Meddeal Private Limited: Putting a Price Tag for the Business

Case

120-0064-1

This case was written by Latha Ramesh (Christ University). It is intended to be used as the basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation. The case was compiled from generalised experience.

Center for Case Research and Development
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MEDDEAL PRIVATE LIMITED

Putting a price tag for the business[1]

In the evening of 10th April 2018, Diwakar, the associate partner of Kautilya Consultants, just finished his final round of discussion with the client Meddeal Private Limited (MPL from now on) which had approached him to value its business, for a possible stake sale. Diwakar created the equity valuation model of the company but knew that many assumptions had gone into its making and the value arrived from the spreadsheet model was as good as the strength of the premises. He was wondering which of the inputs in the model could have a significant impact on the valuation of the company and what he should advise Shyam, the founder and managing director of Meddeal Private Limited

The Dawn of Meddeal Private Limited Phase 1 (2012-15)

Shyam, a pharmacist graduate, was inclined towards studying medicine right from his adolescence. Both his parents worked in the field of health care, too; his mother was a retired nurse from a government hospital, and his father worked as a chief pharmacist in a leading corporate hospital in Bangalore. Both knew several doctors across major hospitals. Shyam worked with his father in the pharmacy for a few years and found that the market for medical consumables was booming. Medical consumables- supply is direct selling, a commission-based business that involves obtaining orders from the hospitals and small clinics and procure the products from the manufacturer. Shyam wanted to bring in a robust customer-based focus by using quick and reliable delivery as the differentiating factor in his business. He quit working with his father to start an enterprise, Meddeal Associates, in 2011. Shyam understood that larger hospitals (with a bed size of 71-120) got the supplies of medical consumables directly from the manufacturers through imports and hence decided to focus only on small hospitals (with a bed size range of 20 to 70) clinics and laboratories. In the initial days, Shyam managed to get the orders and performed the delivery of the orders himself with three hospitals in the initial customer base. As per the advice of his auditors, Shyam converted his enterprise to a corporation. Thus Meddeal Prive Limited was incorporated in April 2012.

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[1]*Prof. Latha Ramesh, Institute of Management, Christ (Deemed to be University), developed this case study. The case study solely provides material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation.*

The first year was expectedly challenging, and Meddeal closed the year with a loss of Rs. 3.3. Mn after posting revenue of Rs.1.5 Mn and operating expenses of Rs. 4.8 Mn. In the second year, Shyam hired another Medical Representative (MR) to expand his business and revenue increased to Rs. 4.9 Mn. The business model adopted in the second year involved incurring a significant proportion of indirect costs and hence was not profitable. The customer acquisition at MPL was dependent on the onboarding rate the MRs tracked through the efficiency ratio (a metric used in the industry to measure the number of new customers onboarded). There was a shortage of qualified and skilled MRs He realised that the best MR (who is 100% efficient) would board 15 customers every year. Shyam could afford to hire two MRs with 100% efficiency. The conversion ratio is another specific metric calculated as the percentage of customers placing the order among the customers onboarded. Records also showed that the ratio of conversion - number of onboarded who become customers was approximately 60%. With Rs. 10 Million in revenue in FY 2015, the company turned profitable.

Meddeal Private Limited- Phase II (2016-2018)

MPL continued to witness steady growth in revenue as it could build a solid customer base. In December 2015, Shyam pitched his company's offerings to the Consortium of Small Health Care Organization[2] (CSHCO). It took a few more months for him to persist with the proposal. By August 2016, a group of members of the consortium agreed to order supplies through MPL that brought in a good turnaround for the business- from a customer size of 120 more than doubling by the end of the year. As of FY 2017, MPL had four Medical Representatives, all of them clocking Efficiency ratios ranging between 85 and 100%. It had 270 customers, of which 211 customers were the members of CSHCO, and 36 customers added during FY 2017 through MRs. The remaining 23 customers were unlikely to continue the orders from the next year. With the total year-end revenue of RS. 22 Million in FY 2017, the balance sheet turned healthier (Exhibit 1 and 2).

Dilution of Stake

MPL set up a stall at the Indian Medical Devices Industry Conference (IMDIC) in February 2017, and Shyam happened to meet Ganesh who had earlier worked as an administrative head Ganesh had come to the conference to identify investment opportunities in a service-based business. He had several rounds of discussions with Shyam, Ganesh liked the simple business model of MPL and was eager to invest and acquire a 10% stake in the company.

[2] The consortium of Small Health Organization is a not-for-profit society formed to promote collaboration among the accredited hospitals and health care units. It currently has members of 100 health care units in the city of Bangalore.

Ganesh offered Rs. 8Mn after valuing the business to buy the stake. Shyam now wanted to know if he is short-changed. Shyam knew that any business could be valued based on the cash flow it is expected to earn in the future, and therefore wanted to check if the price offered by Ganesh was fair. After all, he was also planning to expand his business and was not particularly keen on seeking debt financing to fund growth. Shyam approached Kautilya Consultants and met Diwakar, the associate partner handling the valuation of deals.

Revenue Drivers

Diwakar, after initial rounds of discussion with Shyam, understood the business model of MPL. He knew that the primary step in valuing any business was to understand the industry. The health care industry constitutes four segments (hospitals, diagnostics, pharmaceuticals and medical devices) and he collected data on the medical devices industry, which was estimated to be of the size of $25-30 billion by the year 2025. Medical consumables form 27% of the market in the medical devices industry. The market opportunity for Meddeal was huge, as the private healthcare business constitutes more than 74% of the country's total health care, he prepared a brief version of the industry (Exhibit 3). Diwakar also wanted to understand the revenue model of the company and arranged the next meeting with Shyam to seek information on the specifics.

Diwakar understood that MPL dealt with three varieties of medical consumables, the Syringe (include bandage and dressing), Needle (including sutures) and Catheters. The business worked on a direct commission basis, and the commission had not exceeded 3% on the gross merchandise value. MPL had to hire talented MRs who can acquire and retain the customers. An efficient MR onboards15 new customers every year. Still, not all of them place orders, generally around 60% customers on-board, and the ratio might go up in the future for MPL to 70% by FY 2019 and eventually peak at 80% by FY 2021. MPL had also been able to retain the customers for at least six years. A customer placed on an average, placed 180 orders each year and the order value for the first year had been Rs. 25,000. For each year the customer retained, the order value increased by 10%.

Cost Drivers

Diwakar analysed the costs of MPL into four categories: (i) delivery expense (ii) vehicle maintenance (iii)salary of the medical representatives and (iv) general, sales and administration. MPL had a team of delivery staff in the third-party contractor payroll (included in SG&A) so that the number could be adjusted as per the size of the orders, and reimbursed the fuel cost.

Diwakar understood that one delivery staff could cater only up to 1,800 orders a year and the average distance of travel for each order was 15 Kilometers, and the mileage of the bike was around 60 Km per litre. Price of fuel as of March 2018 was Rs. 68/litre and Diwakar would want to estimate that the fuel price would go up by 5% every year.

MPL, at times, faced the issue of unavailability of vehicles for delivery and hence decided to buy the motorbikes for the delivery staff from the financial year 2018 and the new cars would require a maintenance cost of Rs. 4,000 a year.

The salary of MRs was another high cost for MPL, and it currently stood over Rs. 6,00,000 per annum per person. The increment per year usually stood at 5%. With MPL planning to own the bikes, Diwakar estimated that the general administrative expenses would reduce to 22% of sales in the forthcoming years.

Capex Drivers

MPL had a bulk capex plan for the year 2018 as it decided to procure the motorbikes, it did not have other expansion plans in the future for office space but would incur the capex to replenish the other assets.
According to the estimates, MPL would have to procure 28 motorbikes in the year 2018 and the requirement for additional bikes on the subsequent year would be based on the order book. Diwakar noted that MPL got a vendor to supply the used motorbikes at around RS. 35,000 per bike and it did not foresee any increment in the cost of the bike in the coming years. The depreciation rate for the bike was 14% on the Written Down Value (WDV) method.

For the existing fixed assets, they would be just replaced, thus becoming a maintenance capex. Diwakar wanted to input the assumption of the depreciation of the previous year to be the capex for the next year, as a usual practice. The depreciation rate for the other assets stood at 12% as evident from the financial statements.

Working capital Driver and the Capital Structure

MPL worked on "no inventory" model as it procured the supplies based on order only. The commission for MPL would be credited after the hospitals made the payment to the suppliers and it generally took around 60 days to realise the commission. MPL paid for the expenses on the same month, except for utility and rentals. These expenses, constituting about 10% of the SG&A, settled after a lag of 30 days.

MPL was a debt-free company and considering a lower capex requirement; it did not plan to raise loans in the foreseeable future.

Having collated all the relevant information, Diwakar was all set to build the valuation model for MPL. He used a discounted cash flow, mainly free cash flow to equity model to find the value of the company. He had to make assumptions on the cost of equity for MPL, for which he applied Capital Asset Pricing Model (CAPM), which required estimates on risk-free rate, beta and the market return.

For risk-free rate, Diwakar used the benchmark - yield of the ten years zero-coupon bond of the government, which stood at 7.5% as of FY 2017. For the equity beta, he had taken the average beta of the listed companies in the industry and adjusted for the capital structure of MPL. Through that exercise, he calculated the beta to be used for MPL as 0.41. The Indian capital market had given an average return of around 13.5%, and he would take this as the market return. He finally arrived at the cost of equity of MPL at 10%. Diwakar prepared a set of tables of assumptions (Exhibit 4) to estimate the free cash flow of the MPL from FY 2018 to FY 2022. Beyond FY 2022 he reckoned the terminal growth rate of the company to be 0% as he expected that the company would continue just to maintain the peak year performance of FY 22.

The Numbers and the Story

Coming with the first set of valuation numbers, Diwakar explained the qualitative factors that go behind the valuation of any business. He wanted Shyam to identify the industry and business factors that could evolve. Diwakar would know that someone else using the model with her assumptions could come out with altogether a different value for MPL. He recollected the famous quote by Prof. Aswath Damodaran, on valuation, “An Equity valuation exercise is made of both numbers and narratives, and the good valuation happens when both of them meet together”.

EXHIBIT 1

Income Statement of Meddeal Private Limited (Figures in Rs.)

INCOME	2013	2014	2015	2016	2017
Revenues from Commission	15,03,132	49,63,223	99,92,082	1,73,54,835	2,21,34,641
Net Revenue	15,03,132	49,63,223	99,92,082	1,73,54,835	2,21,34,641
EXPENSES					
Salary of Medical Representatives	5,50,000	11,00,000	17,32,500	23,10,000	25,41,000
General Administration Expenses	46,31,396	41,36,826	47,91,345	53,33,696	59,50,120
Delivery Expenses	1,41,704	3,11,748	4,81,792	6,51,836	7,79,369
Vehicle Maintenance	28,000	60,000	92,000	95,000	99,000
Total Operating Expenses	48,01,100	45,08,574	53,65,137	60,80,532	68,28,489
EBITDA	**- 38,47,967**	**- 6,45,351**	**28,94,445**	**89,64,302**	**1,27,65,152**
Depreciation	1,11,760	87,982	83,369	85,872	90,818
Profit Before Tax	**- 39,59,727**	**- 7,33,333**	**28,11,076**	**88,78,430**	**1,26,74,334**
Income Tax	-	-	6,23,323	33,19,855	54,69,873
Profit After Tax	**- 39,59,727**	**- 7,33,333**	**21,87,753**	**55,58,575**	**72,04,461**

Source: Compiled by case author

EXHIBIT 2
Balance Sheet Meddeal Private Limited (Figures in Rs.)

EQUITY AND LIABILITIES	2013	2014	2015	2016	2017
Shareholders' Funds					
Equity Share Capital	10,00,000	10,00,000	10,00,000	10,00,000	10,00,000
Reserves and Surplus				39,49,797	1,59,40,582
	10,00,000	10,00,000	10,00,000	49,49,797	1,69,40,582
Loan Funds					
Bank overdraft	20,00,000	22,00,000	23,76,754	-	-
Current liabilities					
Expenses payable	-	-	-	-	-
TOTAL	**30,00,000**	**32,00,000**	**33,76,754**	**49,49,797**	**1,69,40,582**
ASSETS					
Non-current assets					
Fixed Assets	3,05,000	5,20,000	5,45,000	6,65,000	7,85,000
Less: Accumulated Depreciation	1,11,760	1,99,742	2,83,111	3,68,983	4,59,801
Net Book Value	1,93,240	3,20,258	2,61,889	2,96,017	3,25,199
Other Non-Current Assets	-	-	-	-	-
Profit andLoss	23,97,757	22,64,076	22,13,468	-	
	25,90,997	25,84,334	24,75,357	2,96,017	3,25,199
Current Assets, Loans and Advances					
Cash & bank balances	-	-	-	33,34,045	1,46,83,159
Advances	-	-	-	-	-
Inventory	-	-	-	-	-
Debtors	4,09,003	6,15,666	9,01,397	13,19,735	19,32,224
Others	-	-	-	-	-
	4,09,003	6,15,666	9,01,397	46,53,780	1,66,15,383
TOTAL	**30,00,000**	**32,00,000**	**33,76,754**	**49,49,797**	**1,69,40,582**

Source: Compiled by case author

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EXHIBIT 3
Industry Analysis- Medical Devices and Consumables

The Indian medical devices industry has an opportunity to leapfrog innovation combining physical devices and integrating digital frameworks for long term innovation

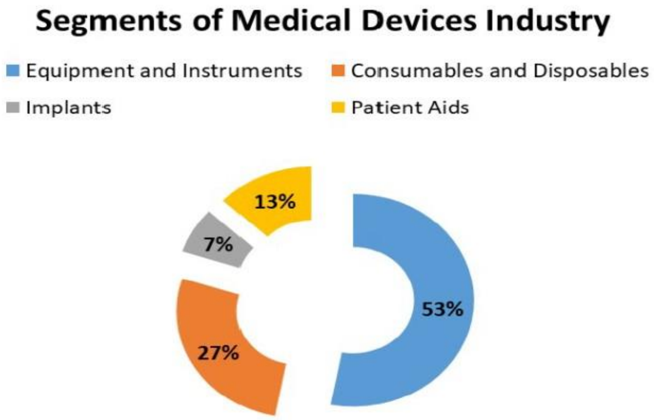
The medical device industry market is very dynamic and the key drivers impacting this sector are healthcare expenditure, technological development, aging population, and chronic diseases. Further emerging trends that impact the medical device industry include the changing medical technology landscape, software as a differentiator in medical devices, as well as design and manufacturing of patient portable or smaller devices. In India, medical devices is now considered to play a key role in the delivery of quality health care to the masses. The launch of MDR 2017 was a significant milestone in creating a robust platform. The awareness around the need to have a robust medical devices ecosystem in the country is gaining traction resulting in higher growth rates for India as compared to the global industry.

The year 2018 has been noteworthy for this space with the emergence of the new medical device rules which came into force from January 2018. This has finally given the medical devices and in-vitro diagnostic devices (IVD) industry, a distinctive regulatory identity. By delinking devices from drugs, the multitudes of devices used in the country today are governed to ensure patient safety, quality and performance parameters of devices sold within the country. Given that 80 per cent of the devices are imported, the legislation has an important role to play in creating a level playing field for domestic and foreign manufacturers. The legislation is hopeful in achieving the main goals of the National Health Policy that calls for addressing the changing priorities in Indian healthcare by mainly bridging the accessibility and affordability gap. On another hand, the industry in India is going through tough times because of anomalies in import-export policy as per the report by ASSOCHAM. This is due to the import duties for raw materials being higher than finished goods, making it difficult to compete with manufacturers from some countries on price who also benefit with incentives of setting up a manufacturing facility in this space.

The manufacturing space in the medical devices sector is at a nascent stage and with the government's encouragement; it will evolve as a sunshine sector. The "Make in India" charter has motivated medical device manufacturers in India, with promise of the government support in the form of land allocation and subsidies to encourage growth of the domestic medical device industry. However, the slow infrastructure development of these parks is creating obstacles for the domestic industry and thereby resulting in an indirect implication of availability of devices in the country. Hence apart from the cost, the government's move to separate manufacturing of medical devices and drugs from the regulatory perspective could usher in better transparency and a level playing field for medical devices makers. This will go a long way in building robust standards ecosystem for the industry, boost domestic production as well as boost exports, usher in greater foreign investment in the sector and bring in more investments into infrastructure and processes.

Digital' makes a very compelling entry into the world of healthcare 2018. Similarly, technology will continue to provide a fantastic platform for disruptive innovation, wherein the wearables and diagnostic framework leveraging technology can provide out-of-the box, innovative and cost-effective solutions for the masses of the country. Wearable medical devices like glucose monitors and exercise trackers are projected to experience double the revenue growth of the overall device market. The launch of Apple Watch Series 4 with a US FDA approved ECG embedded into the watch. Not that we did not have portable ECGs earlier, but with this dawns a new era of a daily use wearable as FDA approved the medical device. This, combined with the new-age analytics and artificial intelligence, along with medical devices in conjunction with IoT and analytics will transform healthcare in unprecedented ways. While there have been reports that AI has bettered diagnosis, there is scope for tremendous development in this domain. Smart devices that measure other vital signs, like blood pressure and glucose levels, will help doctors to keep an eye on their patients. It will do all this while also allowing the patient to take an active role in their own healthcare. The connected health framework, combined with large data sets and AI, will assist the doctors in accurate diagnosis and timely interventions in the near future.

India is fast growing as a key market for medical devices outsourcing and will continue to consolidate its position in 2019. The Indian medical devices industry has an opportunity to leapfrog innovation combining physical devices and integrating digital frameworks for long term innovation. The industry was valued at $3.5 billion in 2015 and could expand to approximately $ 4.8 billion by 2019. According to a Deloitte report, the growth rate of India's medical-device industry is around 15 per cent which is more than double of the global industry growth rate of 4-6 per cent, and is expected to become a $ 25-30 billion industry in India by 2025



Source: Investinida.go.in

EXHIBIT 4
Assumptions on the Model

	2018	2019	2020	2021	2022
No.of Medical representatives	4	4	4	4	4
No.of customer on board	15	15	15	15	15
Ratio of conversion	60%	70%	70%	80%	80%
No.of orders per customer	180	180	180	180	180
Growth in order value	10%	10%	10%	10%	10%
Commission on GMV	3%	3%	3%	3%	3%
Average mileage of the motorbike	60	60	60	60	60
Increase in fuel cost	5%	5%	5%	5%	5%
Maintenance cost per motorbike(INR)	4,000	4,000	4,000	4,000	4,000
Increase in salary of MR	5%	5%	5%	5%	5%
SG&A as a percent of revenue	22%	22%	22%	22%	22%
Tax rate	30%	30%	30%	30%	30%
Cost per motorbike(INR)	35,000	35,000	35,000	35,000	35,000
Depreciation rate Motorbike	14%	14%	14%	14%	14%
Depreciation rate other assets	12%	12%	12%	12%	12%
Days Sales Outstanding	60	60	60	60	60
Days lag in expense payable	30	30	30	30	30
Valuation Assumptions					
Cost of Equity	10%				
Terminal Growth rate	0%				

Source : Compiled by case author