

## The true value of Indian Hotels – Sada’s analysis

**N.R Parasuraman**

“Short-term financing is not given importance by the finance team or management team in most companies, to the extent they spend hours on long-term capital budgeting. Little do they realize that so much of possibilities are there in optimizing short term finance and make the bottom line all the better for it” .

The above statement was ringing in the ears of SadaVasrun. His professor of Finance in the management program he did 4 years back, would keep saying this (or words to this effect) over and over again. While this used to be a point of humour for students then, today Sada felt that it was indeed true in his company. The company which he joined straight from campus – Evegreen and Yellow Finance- was gaining in market respect and stature. Originally started in 2004 as a share broking services company, the company steadily widened its scope of activity, such that it was an investment consultant now and had many key international clients interested in investing in Indian companies. Sada joined the company as a Management Trainee with an initial work of analysing and valuing a host of companies and over time, was able to establish himself as a solid worker with a penchant for accuracy in his records and conclusions. Within a very short time he got projects involving more in-depth analysis and conclusions and a couple of months back was promoted as an Associate Manager in the Portfolio Analysis department.

Sada received a call from his boss HeeraNeerajit. Heera was a workaholic with a special ability to spot great valuations and potential. She has been engaged by a Dubai firm for



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working on the financial position of Indian Hotels Limited and compare and comment on the prospects of the company in terms of the parameters in the whole industry. There were two aspects to Heera's style that Sada was well aware of. First, she would want comprehensive and incisive details about every single parameter in the comparison. Her reports (and those that she wanted to be sent to her) would have a summary page of key findings, but an elaborate essay running into several pages of explanations on each of the points. Secondly, Sada knew that Heera would not be satisfied with just a discussion on the ratio and profitability parameters, but would actually be looking for valuation drivers. He knew that he would have to be careful here, because he cannot afford to miss a possible driver and the same time cannot exaggerate the significance of an unimportant one.

Sada recalled that when they dealt with the subject in the management program, his professor would recall the importance of literature review and the findings from the latest research. The professor was always clear that the fundamental purpose of research is to aid decision-making. Sada rummaged his old papers and books taken as a legacy from his management program and could zero in on several theories which appeared relevant. The Capital Assets Pricing Model and Du Pont analysis seemed to have application here. Sada then took from the corporate database the key parameters in the hotel industry and separately those relating to Indian Hotels. Similarly, he took the Profit & Loss account of the industry as a whole and compared this with Indian Hotels.

Among the archive papers, Sada also got hold of the class notes the Professor had given them regarding the key concept of cost of capital. This read as follows:

One of the first measures that is to be determined before we decide whether a project is viable or not is what the expectations of the lenders and the shareholders are. Shareholders invest money in a company partly for the periodic dividend and partly for the capital appreciation of the shares. Lenders give loans to companies with the expectation of a specified income, which is relatively less risky. In other words, the company has to be making a specified amount of profit to enable it to satisfy the shareholders and lenders. The cost of servicing the various providers of capital is called the cost of capital. The cost of capital is an important measure for determining whether the company performs to its promise.

**Cost of debt:** Loans would entail a periodic amount of interest payment. The lenders will thus get what has been agreed upon as the interest rate. At first glance, it might appear that this is the cost of debt. However, it has to be borne in mind that payments of interest are deductible for tax purposes. So from the companies' angle, the full payment towards interest is not an expenditure since a portion of it comes back as tax shield. The same principle would hold good for unsecured loans and borrowings by way of public deposits.

**Cost of equity:** Next, is the compensation to be paid towards equity capital. Unlike a debt instrument, there is no promised figure of payment to equity holders. However, equity holders have an expectation from the company dependent upon the risk profile of the projects undertaken by the company, the market expectation for similar industries, expected growth and the overall outlook for the company. Since most of these are abstract and cannot be calculated with accuracy, we have to depend upon models that encompass all or most of the above parameters. One such framework is the famous Capital Assets Pricing Model. Shorn of complications and embellishments, the model says that the required rate of return of a company is the sum total of the risk free rate of interest and the market risk premium. The market risk premium in turn is calculated by reducing the risk free return from the expected market return and multiplying the difference by a measure called Beta. Beta represents the degree to which the Company is correlated to the market. This is one way in which the shareholder expectation can be assessed. Another possibility is to estimate the cost by way of a dividend-discounting model. The stream of dividends or return to shareholders over a period of time is first estimated. The hurdle rate that discounts these flows to the price is the rate of return that is required, and, therefore, the cost of equity. Though conceptually sound, the method suffers from the difficulty of proper estimation. Cost of equity can also be thought of as the opportunity cost of alternative investment possibilities forgone by the shareholders. For undertaking the degree of risk commensurate with the industry that the company is in, shareholders are entitled to the regular expected return in the sector.

**Cost of retained earnings:** Companies do not distribute their entire surplus as dividends. A portion of it is retained as reserves and kept aside. This is done partly to meet any shortfall that may arise in future profits and partly to help the company in meeting the capital expenditure for on-going projects. When capital is deployed this way, what is the return on such amounts that should be earned? On the face of it, it may appear as though reserves and

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past profits not distributed and deployed for capital expansion do not have any cost at all. However, it has to be borne in mind that the funds really belong to the shareholders and by not distributing the amounts in full the company is telling them that it will earn on it at least as much as the share capital itself. The alternative would have been to distribute the amount and let the shareholders invest it anywhere they like and earn returns there from. By not doing that, the company is duty bound to give a return at least as much as what is given on the share capital. Thus, cost of retained earnings is to be calculated in the same way as the share capital.

**Cost of Depreciation-generated funds:** Companies would deduct depreciation from the profits before arriving at the net profit. Depreciation is a charge that does not result in a cash outflow. So much so, the amount still lies with the Company and unless it is invested in a special sinking fund investment, it is being used by the business. The question is whether such funds have a cost and if so what that is. Depreciation is a non-cash item and since it is a charge on the company's assets, the fund belongs to the company as a whole. Since the assets of the company are partly financed by debt and partly by equity, it follows that depreciation-generated funds belong to both the lenders and the shareholders in the same proportion as their lending. It has been established by mathematical equations that the overall cost of capital would not undergo any change whether we cost the depreciation-generated funds separately or not. Hence, it is not necessary to take this into the computation of cost of capital.

**Weighted average cost of capital:** For purposes of project appraisal, we are interested in only a single benchmark rate representing the entire financing pattern of the Company. Such a rate is the weighted average cost of capital. It is the average of cost of the various components of its capital structure, duly weighted by the respective strengths. The WACC can be computed taking book weights or market weights as found fit. Book weights would mean the book value of the various components of capital. When the company is an actively traded scrip in the stock exchange, it would make better sense to take market weights. By market weights we mean the components of the capital structure taken at market value. Recently, there has been a lot of thought on weighting the cost of capital components at the target capital structure

– that is the planned capital structure of the company rather than what it is currently doing, since the target structure is what the company will soon be having.

From the managerial angle, he knew that ratios have limited direct application. One cannot come to direct conclusions based on ratios. But they are surely indicators for specific strategic issues in the company. If ratios are viewed this way, their usefulness will go up. Secondly, there are operational issues thrown up by ratios which show areas for improvement. In other words, ratios will ask why certain areas are working one way as against another.

Sada knew that he had a task on hand. He set out to do the analysis. He decided to work on the Profit & Loss account and key ratios of Indian hotels and also take industry parameters into account. He knew he could not get guidance on the step by step approach to this from Heera. He had to take an approach and get ready to face criticism. He considered the following annexures:

1. Aggregate ratios in the industry
2. Applicable ratios of Indian Hotels
3. Hotel industry aggregate data
4. Indian Hotels P&L account for last three years
5. Indian Hotels Balance Sheet for last three years
6. Indian Hotels Cash flows for last three years

## Annexure 1

Industry : Hotels - Large			
Year	2016	2017	Latest
No.Of Companies	5	4	6
Key Ratios			
Debt-Equity Ratio	1.41	1.37	1.4
Long Term Debt-Equity Ratio	1.41	1.37	1.4
Current Ratio	1.99	1.55	2
Turnover Ratios			
Fixed Assets	0.41	0.49	0.42
Inventory	32.62	32.9	32.99
Debtors	9.68	8.55	9.84
Interest Cover Ratio	2.3	1.82	2.36
PBIDTM (%)	23.72	21.15	23.92
PBITM (%)	13.41	11.4	13.68
PBDTM (%)	17.9	14.89	18.14
CPM (%)	14.4	12.2	14.55
APATM (%)	4.09	2.45	4.31
ROCE (%)	4.39	4.09	4.51
RONW (%)	3.15	2.01	3.32
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Indian Hotels Co Ltd			
Industry : Hotels - Large			
Year	Mar 16	Mar 17	Mar 18
Key Ratios			
Debt-Equity Ratio	1.08	0.82	0.54
Long Term Debt-Equity Ratio	1.01	0.71	0.45
Current Ratio	0.56	0.41	0.44
Turnover Ratios			
Fixed Assets	0.81	1.02	0.98
Inventory	51.4	51.85	52.19
Debtors	15.08	12.79	10.98
Interest Cover Ratio	1.63	2.14	2.76
PBIDTM (%)	23	23.97	26.48
PBITM (%)	17.45	17.67	20.63
PBDTM (%)	12.3	15.73	19
CPM (%)	9.27	11.45	12.72
APATM (%)	3.71	5.15	6.86
ROCE (%)	6.99	8.48	9.18
RONW (%)	3.37	4.81	4.95
<a href="http://www.capitaline.com">http://www.capitaline.com</a>			

Industry : Hotels - Large						
Company Name	NOC	Full Year (Rs Cr.)				
		Year End	Equity	Gr. Blk	Sales	NP
Hotels - Large	5		521.11	11975.74	5513.84	328.92
EIH		201803	114.31	1,785.55	1,349.90	112.27
Hotel Leela Ven.		201803	126.11	5,584.29	718.54	9.72
I T D C		201803	85.77	174.97	343.87	3.75
Indian Hotels		201803	118.93	2,814.61	2,583.95	177.28
<a href="http://www.capitaline.com">http://www.capitaline.com</a>						

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Company : Indian Hotels Co Ltd			
Company >> Finance >> Balance Sheet (Rs in Crs.)			
Year	Mar 16	Mar 17	Mar 18
<b>SOURCES OF FUNDS :</b>			
Error! Hyperlink reference not valid.	98.93	98.93	118.93
Error! Hyperlink reference not valid.	2,276.65	2,668.27	4,275.03
<b>Total Shareholders Funds</b>	<b>2,375.58</b>	<b>2,767.20</b>	<b>4,393.96</b>
Error! Hyperlink reference not valid.	793.77	1,050.96	1,043.86
Error! Hyperlink reference not valid.	1,363.88	998.02	740.02
Shop Security Deposits	0	0	0
<b>Total Debt</b>	<b>2,157.65</b>	<b>2,048.98</b>	<b>1,783.88</b>
Error! Hyperlink reference not valid.	347.01	312.31	309.44
<b>Total Liabilities</b>	<b>4,880.24</b>	<b>5,128.49</b>	<b>6,487.28</b>
<b>APPLICATION OF FUNDS :</b>			
Error! Hyperlink reference not valid.	2,267.37	2,456.58	2,814.61
Error! Hyperlink reference not valid.	125.1	269.05	416.11
Less: Impairment of Assets	0	0	0
Error! Hyperlink reference not valid.	2,142.27	2,187.53	2,398.50
Lease Adjustment	0	0	0
Error! Hyperlink reference not valid.	55.58	107.91	65.01
Error! Hyperlink reference not valid.	1,954.71	3,029.15	4,161.46
Current Assets, Loans & Advances			
Error! Hyperlink reference not valid.	45.08	47.56	51.47
Error! Hyperlink reference not valid.	161.83	213.74	256.81
Error! Hyperlink reference not valid.	29.21	22.63	129.01
Error! Hyperlink reference not valid.	167.09	210.14	191.5
<b>Total Current Assets</b>	<b>403.21</b>	<b>494.07</b>	<b>628.79</b>
Less : Current Liabilities and Provisions			
Error! Hyperlink reference not valid.	780.04	730.63	759.41
Error! Hyperlink reference not valid.	78.14	86.91	108.23
<b>Total Current Liabilities</b>	<b>858.18</b>	<b>817.54</b>	<b>867.64</b>
<b>Net Current Assets</b>	<b>-454.97</b>	<b>-323.47</b>	<b>-238.85</b>
Error! Hyperlink reference not valid.	0	0	0
Deferred Tax Assets	216.07	155.32	117.45
Deferred Tax Liability	444.87	446.26	466.26
<b>Net Deferred Tax</b>	<b>-228.8</b>	<b>-290.94</b>	<b>-348.81</b>
Error! Hyperlink reference not valid.	1,411.45	418.31	449.97
<b>Total Assets</b>	<b>4,880.24</b>	<b>5,128.49</b>	<b>6,487.28</b>
Error! Hyperlink reference not valid.	166.62	212.54	365.53
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Company : Indian Hotels Co Ltd			
Company >> Finance >> Profit & Loss Consolidated (Rs in Crs.)			
Year	Mar 16 (12)	Mar 17 (12)	Mar 18 (12)
<b>INCOME :</b>			
Error! Hyperlink reference not valid.	4,023.02	4,020.57	4,103.55
Error! Hyperlink reference not valid.	42.15	152.29	87.31
<b>Total Income</b>	<b>4,065.17</b>	<b>4,172.86</b>	<b>4,190.86</b>
<b>EXPENDITURE :</b>			
Error! Hyperlink reference not valid.	366.93	363.95	376.44
Error! Hyperlink reference not valid.	483.2	607.05	603.49
Error! Hyperlink reference not valid.	1,423.26	1,364.65	1,346.62
Error! Hyperlink reference not valid.	275.43	258.61	259.11
Error! Hyperlink reference not valid.	794.77	685.17	709.66
Error! Hyperlink reference not valid.	152.34	239.65	141.01
Total Expenditure	3,495.93	3,519.08	3,436.33
Operating Profit	569.24	653.78	754.53
Error! Hyperlink reference not valid.	375.59	323.83	269.04
Profit before Depreciation & Tax	193.65	329.95	485.49
Error! Hyperlink reference not valid.	284.82	299.37	301.2
Profit Before Tax	-91.17	30.58	184.29
Error! Hyperlink reference not valid.	77.65	125.76	138.37
Error! Hyperlink reference not valid.	12.98	-12.02	-17.31
Net Profit	-181.8	-83.16	63.23
Minority Interest (after tax)	27.87	17.6	2.65
Profit/Loss of Associate Company	-21.41	37.56	40.29
Net Profit after Minority Interest & P/L Asso.Co.	-231.08	-63.2	100.87
Error! Hyperlink reference not valid.	-0.5	32.01	5.39
Adjusted Net Profit	-230.58	-95.21	95.48
Error! Hyperlink reference not valid.	2,016.36	-119.05	28.1
P & L Balance brought forward	1,793.34	-11.38	-193.63
Error! Hyperlink reference not valid.	3.32	0	-7.8
P & L Balance carried down	-11.38	-193.63	-56.86
Equity Dividend (%)	30	35	40
Book Value (Unit Curr.)	26.08	25.45	35.16
Book Value (Adj) (Unit Curr.)	24.41	23.82	35.16
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Indian Hotels Co Ltd			
Industry : Hotels - Large (Rs. Crores)			
Year	Mar 16	Mar 17	Mar 18
Cash Flow Summary			
Cash and Cash Equivalents at Beginning of the year	283.44	21.12	15
Net Cash from Operating Activities	469.35	458.32	481.12
Net Cash Used in Investing Activities	311.3	-95.52	-
Net Cash Used in Financing Activities	-1,042.97	-368.92	1,012.79
Net Inc/(Dec) in Cash and Cash Equivalent	-262.32	-6.12	105.76
Cash and Cash Equivalents at End of the year	21.12	15	120.76
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