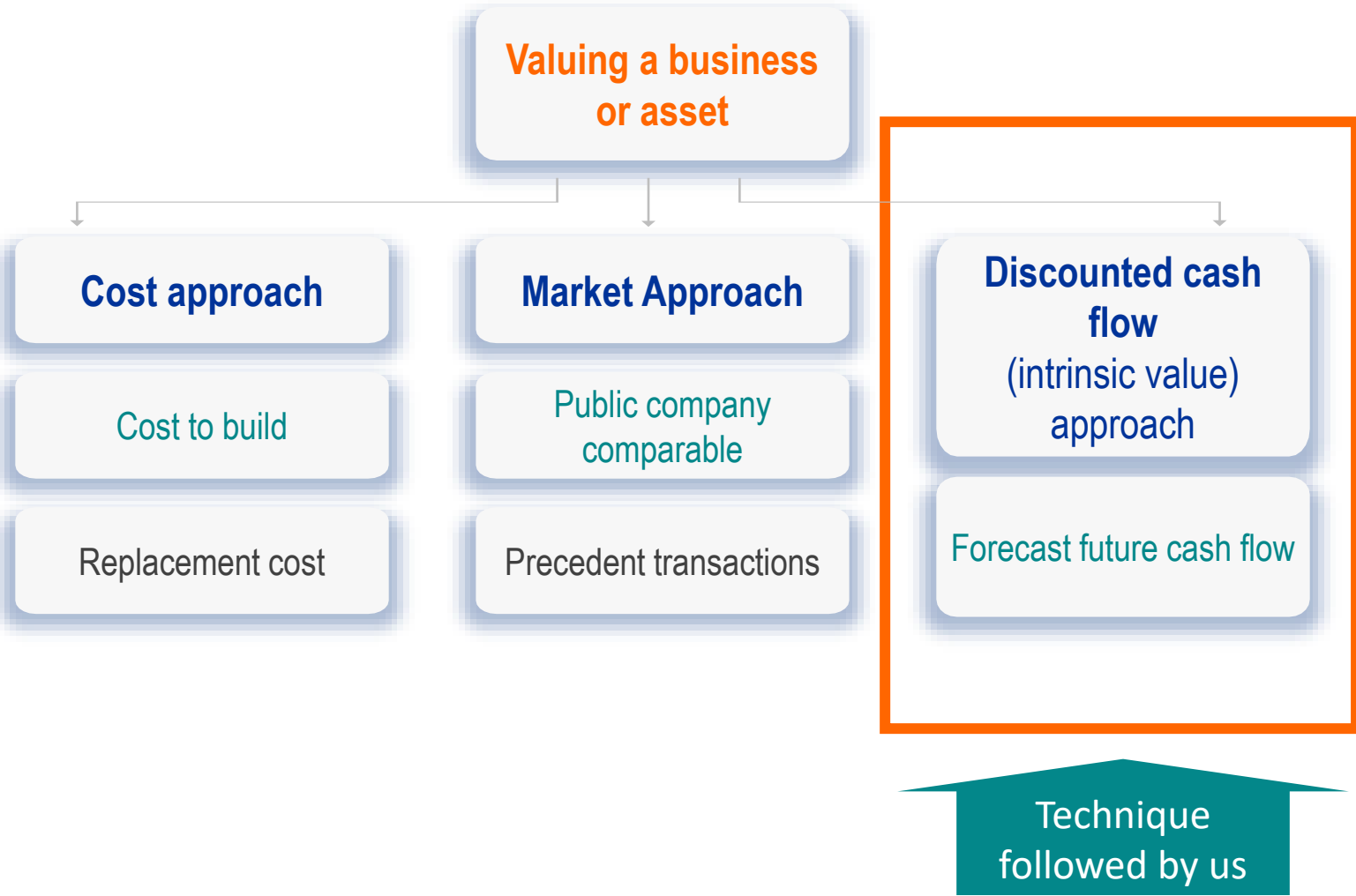


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To further highlight that this is a sample report, certain figures and facts have been intentionally distorted to abnormal levels. For instance, the levered beta and WACC calculation have been made abnormally high. Also, the report has been made with slight different numbers than what is contained in the financial model.

Overview of financial valuation techniques



Since our primary objective for this valuation exercise is the evaluation of the 'all-cash' acquisition offer, using a **precedent transaction approach** could be very useful as it would include any takeover premium. However, identifying a suitable precedent transaction is a difficult and restrictive process so we are not attempting to use this valuation technique at this point in time.

The **discounted cash flow** methodology establishes the intrinsic value of the business (i.e. ignoring the value of any synergies for the acquirer). This technique relies on the accuracy of a financial forecast for the business and then uses the estimated **average cost of capital** to discount the forecast future cash flows to arrive at a value of the business today. In the circumstance, this technique should be a preferred technique and therefore has been followed for the purpose of this exercise.

An overview of valuation assumptions & Limitations

Valuation is an **art** and a **science**



Science

1. Historical financials
2. Ratios
3. Assets
4. Track record
5. Statistical analysis



Art

1. Management team
2. Culture and Strategy
3. Forecasting
4. "Moat"
5. Competition
6. Macroeconomic factors
7. Cost of capital

Valuation is based on **expected future performance** not past performance and involves:



An analysis of the **financial history** and prospects of the business, project or asset



Forecast the future operations of the business, project or asset



Analysis of the **industry**



Analysis of the **economic environment**



Applying acceptable **valuation methods**

There are various **valuation methodologies** which may arrive at **differing values** for a **business, project or asset**.

How **Cost of Capital** is established?

Weighted Average Cost of Capital or **WACC** =

(**Cost of debt** x proportion of debt in capital) +
(**Cost of equity** x proportion of debt in capital)

Challenges with calculating **Cost of Capital** for a private company

Whilst establishing the after tax **cost of debt** for most private companies is fairly straight forward, establishing the **cost of equity** poses many challenges. It is usually established with reference to the **risk free rate** and **equity risk premium** in the relevant economy and the **beta** of the business. All these values are challenging to establish with certainty.

Overview of the market/industry landscape

Global speakers market | Size and growth rates

The global speakers market is expected to grow at a CAGR of over 18% during 2018-2023, and the market size will increase by USD 42.67 billion during 2018-2023. The market's growth momentum is expected to decelerate throughout the forecast period.

North America was the largest market in 2017, and its position will remain the same during 2018-2023. Market growth in this region will be faster than the growth of the market in rest of the world. According to analysts **about 32% of the overall market growth will originate from this region**, and the US will offer maximum growth opportunities to market participants.

Global speakers market | Major growth drivers

Rapid advances in technology, changing end-user preferences, increasing partnerships between smart speaker vendors and security service providers, and the rising adoption of music streaming services are some of the factors fuelling speakers market growth globally and especially in the US.

The market is fragmented, and the degree of fragmentation is expected to increase by 2023. **Decelerating growth would drive up the competitive intensity by 2023.** Market participants would need to focus not only on the opportunities on the demand side but also prepare themselves for increasing competitive pressures by 2023.

Global speakers market | Segmentation and trends

Smart speakers, home audio speakers, and portable speakers are the major types of speakers currently available in the market. Smart speakers were the most popular product in 2017, and this segment's position is expected to remain unchanged throughout the forecast period. During 2019-2023, the growth rate of smart speaker and portable speaker segments will be faster than the global market growth.

The increasing penetration of smart homes and multi-room solutions and the growing adoption of digital content will boost the smart speakers market growth during the next five years.

The growing focus on **AI-ready speakers** will be a critical trend fuelling the growth of the speakers market size. Several vendors are incorporating AI technology into their products to track user behaviour through smart bands, connected appliances, and smart security devices.

The growing demand for **high definition (HD) streaming** has led to the development of new and innovative technologies such as wireless HD and ITU-T G.hn. The launch of portable and smart speakers will further boost the popularity of wireless audio streaming. The growing popularity of wireless streaming of audio content coupled with the integration of AI technology in speakers will drive market growth at a CAGR of over 18% during the forecast period. However, the market's growth momentum will decelerate during the forecast period because of the decline in year-over-year growth.

Assessment of business's strategic position

SWOT Analysis

STRENGTHS

1. Mature business which probably has a **moat** built around its quality reputation and unrelenting commitment to maintain that reputation.
2. Well established **distribution networks** around the globe.
3. History of fairly **stable and solid EBITDA**, very healthy Gross & Net Margins.

WEAKNESSES

1. Plant/production **capacity** constraints.
2. Low **asset turnover** (must be benchmarked against competitors & best in class).
3. Lack of primary business/financial focus.
4. Weak **marketing/promotional** function

OPPORTUNITIES

1. Growth prospects in **Asia & North America**.
2. Possibility of establishment of '**Direct to Customer**' online sales channels eliminating the distributors & retailers where possible.
3. Possibility of **leveraging quality reput**e to develop product varieties more in-line with mainstream public needs and sell at premium prices to a wider market.

THREATS

1. Slowing overall **growth** (volume as well as revenue) and falling sales in UK market (should be an immediate cause of concern)
2. High **gearing**
3. Weakening of **Euro against GBP**. This could be partially addressed by establishing assembly bases in Eurozone as well.

Overall Strategic Position

The business on whole has a solid set of strengths. It does not seem to suffer with any such weaknesses or face any such threats which could not be overcome by appropriate strategy response.

By building on its strengths of being a long established business with a possible quality connected moat around its brand name and a well established dealer network around the globe, the business is rather very well placed to take advantage of the opportunities for market expansion and growth.

For better alignment of objectives, the primary business mission should be revisited and clarified. There is not necessarily a tension between a financial/business focus and commitment to excellence. Rather, an unrelenting commitment to quality & excellence should be a source of competitive advantage and not a hinderance to it.

Assessment of business's future outlook

Refer to the sheet
Revenue Assumptions in
the excel model

Three scenario assumptions: Without a fundamental change in production capacity

Base Case Scenario

1. Recent trend of reduction in sales in UK will be halted and the company will be able to continue operating in the local UK market with at-least stagnation in sales growth (at current levels).
2. Since the company already has strong presence in Western Europe, it will continue to see at-least modest sales growth in Eurozone.
3. Sales growth in Asia & Rest of the word (including North America) will continue at least at decent moderate levels.

Upside Case Scenario

1. Recent trend of reduction in sales in UK will be reversed and decent growth will resume.
2. Demand growth in Eurozone will stay robust.
3. Sales growth is in Asia & Rest of the word (including North America) will meet or exceeds expectations/prospects.

Downside Case Scenario

1. Recent trend of reduction in sales in UK will **NOT** be halted any time soon.
2. Since the company already has strong presence in Western Europe, further growth will become increasingly difficult to get and growth will be at very modest levels.
3. Sales growth is in Asia & Rest of the word (including North America) stays considerably below current expectations.

Most likely growth outlook fundamentals

Production capacity & throughput

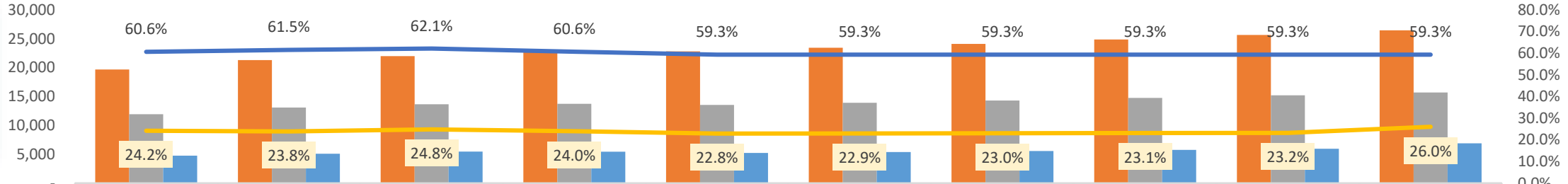
1. Existing **production facilities** have a theoretical capacity of around **61,540** units. Last year (2017) the company utilized around **80%** of that installed capacity.
2. However, it is not clear if an immediate increase in the production capacity could result in increased sales. It has to be investigated what is the **total addressable market** and what share of that market can be acquired by a combination of more keen marketing efforts and **product variations** to suit new market segments needs.
3. We therefore are working within the constraints of our existing capacity and assume that the company will continue to operate with the existing production capacity. It should also be mentioned that automation is not the only possible means to reduce cycle time and enhance productivity. Potentially the **elimination/reduction of all wasteful time and motion** (like gaps in the supply chain) potentially could increase the throughput rate. At the moment, **inventory turnover ratio** is just above 8. This is not a great figure considering the rather simple assembly processes involved. Arguably, there could be inefficiencies in the supply chain which could be removed to enhance throughput.

Revenues, cost & margins

1. **Sales volume in the UK** (which make a significant portion of the total sales i.e. around 30% of total sales volume last year) have been falling for the past two years. In the years prior to the last two year, sales in UK were growing at a decent rate. A thorough investigation into the causes is recommended with a minimum objective to halt sales at the current levels. If the company is successful in halting a further fall in sales in UK, it is likely that incremental strategic steps will ensure a gradual pick up in growth to modest levels.
2. Although **sales volume growth rate in Eurozone** reduced from **10.3 %** (in 2016) to **6.2%** last year, there seem no major challenges or disruptions in the market (other than a gradual strengthening of Sterling) and it looks likely that sales volume growth in the Eurozone will stay stable at modest to good levels. **North America** and **new markets in Asia** could have huge potential, however these are unchartered territories and most likely assumption should be at-least modest growth in these markets.
3. **The market size, share and growth** (and not the production capacity) seem to be main limiting factors at the moment. The revenue per unit has seen a consistent and slight reduction in the past five years, however this could have been caused by either changing exchange rates or due to economies of scale (enabling a slight reduction in price) or it could have been caused by competition pressure (for instance in the Korean market). Since we do not see an alarming trend there, and there are no unusual visible risk factors in the environment threatening a material downward price push, it is reasonable to assume that the company should be able to drive more or less consistent level of prices per unit.
4. **Gross margins** (on per unit basis as well as overall basis) as well as **operating & net margins** have shown a slight downward trend over the past few years. However the movements have not been dramatic and it will not be unreasonable to assume that in the forecast years the margins will more or less stay constant at the last year level.

Projections of the company's financials

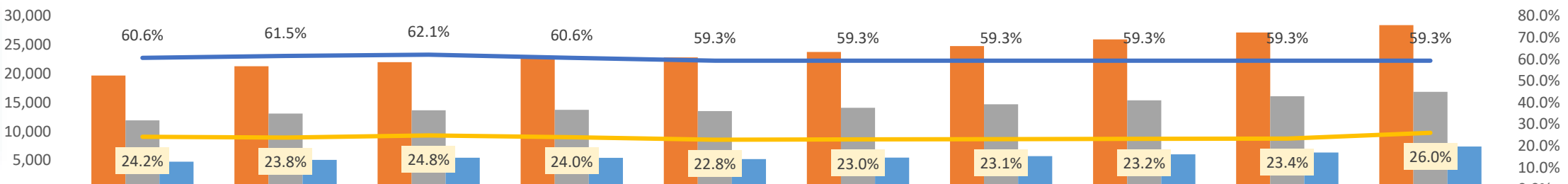
Base Case scenario



	2013 A	2014 A	2015 A	2016 A	2017 A	2018 F	2019 F	2020 F	2021 F	2022 F
Revenue	19,667	21,288	21,991	22,655	22,807	23,442	24,103	24,859	25,643	26,457
Gross Profit	11,919	13,091	13,659	13,738	13,527	13,904	14,295	14,744	15,209	15,692
Net Earnings	4,752	5,074	5,452	5,432	5,211	5,376	5,548	5,744	5,948	6,880
Gross Profit Margin	60.6%	61.5%	62.1%	60.6%	59.3%	59.3%	59.3%	59.3%	59.3%	59.3%
Net Earnings Margin	24.2%	23.8%	24.8%	24.0%	22.8%	22.9%	23.0%	23.1%	23.2%	26.0%

Revenue Gross Profit Net Earnings Gross Profit Margin Net Earnings Margin

Upside Case scenario



	2013 A	2014 A	2015 A	2016 A	2017 A	2018 F	2019 F	2020 F	2021 F	2022 F
Revenue	19,667	21,288	21,991	22,655	22,807	23,753	24,781	25,929	27,134	28,398
Gross Profit	11,919	13,091	13,659	13,738	13,527	14,088	14,697	15,379	16,093	16,843
Net Earnings	4,752	5,074	5,452	5,432	5,211	5,457	5,724	6,023	6,336	7,385
Gross Profit Margin	60.6%	61.5%	62.1%	60.6%	59.3%	59.3%	59.3%	59.3%	59.3%	59.3%
Net Earnings Margin	24.2%	23.8%	24.8%	24.0%	22.8%	23.0%	23.1%	23.2%	23.4%	26.0%

Revenue Gross Profit Net Earnings Gross Profit Margin Net Earnings Margin

Major assumptions made for this valuation exercise

WACC Assumptions & Calculations

Gross Cost of Debt	5.0%
Effective Tax Rate	20.0%
Cost of Debt Net of Tax Shield	4.0%
Risk Free Rate in the UK (01 Jan 2018)	1.26%
Equity Risk Premium in the UK (Jan 2018)	5.89%
Implied Market Return	7.15%
Implied Levered Beta	3.47
Cost of Equity	21.7%
Debt to Equity Ratio	269.8%
Proportion of Debt in Capital	73.0%
Proportion of Equity in Capital	27.0%
WACC	8.8%

Valuation Assumptions

Effective Tax Rate	20%
Discount Rate (WACC)	8.8%
Perpetual Growth Rate	3.0%
EV/EBITDA Multiple	13.0x
EV/EBIT Multiple	18.0x
Valuation Date	01/01/2018
Fiscal Year End	31/12/2018
Offer Value USD' 000	145,000
USD to GBP Conversion Rate	0.78
Offer Value GBP' 000	113,100

Levered beta is very high because of the company's high financial gearing ratio. Alternative assumptions lowering this value will have significant effect on the valuation figure

Beta Calculation

Average Unlevered Beta, UK, Jan 2018

Consumer Electronics Industry -> 1.10

Levered Beta = Unlevered Beta x ((1 + (1 - Tax Rate) x (Debt / Equity))

Levered Beta 3.47

Business Strategy, Underlying Business Model & Capital Structure

1. This valuation exercise does not assume any fundamental change in the business strategy or underlying business model. It attempts to estimate an intrinsic value of the business under the assumption that it continues to operate and seek organic growth with no fundamental change in the mission, competition strategy, marketing and expansion/diversification strategy.
2. The model does not assume replacement of long-term debt after the 10 years note matures in 2021. The result is an assumption that dividend pay-out pattern will have to alter to accumulate sufficient cash for the repayment of the long-term debt. An alternative method would be to assume replacement of existing debt by issuing fresh debt. However such a method will require detailed debt modelling including estimation of the cost of issuance of new debt.

Estimating the intrinsic value of the business

Refer to the excel model for seeking valuation with amended assumptions.

Discounted Cash Flow	Entry	2018	2019	2020	2021	2022	Exit
GBP' 000	<i>01/01/2018</i>	<i>31/12/2018</i>	<i>31/12/2019</i>	<i>31/12/2020</i>	<i>31/12/2021</i>	<i>31/12/2022</i>	<i>31/12/2022</i>
EBT		6,720	6,935	7,180	7,435	8,600	
Interest		900	900	900	900	-	
EBIT		7,620	7,835	8,080	8,335	8,600	
Less: Cash Taxes		1,524	1,567	1,616	1,667	1,720	
Plus: D&A		1,061	1,090	1,125	1,160	1,197	
EBITDA		8,680	8,925	9,205	9,496	9,797	
Less: Capex		1,061	1,090	1,125	1,160	1,197	
Less: Changes in NWC		(29.6)	63	65	81	77	
Unlevered FCF		6,126	6,205	6,399	6,587	6,803	
Exit Value							134,372
Net FCFE	(129,907)	6,126	6,205	6,399	6,587	6,803	134,372

Discounted Cash Flow	Entry	2018	2019	2020	2021	2022	Exit
GBP' 000	<i>01/01/2018</i>	<i>31/12/2018</i>	<i>31/12/2019</i>	<i>31/12/2020</i>	<i>31/12/2021</i>	<i>31/12/2022</i>	<i>31/12/2022</i>
EBT		6,821	7,155	7,528	7,920	9,231	
Interest		900	900	900	900	-	
EBIT		7,721	8,055	8,428	8,820	9,231	
Less: Cash Taxes		1,544	1,611	1,686	1,764	1,846	
Plus: D&A		1,075	1,121	1,173	1,228	1,285	
EBITDA		8,796	9,176	9,601	10,048	10,516	
Less: Capex		1,075	1,121	1,173	1,228	1,285	
Less: Changes in NWC			98	102	121	120	
Unlevered FCFE		6,177	6,346	6,640	6,935	7,265	
Exit Value							144,010
Net FCFE		6,177	6,346	6,640	6,935	7,265	144,010

Terminal Value	GBP' 000
Perpetual Growth (3.0%)	120,958
EV/EBITDA (13x)	127,359
EV/EBIT (18x)	154,798
Average	134,372

Base Case scenario

Intrinsic Value	GBP' 000
Enterprise Value	113,178
Plus: Cash	1,193
Less: Debt	18,000
Equity Value	96,372

Terminal Value	GBP' 000
Perpetual Growth (3.0%)	129,172
EV/EBITDA (13x)	136,703
EV/EBIT (18x)	166,156
Average	144,010

Upside Case scenario

Intrinsic Value	GBP' 000
Enterprise Value	120,408
Plus: Cash	1,193
Less: Debt	18,000
Equity Value	103,601

Options Assessment & Recommendations

**BUSINESS
VALUATION**



INVESTME
PROFIT
RISK
BUSINESS
LOAN



Proposition evaluation

Attractiveness of the offer in isolation of other factors: Since Hammer & Jason is a mature stable business, the forecast free cash flows at reasonably moderate growth level seem very probable. It is essentially the cost of capital and exit value multiples (that we choose to use for this exercise) which are decisive in establishing a theoretical equity value.

Seeking to establish a realistic value, we believe that the assumptions we have made for this valuation are very conservative and the chances of over-valuation are minimal. Keeping the above in mind, the offer/bid presents about **17 % upside** to your existing equity value assuming the most likely growth scenario and about **9% upside** assuming an optimistic growth scenario. Provided the points raised in the discussion below are fully considered, theoretically speaking, the shareholders could benefit by accepting this offer.

It must however be remembered that by assuming a slightly lower cost of capital the theoretical intrinsic value would appear to be higher than the offer value. For instance, under the most likely growth scenario, if we are able to assume that the cost of capital is 7% or lower, the intrinsic value of equity will exceed the offer value.

Emotional factors: In addition to evaluating the absolute financial attractiveness of the offer, the shareholders must establish if a total exit is in line with their life objectives, goals, aspirations, lifestyle etc. The business was probably established more as a pursuit of a passion rather than a commercial enterprise and 20 years down the line, it is very possible that the pursuit of similar passionate objectives are still very dear to a majority of the shareholders. i.e. emotional factors are extremely important for this decision and must not be ignored completely.

Source of income & taxation implications: The business has kept a very high dividend payout ratio. It must therefore be evaluated by the shareholders how do they propose to replace that source of income i.e. do they have any other investment opportunities which could provide them with a similar dividend yield? In addition, the tax implications for the shareholders (of a complete sale) must also be considered.

Value of the business as a going concern with amended strategy: The receipt of an unsolicited all-cash offer from a US based competitor also (in a way) reaffirms the business's strong position in UK and Euro zone. With active pursuit of a well-defined growth strategy, the business could potentially grow many folds than what seems probable at the current levels. If majority of the shareholders do not aspire a total exit, the business could use this offer as a basis for future strategy development i.e. how to consolidate position in UK and Eurozone, how to expand capacity and how to capture new market share (US, Asia etc.). Non-organic growth initiatives i.e. acquiring competitors in US and Asia could also be evaluated.

Pros and cons of each response option

Response option one: Urge fellow shareholders to accept the bid

Pros:

1. An immediate all-cash exit opportunity with decent possible equity upside.
2. An opportunity for all shareholders to seek new investment avenues.
3. Potentially an opportunity for some shareholders to retire (if desired).

Cons:

1. Complete exit. Resulting in loss of source of income (dividends). Alternative options with such high dividend yield could be difficult to find.
2. Possible loss of employment (for employees holding shares as well as for the chairman)

Response option Two: Urge fellow shareholders to reject the bid

Pros:

1. Total exit will be avoided.
2. Could focus on growth strategies with the comfort of business value affirmation.
3. Preservation of employment as well as source of income (dividends).

Cons:

1. Could be a missed exit opportunity. The offer potentially includes the values of synergies and takeover premium. There might not be other buyers in the future who put similar value to those synergies.

Response option Three: Suggest that the bid be put off, and engage sell-side advisors to run a formal process

Pros:

1. Possibility of exploring better sale options.
2. Avoid the possibility of a knee-jerk kind of decision.

Cons:

1. Could be a missed exit opportunity.
2. Added cost.

Advice on how to best proceed

Mr. Chairman, you are a major shareholder as well (holding 10% of the equity). To begin with, you should evaluate the points highlighted in the discussion above to establish if a total exit is in line with your objectives and circumstances. Essentially this should be the starting point on this assessment exercise and not the financial attractiveness (or otherwise) of an acquisition offer. All the shareholders (including yourself) have to convince themselves that they are willing to take a total exit from this business, provided a decent offer is received,

I advise that you call a general meeting of the shareholders (formal or informal) and present this opportunity to them with pros and cons of each possible response option. I would further advise that you do not take an affirmative position at the very outset of your presentation (one way or another) and rather try to present the opportunity in the most objective manner possible. i.e. avoid being perceived as having a firm preconceived agenda.

You can begin by presenting the business valuation exercise that we have performed whilst highlighting the limitations of any valuation exercise at the same time. You may then draw a conclusion that under the circumstances the offer potentially represents a very decent opportunity to take an exit and realize investment gains provided all the shareholders seek such an opportunity. At this point, you may speak your mind and tell them that what will be your own preference.

You can then carry on with discussions on the future prospects of the business with an appropriate growth strategy formulation and implementation. At the same time you should also highlight the uncertainty of any future plans which could add weight to the argument for realizing the investment gains rather than carrying on to run the business.

Provided the shareholders develop a consensus on selling the business at this offer price, you should convey the decision to the bidder and prepare for a due diligence exercise which they will most likely want to perform before concluding the deal.

If the shareholders cannot develop a consensus on accepting the price offered, but they agree that they will be willing to sell provided a better offer is received, you can look into engaging sell side advisors to engage the existing bidders to better the price offered or identify and facilitate better deal opportunities. A cost benefit analysis must be done before engaging sell-side advisors.

An additional option would be to evaluate (and then propose to the bidder) any prospects of a merger rather than a sale of business by the existing shareholders i.e. all the shareholders may be issued with shares of the merged entity.

If the shareholders reject the idea altogether on the grounds that they do not want to sell, then focus should be kept on continuing to build the shareholder value rather than seeking buyers.

Hammer & Jason Limited

Business Valuation &
Assessment of Acquisition Offer

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Thank **you**

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