

Valuation Insights

Control Premium

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What is Control Premium?

Assessing the right value of a target company is one of the most important aspects of any M&A transaction. The value of target, in addition to several factors like quality of management, financial performance and future outlook, also depends on whether a controlling stake is being acquired in the target or a minority stake. Traditionally it has been observed and widely accepted that an investor, on a per share basis, would be ready to pay a premium to buy a controlling stake in the company versus buying a minority stake.

This premium is easily observable in transactions where the target is a listed company. For example, in a recent transaction, Sun Pharma bought Ranbaxy for an implied value of approx. INR 455 per share which was at a premium of approx. 20% to Ranbaxy's market price. In another transaction, Baring Private Equity Asia bought a controlling stake in Hexaware Technologies Ltd. for INR 135 per share, reflecting a premium of approx. 12% over its pre-acquisition market price. This premium, as observed in the aforementioned transactions, is often referred to as “control premium” or “acquisition premium”.

Summary of items included in this newsletter

Page 1

What is Control Premium?

Page 2

Why do we need to know about Control Premium?

Page 4

About Grant Thornton

Page 2

What drives Control Premium?

Page 3

Empirical analysis of transactions involving Controlling Stake

Page 6


Contact us

What drives Control Premium?

The acquirer pays a premium for a controlling stake because, unlike a minority stake, the acquirer can generate incremental value from the target by exercising prerogatives of control like ability to change the management, take better decisions for the company, change the capital structure to a more optimal level, etc. Further in case of strategic acquisitions, the acquirer, in addition to aforementioned benefits of control, could also generate incremental value through synergies derived from the target.

In case of the Baring-Hexaware transaction, Baring being a financial investor would have mainly expected to generate operational improvements by virtue of control, though it could have also generated revenue synergies for Hexaware from its portfolio. While in case of the Sun Pharma-Ranbaxy transaction, Sun Pharma mainly expected to generate significant synergies in the form of gaining a leadership position in the branded generics market, cross selling their products, operational synergies from procurement and supply chain efficiencies and also reducing the compliance costs by substituting Ranbaxy's FDA affected products with its own products.

Further, if there are several potential acquirers who are able to generate the aforementioned incremental value from the target, the existing shareholders of the target would have a better bargaining power to realise a larger share of this incremental value. Hence, the quantum of control premium being shared with the existing shareholders is dependent not only on the quantum of incremental value an acquirer expects to generate from the target, but also on the nature and number of potential acquirers. Since these factors vary significantly for each target, one can observe a wide range of premiums being paid in acquisitions ranging from nil to as high as 100%.



Very often in consummation of a deal, Control Premium plays a critical role. The right price determination is generally based on the perceived benefit of the acquirer in owning and managing the company his way.

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Why do we need to know about Control Premium?

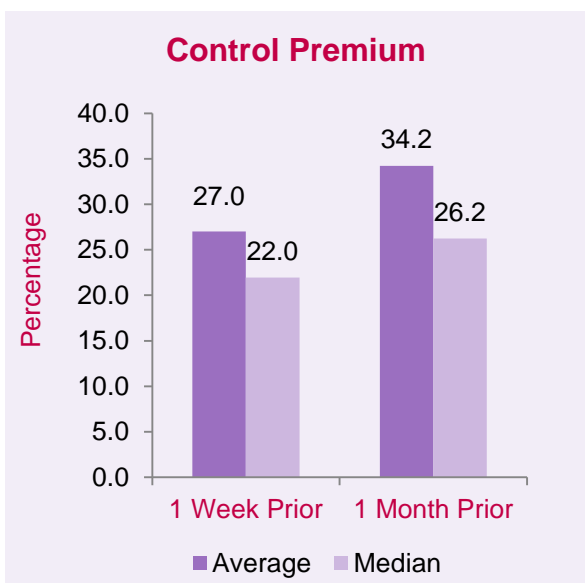
Though the premiums paid in transactions vary significantly, an empirical analysis of the historical premiums in the control transactions can be useful for the acquirer and seller in negotiations. It can also be useful for shareholders of the target in evaluating whether the shares should be tendered in an offer made by the acquirer.

Further, the control premium can become an important input for valuation of privately held companies for non-transaction related purposes e.g. for litigation, regulatory purposes, financial reporting, etc. In these valuations, where there is no willing buyer or a willing seller involved, the control premium data derived empirically could become a very important input in estimating the right value of the business being valued.

An empirical analysis of a transaction involving Controlling Stake.

For the empirical analysis, approximately 90 mid to large transactions carried out in India during the last 10 years involving acquisition of controlling stake in listed targets were identified. The 1 month and 1 week control premium was then calculated for each target by comparing the offer/acquisition price with the market price prevailing 1 month and 1 week prior to the announcement of the acquisition.

As per the chart below, the average 1 month and 1 week control premium paid in these transactions was estimated as 34.2% and 27.0% respectively; while the median control premium was approx. 26.2% and 22.0% respectively.

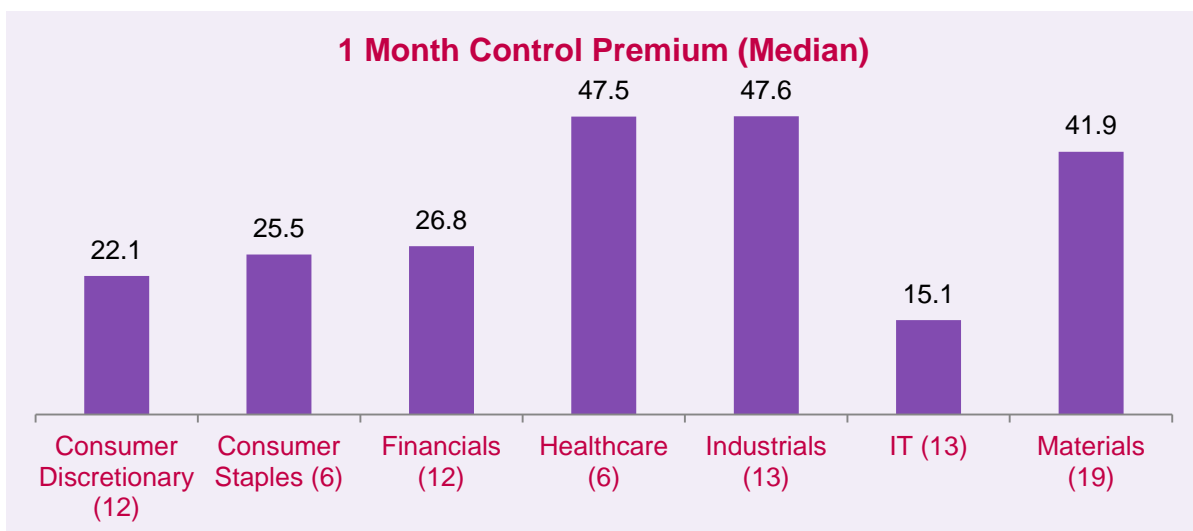


Since the average premium could be influenced by a few outlier transactions, a median was considered as a better measure.

Further, 1 month median control premium was considered as a better measure as 1 week market prices before the transactions could have been influenced by leakage of information on the transaction. Accordingly, based on the median 1 month control premium, the premiums paid in control transactions in India could be broadly considered to be approximately 26%.

An analysis of control premiums across various industries indicates that the control premiums have been lowest in the IT industry while being the highest in the healthcare industry. The higher premiums observed in healthcare, industrial and materials industries could be on account of scarcity of good assets and also due to involvement of foreign acquirers expecting to generate significant synergies from Indian targets.

Though it is difficult to generalise based on the lower number of transactions involving listed IT sector companies, the lower premiums observed in the IT sector might indicate that there are not too many acquirers trying to derive synergistic benefits from Indian IT companies. On the contrary, India IT companies have been acquiring smaller and niche targets outside India.



In a nutshell

To conclude, despite variance across various industries, significant control premiums, with a median of approximately 26%, have been paid historically to buy controlling stake in Indian companies. However, this figure should be considered only as a reference or starting point.

The appropriate premium for any target over the prevailing market price or the pre-acquisition value of the target, should be evaluated based on the industry in which the target operates, an analysis of the incremental value that can be generated from the target by exercising control, the number and nature of potential acquirers for the target and the kind of synergies potential acquirers can generate.

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