Business Valuation & Emerging Opportunities for Professionals

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AGENDA

-Overview of Valuation

-Valuation Approaches and Methodologies

-Valuation Methodologies and Value Impact

-History of Valuation in India

-Major Business Valuation Methodologies

- Discounted Free Cash Flow
- Relative Valuation

-Regulatory Valuation in India

- Transactions
- Applicable Laws

-Emerging Opportunities in Valuation in India

- Registered Valuer
- Ind AS

-Tricky Issues

Company Share Valuation

“Price is what you Pay,
Value is what you get”

Warren Buffett

Valuation is the process of determining the "Economic Worth" of an Asset or Company under certain "Assumptions" and "Limiting Conditions" and subject to the "Data" available on the "Valuation Date"

***Source -International Valuation Standard Council**

'WHY VALUATION' ?

Transactions

- Mergers
- Acquisitions / Investment
- Fund Raising
- Sale of Businesses
- Voluntary Assessment

Regulatory

- RBI
- Income Tax
- SEBI
- Stock Exchange
- Companies Act
- CLB/Courts

Accounting

- ESOP
- Purchase Price Allocation
- Impairment / Diminution
- Fair Value (Ind AS)

CHOOSING THE RIGHT 'STANDARD' & 'PREMISE' OF VALUE

STANDARD OF VALUE

Standard of Value is the hypothetical conditions under which a business is valued.

While selecting the Standard of Value following points is to be taken care of

- Subject matter of Valuation;
- Purpose of Valuation;
- Statute;
- Case Laws;
- Circumstances.

Types of Standard of Value:

FAIR MARKET VALUE

INVESTMENT VALUE

INTRINSIC VALUE

FAIR VALUE

PREMISE OF VALUE

Premise of Value relates to the assumptions upon which the valuation is based.

Premise of Value

- **Going Concern –** Value as an ongoing operating business enterprise.
- **Liquidation –** Value when business is terminated . It could be 'forced' or 'orderly'.
  - **Value-in-use**
  - **Value-in-exchange**

‘VALUATION APPROACHES’

'VALUATION APPROACHES'

Fundamental

Income Approach

- Capitalization of earning Method (Historical)
- Discounted Cash Flow Method (Projected Time Value)

Asset Approach

- Book Value Method
- Liquidation Value Method
- Replacement Value Method

‘VALUATION APPROACHES’

- Comparable Companies Market Multiples Method (Listed Peers)
- Comparable Transaction Multiples Method (Unlisted Peers)
- Market Value Method (For Quoted Securities)

Market Based Approach

Relative

'VALUATION APPROACHES'

Other Methods

- Contingent Claim Valuation (Option Pricing models : Black Scholes / Binomial etc.)
- Price of Recent Investment / Backsolve Method
- First Chicago Method (Start Up) – Scenario based
- Venture Capitalist Method (Start Up)
- Rule of Thumb (Industry wise)

CHOICE OF VALUATION APPROACHES

Purpose of Valuation (Regulatory or Transaction), Size of Transaction (Minority or Control), Stage of Business, and Business Model determine Valuation Approaches

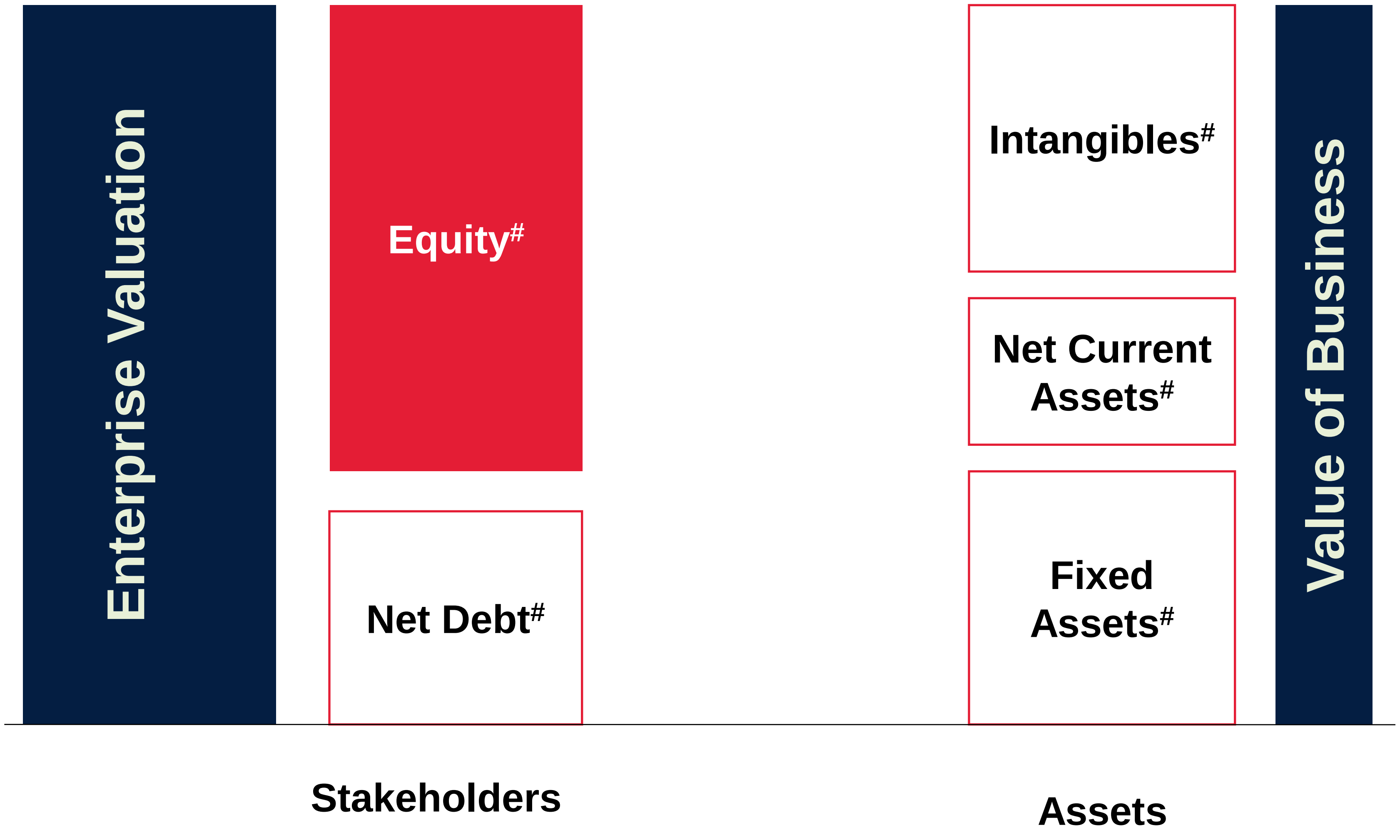
In General, Income Approach is preferred;

- The **dominance of profits for valuation of share was emphasised in "McCathies case"** (Taxation, 69 CLR 1) where it was said that *"the real value of shares in a company will depend more on the profits which the company* ***has been making and should be capable of making****, having regard to the nature of its business, than upon the amount which the shares would realise on liquidation".*
- This was also re-iterated by the Indian Courts in Commissioner of Wealth Tax v. **Mahadeo Jalan's case (S.C.)** (86 ITR 621) and Additional Commissioner of Gift Tax v. Kusumben D. Mahadevia (S.C.) (122 ITR 38).
- **However, Asset Approach is preferred in case of Asset heavy companies and on liquidation; The liquidated value of the Net Assets is also considered the minimum value of the whole company and will prevail even if Earning capacity is low or negative subject to any discounting in appropriate circumstances (like Reluctance to wind up, Ability to control, Tax adjustments etc.)**
- **Market Approach is preferred in case of listed entity and also to evaluate the value of unlisted company by comparing it with its peers;**

VALUATION METHODOLOGIES & VALUE IMPACT

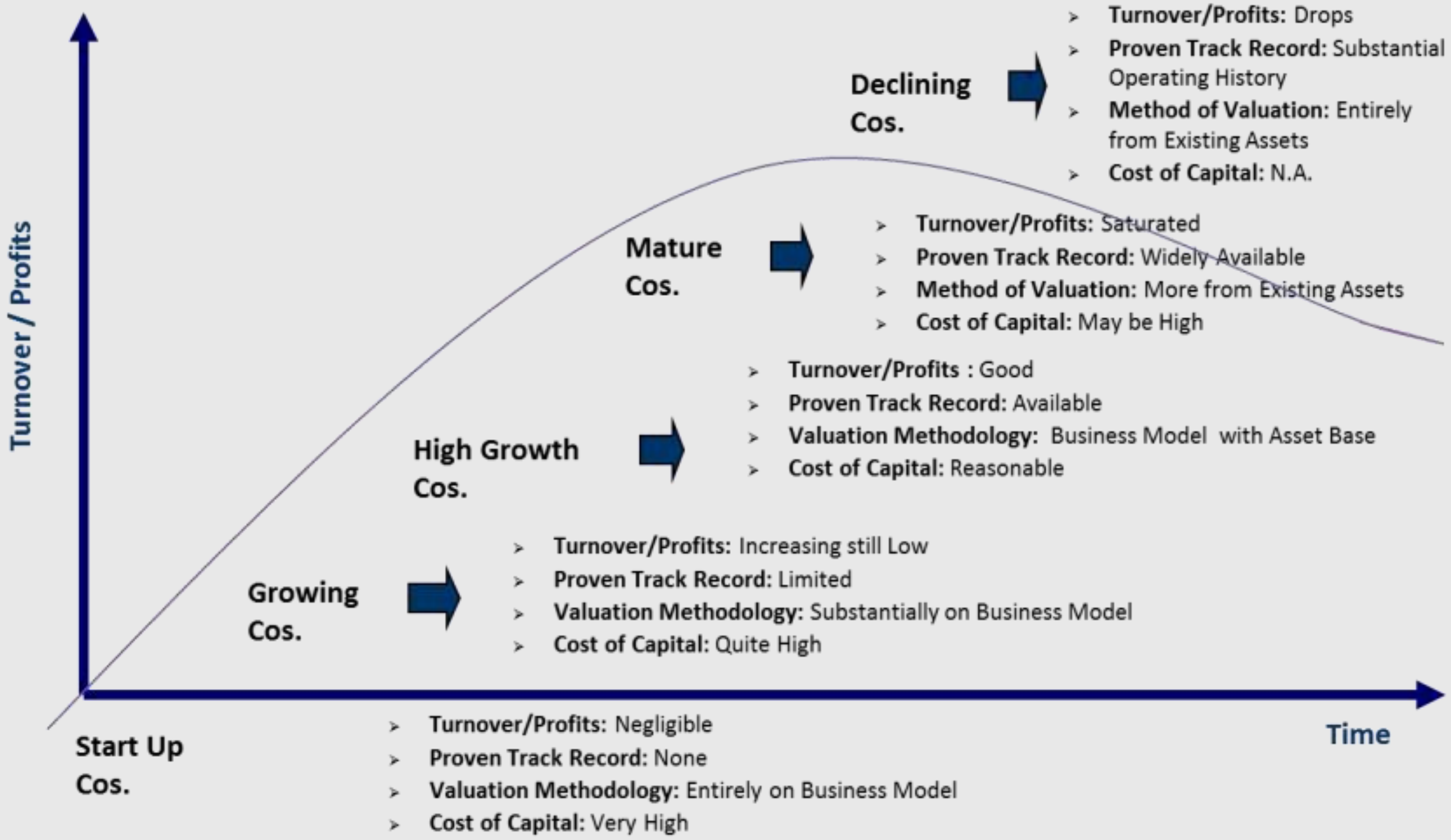
Major Valuation Methodologies	Ideal for	Result
Net Asset Value		
Net Asset Value (Book Value)	Minority Value	Equity Value
Net Asset Value (Fair Value)	Control Value	
Comparable Companies Multiples (CCM) Method		
Price to Earning , Book Value Multiple	Minority Value	Equity Value
EBIT , EBITDA Multiple		Enterprise Value
Comparable Transaction Multiples (CTM) Method		
Price to Earning , Book Value Multiple	Control Value	Equity Value
EBIT , EBITDA Multiple		Enterprise Value
Discounted Cash Flow (DCF)		
Equity	Control Value	Equity Value
Firm		Enterprise Value

‘Enterprise / Business Valuation’



Based on Market Values

Valuation across business cycle follow the LAW of ECONOMICS



KEY DRIVERS OF VALUATION

CASH FLOW

Investor assign value based on the cash flow they expect to receive in the future

- *Dividends / distributions*
- *Sale of liquidation proceeds*

Value of a cash flow stream is a function of

- ***Timing** of cash Receipt*
- ***Risk** associated with the cashflow*

THAT'S WHY DCF IS MOST

KEY DRIVERS OF VALUATION

ASSETS

Operating Assets

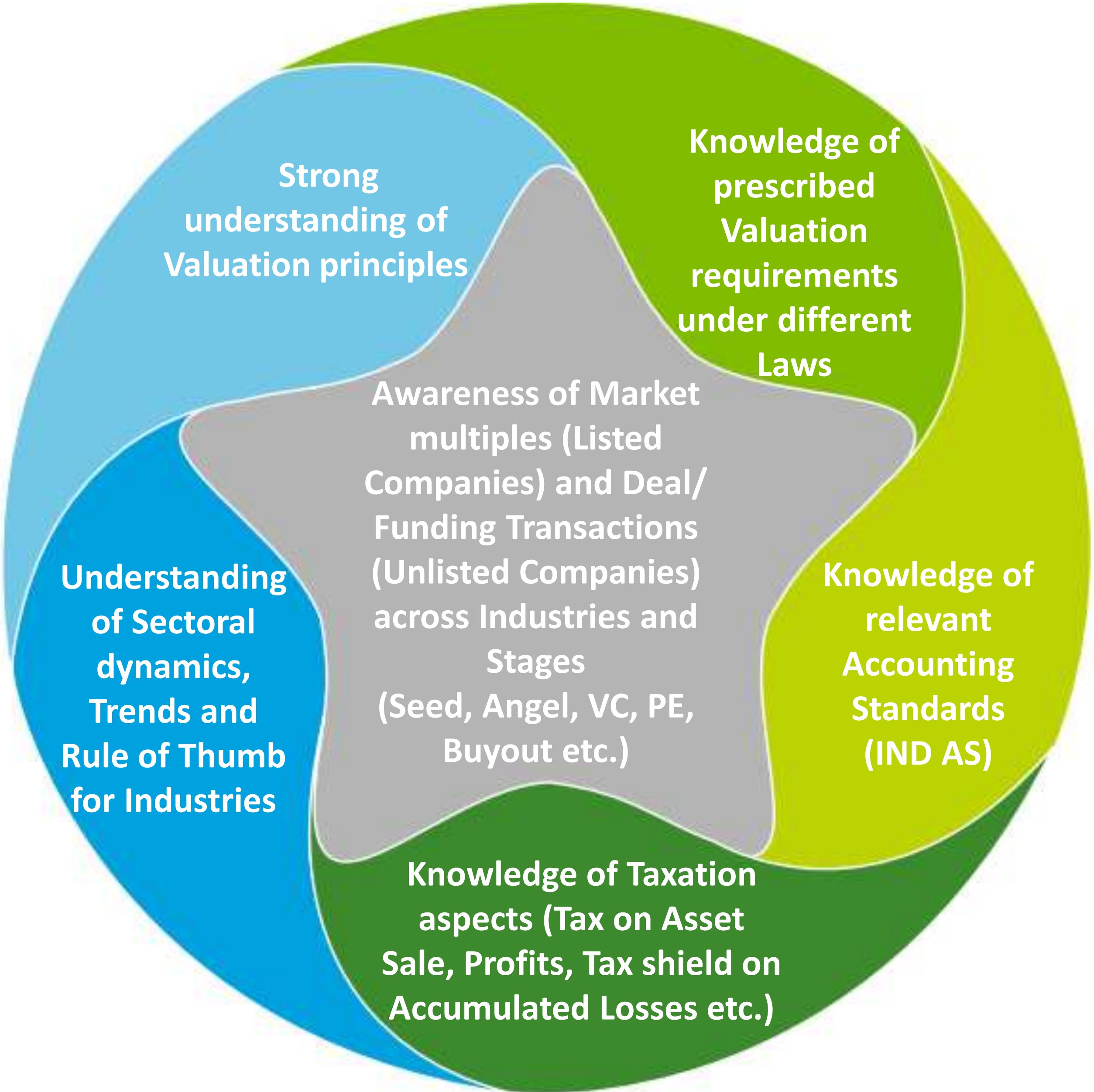
- Assets used in the operation of the business including working capital, Property, Plant & Equipment & Intangible assets
- Valuing of operating assets is generally reflected in the cash flow generated by the business

Non - Operating Assets

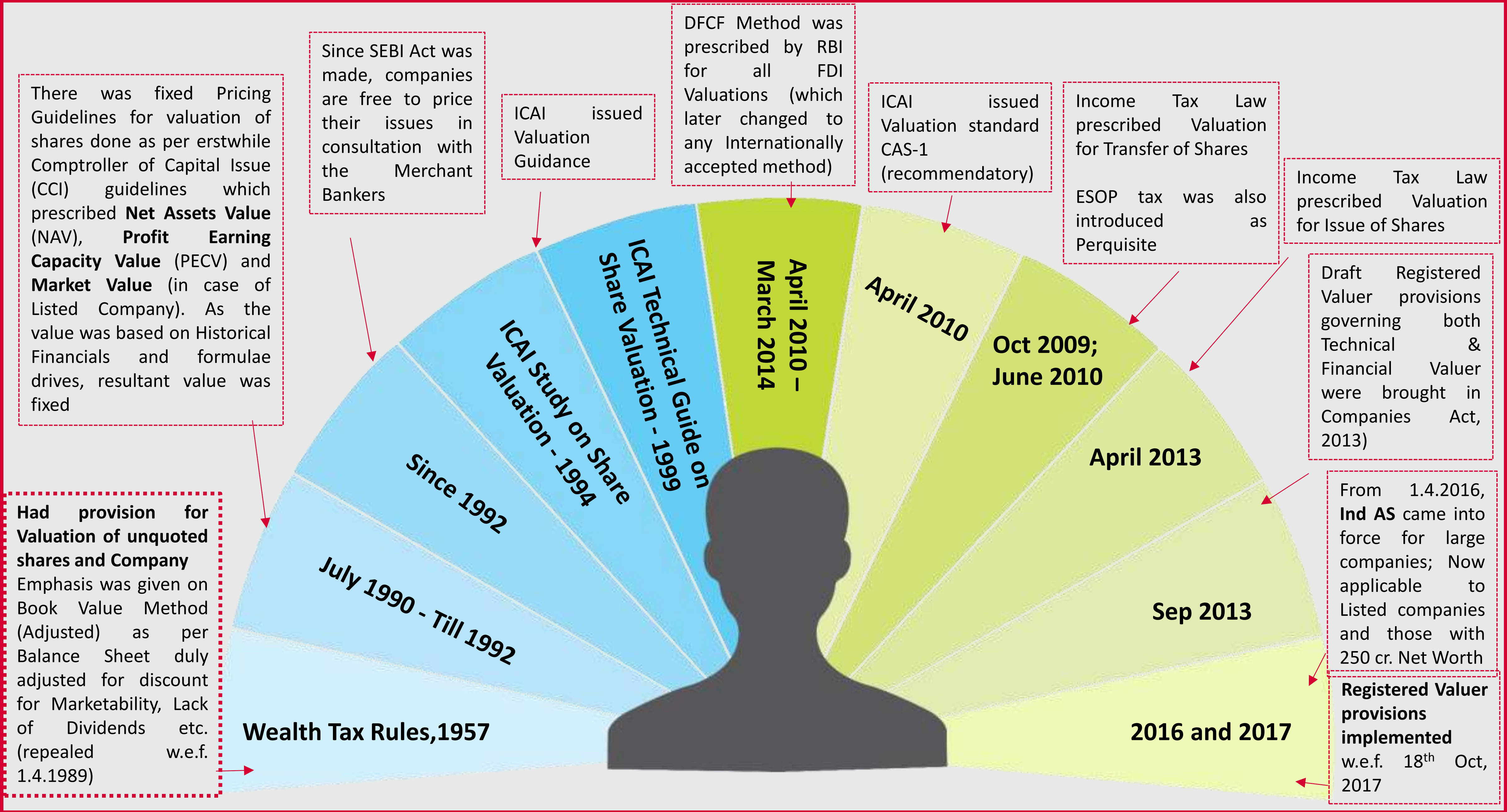
- Assets not used in the operations including excess cash balances, and assets held for investment purposes, such as vacant land & Securities
- Investors generally do not give much value to such assets and Structure modification may be necessary

NEED FOR RESTRUCTURING

Skills required for performing Valuations



History of Valuation in India


Wealth Tax Rules,1957
Had provision for Valuation of unquoted shares and Company
Emphasis was given on Book Value Method (Adjusted) as per Balance Sheet duly adjusted for discount for Marketability, Lack of Dividends etc. (repealed w.e.f. 1.4.1989)
July 1990 - Till 1992
There was fixed Pricing Guidelines for valuation of shares done as per erstwhile Comptroller of Capital Issue (CCI) guidelines which prescribed Net Assets Value (NAV), Profit Earning Capacity Value (PECV) and Market Value (in case of Listed Company). As the value was based on Historical Financials and formulae drives, resultant value was fixed
Since 1992
Since SEBI Act was made, companies are free to price their issues in consultation with the Merchant Bankers
ICAI Study on Share Valuation - 1994
ICAI issued Valuation Guidance
ICAI Technical Guide on Share Valuation - 1999
April 2010 – March 2014
DFCF Method was prescribed by RBI for all FDI Valuations (which later changed to any Internationally accepted method)
April 2010
ICAI issued Valuation standard CAS-1 (recommendatory)
Oct 2009; June 2010
Income Tax Law prescribed Valuation for Transfer of Shares
ESOP tax was also introduced as Perquisite
April 2013
Income Tax Law prescribed Valuation for Issue of Shares
Sep 2013
Draft Registered Valuer provisions governing both Technical & Financial Valuer were brought in Companies Act, 2013)
2016 and 2017
From 1.4.2016, Ind AS came into force for large companies; Now applicable to Listed companies and those with 250 cr. Net Worth
Registered Valuer provisions implemented w.e.f. 18th Oct, 2017

Discounted

Free Cash

Flow

Valuation

MAJOR CHARACTERISTICS OF DISCOUNTED FREE CASH FLOW (DFCF) VALUATION

- **Forward Looking** and focuses on **cash generation**
- Recognizes **Time value of Money**
- Allows **operating strategy** to be built into a model
- Incorporates value of **Tangible and Intangible assets**
- Only as accurate as **assumptions and projections** used
- Works best in producing a **range of likely values**
- It Represents the **Control Value**

DISCOUNTED FREE CASH FLOW METHOD (DFCF)

DFCF expresses the present value of the business as a function of its future cash earnings capacity. In this method, the appraiser estimates the cash flows of any business after all operating expenses, taxes, and necessary investments in working capital and capital expenditure is being met. Valuing equity using the free cash flow to stockholders requires estimating only free cash flow to equity holders, after debt holders have been paid off.

DFCF VALUATION PROCESS

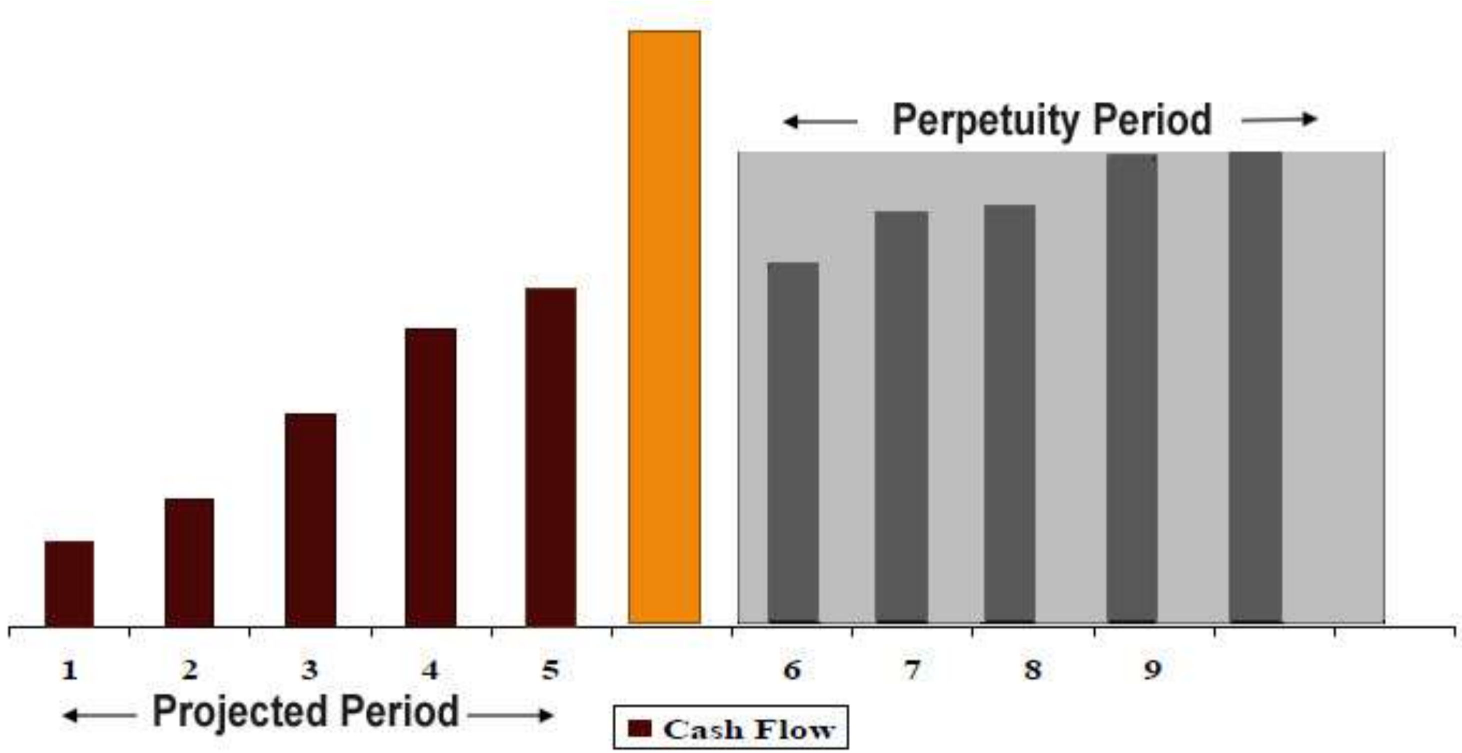
- ❑ Understand Business Model
- ❑ Identify Business Cycle
- ❑ Analyze Historical Financial Performance
- ❑ Review Industry and Regulatory Trends
- ❑ Understand Future Growth Plans (including Capex needs)
- ❑ Segregate Business and Other Cash Generating Assets
- ❑ Identify Surplus Assets (assets not utilized for Business say Land/Investments)
- ❑ Create Business Projections (Profitability statement and Balance Sheets)
- ❑ Discount Business Projections to Present (Explicit Period and Perpetuity)
- ❑ Add Value of Surplus Assets and Subtract Value of Contingent Liabilities

Discounted Cash Flow Valuation

<u>The following box provides generalized steps for using discounted free cash flows to estimate the value of the firm and then to derive the value of equity shareholders of the Company</u>

STEPS FOR FINDING FCF TO VALUE EQUITY SHARES			
		Profit before tax	Step 1:Arrive at Profit Before Tax
	-	Taxes	Step 2: Less tax.
	=	Profit after tax	Step 3: Add back non-cash costs (already subtracted in step 1).
	+	Non-cash costs	Step 4: Subtract capital expenditures.
	-	Capital expenditures	Step 5: Subtract Increases in non cash working capital.
	-	Increase in NCWC	Step 6: Adding Interest cost (post Tax)
	+	Interest Tax (Post Tax)	Step 7: Add the terminal value accruing in the final year.
	+	Terminal Value	
	=	Free Cash Flow to Firm	
	=	DFCF	Step 8: Discount the FCF for each year with WACC
	=	Enterprise Value	Step 9: Value of the Firm
	+	Cash as on Valuation Date	Step10: Adding Cash
	-	Debt as on Valuation Date	Step11:Substract Debt
	=	Equity Value	Step12:Value to equity share holders

FREE CASH FLOWS – VALUE TREND



Terminal Value is calculated for the Perpetuity period based on the Adjusted last year cash flows of the Projected period (<u>when the business has stabilized</u>).

COMPONENTS OF DISCOUNTED CASH FLOW

1. **Future Free Cash Flows** (derived on the basis of likely future earnings of the company) (after meeting operating expenses, taxes and necessary investments in Capital Expenditure and Working Capital)

2. **Present Value Discounting of future cash flows at Weighted Average Cost of Capital (WACC)**

Cost of Equity (Ke) = Risk free rate + Risk Premium + CSRP* + SCRP^

(basically the IRR expectations of the Investors)

****Company Specific Risk Premium; ^Small Company Risk Premium***

3. **Perpetuity/Terminal Value -** Usually the free cash flows are projected for a limited period of time say 5 years and thereafter Perpetuity value is computed. It is emphasized that the perpetuity value is very sensitive and even small changes may lead to substantial value differences

FUTURE FREE CASH FLOWS

FREE CASH FLOWS

Free cash flows to firm (FCFF) is calculated as

EBITDA − Taxes, Change in Non Cash Working capital, Capital Expenditure = Free Cash Flow to Firm

EBITDA	−	Taxes Change in Non Cash Working capital Capital Expenditure	=	Free Cash Flow to Firm

Note that **an alternate to above is following (FCFE) method in which the value of Equity is directly valued in lieu of the value of Firm**. Under this approach, the Interest and Finance charges is also deducted to arrive at the Free Cash Flows. Adjustment is also made for Debt (Inflows and Outflows) over the definite period of Cash Flows and also in Perpetuity workings.

Theoretically, the value conclusion should remain same irrespective of the method followed (FCFF or FCFE), (Provided, assumptions are consistent).

VALIDATION OF FUTURE CASH FLOWS

- **Future cash flow projections should reasonably capture the growth prospects and earning capability of the company.** Past performance, any envisaged savings or pressure on margins due to say competition should be properly reviewed.
- **Discontinuation of any part of business, Business Expansion or Diversification and any major changes in policies of the company may materially impact the projections and make it different than the historical trends.**
- **In case of Business Expansion, state of execution at time of valuation should be given due consideration.** Mere paper plans for expansion should not be taken into account.
- **In case profits are expected to be realized after a lapse of some years or if material amount is to be incurred before profits are realized, due consideration have to be given to these circumstances.** A better way could be valuing new business stream separately as it carries a different risk reward characteristics.
- Similarly in Turnaround cases, the uncertainty of higher profits in much greater. **Careful evaluation of the steps actually taken to implement its strategy should be undertaken before accepting management's claims.** If necessary, reports of Technical and other consultants should be called for.
- **For Companies which are cyclical, the forecast period should necessarily cover entire business cycle**
- **Appropriate allowance should be made for Capital Expenditure and Working Capital in Projections (for growth and also for existing capacity).**
- **In case of multiple unrelated businesses, SOTP valuation is preferred**

DISCOUNT RATE / COST OF CAPITAL (WACC)

Discount rate – Weighted Average Cost of Capital

$$\textbf{WACC} = \frac{(K_d \times D) + (K_e \times E)}{(D + E)}$$

Where:
D = Debt part of capital structure
E = Equity part of capital structure
K_d = Cost of Debt (Post tax)
K_e = Cost of Equity

In case of following FCFE, Discount Rate is Ke and Not WACC

COST OF EQUITY (KE)

Discount rate - Cost of Equity

The Cost of Equity (Ke) is computed by using Modified Capital Asset Pricing Model (Mod. CAPM)

Mod. CAPM Model

ke = Rf + B (Rm-Rf) + SCRP + CSRP

Where:

Rf = Risk free rate of return (Generally taken as 10-year Government Bond Yield)

B = Beta Value (Sensitivity of the stock returns to market returns)

K_e = Cost of Equity

Rm= Market Rate of Return (Generally taken as Long Term average return of Stock Market)

SCRP = Small Company Risk Premium

CSRP= Company specific Risk premium

TERMINAL CALCULATION

Perpetuity Formula

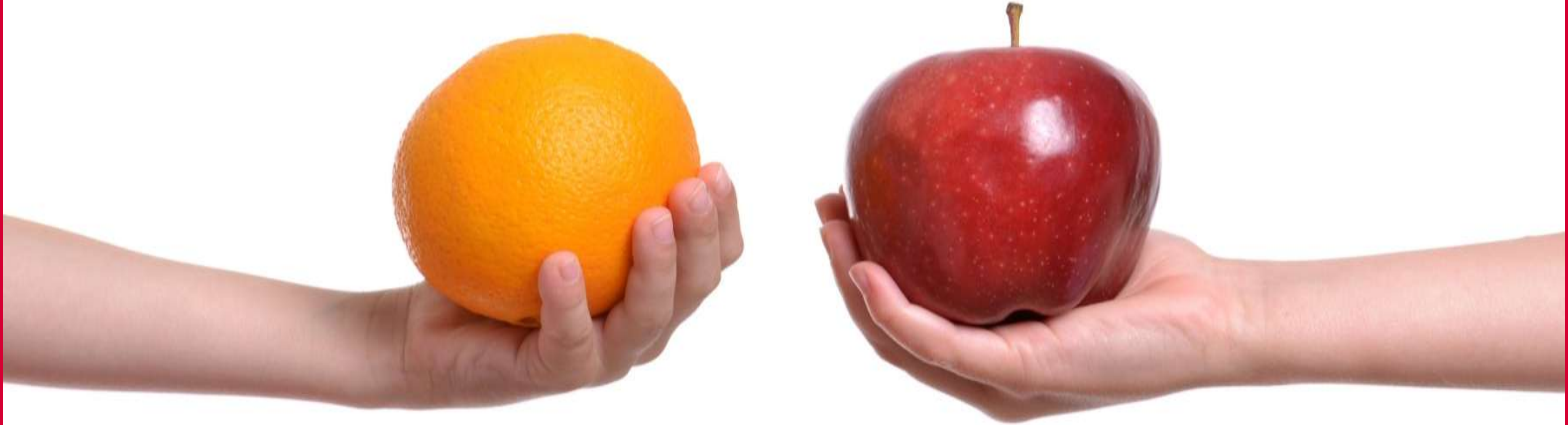
- Usually comprises a Large part of Total Value and is sensitive to small changes
- Capitalizes FCF after definite forecast period as a growing perpetuity;
- Estimate Terminal Value using Terminal Value Multiplier applied on last year cash flows
- Gordon Formula is often used to derive the Terminal Cash Flows by applying the last year cash flows as a multiple of the growth rate and discounting factor

$$\frac{(1 + g)}{(WACC - g)}$$

- Estimated Terminal Value is then discounted to present day at company's cost of capital based on the discounting factor of last year projected cash flows

IMPORTANT TIP- It is advised to do Sanity check by applying Relative Valuation Multiples to the Terminal Year Financials and also doing Scenario Analysis.

Relative Valuation



RELATIVE VALUE MULTIPLES

The Value of an asset is compared to the values assessed by the market for similar or comparable assets.

Pros/Cons of Different Multiples

Earnings : Audited Earnings (PAT)
:TTM Earnings (PAT)
Price : Latest / Volume Weighted / Simple Average of say 6 Months
(+) Easy to apply
Net Profitability linked
(-) Prone to Accounting Adjustments

- Best multiple to apply
- Considers Operational Profits
- Not prone to Accounting Adjustments (Depreciation & Amortizations)
- Values irrespective of Debt levels

(+) Simplest to apply even when in Losses
- Used to Value e-Commerce Companies / Media Companies in Losses

(-) Not a preferred method as such, other than for Mature Companies

- Book Value is the Investment (Net Worth) that equity shareholders have put in & earned in Company
- Not much relevant as Earnings not factored in (other than mature cos)

MULTIPLES CAN BE MISLEADING

To use a multiple you must:

Know what are the <u>fundamentals</u> that determine the multiple and how <u>changes in these fundamentals</u> change the multiple

Know what the distribution of the multiple looks like (Mean/Median/Outliers)

Ensure that both the denominator and numerator represent same group

- **PE, Book Value, Mcap/Sales Multiples result in Equity Value**
- **EBIT, EBITDA, EV / Sales Multiple result in Enterprise Value**

<u>Ensure that firms are comparable</u> (Business Model, Product Profile, Geography, Stage & Size of Business, Profitability margins, Borrowings etc. play a crucial role in finding “Comps”

RULE OF THUMB

A rule of thumb or benchmark indicator is used as a reasonableness check against the values determined by the use of other valuation approaches.

Industry	Valuation Parameters
Hospital	EV/Room
Engineering	Mcap/Order Book
Mutual Fund	Asset under management
OIL	EV/ Barrel of equivalent
Print Media	EV/Subscriber
Power	EV/MW, EBITDA/Per Unit
Entertainment & Media	EV/Per screen
Metals	EBITDA/Ton, EV/Metric ton
Textiles	EBITDA depend upon capacity utilization Percentage & per spindle value
Pharma Bulk Drugs	New Drug Approvals , Patents
Airlines	EV/Plane or EV/passenger
Shipping	EV/Order Book, Mcap/Order Book
Cement	EV/Per ton & EBITDA/Per ton
Banks	Non performing Assets , Current Account & Saving Account per Branch

However, Exclusive use of Rule of Thumb is not recommended

Regulatory Valuation in India for different Transactions under different Laws

Fresh Issue of Shares

- Reserve Bank of India – FDI
- Reserve Bank of India – ODI
- Income Tax
- Companies Act
- SEBI

Business Combination/ Scheme of Arrangement

- Companies Act
- SEBI
- Accounting

Transfer of Shares

- Reserve Bank of India – FDI
- Reserve Bank of India – ODI
- Income Tax

ESOP/Sweat Equity

- Income Tax
- Companies Act
- Accounting

Fresh Issue of Shares

- **Reserve Bank of India – FDI**

  (Foreign Direct Investment)

- **<u>Valuation as per Internationally Accepted Pricing methodology. Value determined is Minimum Price.</u>**
- **SEBI Preferential allotment guidelines, in case of Listed Co.**
- **Applicable in case of Downstream Investment also**
- **The price/ conversion formula of compulsory convertible instruments should be determined upfront upon issue of the instrument**
- **No Fixed IRR**
- **Right Issue to Non Resident allowed but at a price not less than as made to Resident Shareholder**

Fresh Issue of Shares

- Reserve Bank of India – ODI

  (Overseas Direct Investment)

- No Valuation norms prescribed
- Mandatory by SEBI Registered Merchant Banker where Swap of Shares is involved or where Transaction Value exceeds USD 5 Mn

Fresh Issue of Shares

- Income Tax

- **Fresh Issue of Shares as per Discounted Cash Flow (DCF) or any other Methodology. Value determined is Maximum Price.**
- ***Not applicable to Non Residents***
- ***In case of unquoted shares, other than Equity Shares, Valuation shall be price it would fetch if sold in open market***

Fresh Issue of Shares

- Companies Act

- Fresh Issue of Equity and Convertible Instruments as per Registered Valuer Rules based on Internationally accepted valuation standards. <u>Value determined is Minimum Price.</u>

Fresh Issue of Shares

- SEBI

- Valuation of Frequently Traded Shares : SEBI Preferential Allotment Guidelines (Average of VWAP – 26 w or 2 w – higher)
- Valuation of Frequently Traded Shares for Takeover Code (VWAP for 60 trading days)
- Valuation of Infrequently Traded Shares as per Book Value, Comparable Trading Multiples, other parameters

Transfer of Shares

- Reserve Bank of India
  - FDI and ODI

- Same as in case of Fresh Issue of Shares

Transfer of Shares

- Income Tax

- Transfer of Shares as per Net Assets Value method subject to certain Tax and misc. adjustments
- <u>Fair Market Value of Immovable Property, Shares and Jewellery to be considered</u>
- <u>No differentiation in Asset held as Stock or Investments</u>
- <u>It seems value of Shares to be done based on Net Assets Value of all Investments, down the line</u>

Business Combination/ Scheme of Arrangement

- Companies Act

- **Valuation in Scheme of Arrangement and "<u>Swap Ratio</u>" determination on Relative valuation of companies (Absolute Value not important)**
- **The key issue to be addressed is that of fairness to all shareholders**

  (in case of Listed Co. and where shareholders vary between the two companies)

- **There are established legal precedence for merger valuation methodologies**
  - **HLL Case (Supreme Court) allowed 2:2:1 weights to Income, Market and Asset methods**
  - Market price method and Earnings methods dominate for operating entities, Asset for Holdco.
  - Usually, best to give weight ages to valuation by all methods

- **Same norms as in Issue of Shares apply**
- SEBI has clarified that the Valuation of Listed Company is to be done upto the date of Board Meeting in which Scheme of Arrangement is approved
- SEBI has recently prescribed format of Value conclusion table to be put by all Valuers in their Valuation report. This includes Value per Share determined through all three Valuation Approaches, weights given to each of them, Relative Value per share and the Swap Ratio
- Fairness Opinion on Valuation under Scheme of Arrangement required by a Merchant Banker where Listed Company is involved

- **SEBI**

Business Combination/ Scheme of Arrangement

- Accounting

- Purchase Price Allocation (PPA) is done for allocating Acquisition Value into different class of Assets including Intangibles
- Intangibles need to be separable and identified based on their unique characteristics
- Difference amount, if any is booked to Goodwill

- Perquisites Value (ESOP / Sweat Equity) needed for Salary TDS at time of exercise / allotment of options / shares. <u>To be done by SEBI Registered Merchant Banker.</u>
- Valuation based on average of Opening and Closing Market Price in case of Listed Company

- Income Tax

ESOP/Sweat Equity

- Valuation of Technical Know How or Value additions (Intangibles) of the person shall be performed for issuance of Sweat Equity Shares. <u>To be done by Merchant Banker in case of Listed Company</u>

- **Companies Act**

ESOP/Sweat Equity

ESOP/Sweat Equity

- Accounting

- ESOP Compensation expense is to be booked in P&L at time of Grant of Options during Vesting period. Reduces EPS
  - Intrinsic Value Method : Unlisted Companies – Normal Valuation
  - Fair Value Method : Listed Companies / Under IND-AS – Option Pricing Valuation (Black Scholes; Binomial Valuation)

Emerging Opportunities in Valuation in India

- Regulating Valuation practice
- Legal Recognition
- Requires Judgement
- Introduces Volatility
- Requires Skill set

REGISTERED VALUER (SECTION 247 OF COMPANIES ACT, 2013 AND COMPANIES (REGISTERED VALUERS AND VALUATION) RULES, 2017

Companies (Registered Valuers and Valuation) Rules, 2017

MCA has now issued the Companies (Registered Valuers and Valuation) Rules, 2017 (Rules) on 18th October, 2017. Simultaneously, section 247 of the Companies Act, 2013 has now come into force.

These rules contain various aspects pertaining to Registered Valuers including:

- Who can become Valuer (**Qualification**, **experience** and clearance of **Valuation exam**) for each **Asset Class** (Land & Building, Plant & Machinery and Financial Assets);
- **Eligibility and Role of Registered Valuers Organisation (RVO)**;
- The **Valuation Standards** required to be adhered to while performing and reporting;
- **Contents of the Valuation Report** including permissible caveats and limitations;
- **Professional competence** and **Due Care** and **Independence** of Valuer;
- **Maintenance of record** of each assignment for minimum 3 years and
- **Regulation of the profession** including Model code of conduct for Registered Valuers

REGISTERED VALUER

Companies (Registered Valuers and Valuation) Rules, 2017 (contd.)

As of now, the Registered Valuer provisions shall cover the following Acts/Regulations - Companies Act, 2013, Insolvency Code, 2016 and SEBI (REIT and InvIT) Regulations, 2016. However in times to come it is expected that other Regulators would also align their Act/Rules with these Registered Valuer provisions.

Specific provision dealing with the punishment and liability of the valuers which states that upon contravention of any of the Registered Valuer provisions, the Valuer shall be punishable with fine *including refund of remuneration and payment of damages out of incorrect/misleading statement in valuation report.*

However in case the valuer has intention to defraud, valuer shall be punishable with imprisonment upto 1 year and fine upto Rs. five lacs.

SECTION WISE REQUIREMENT OF REGISTERED VALUER

Companies Act, 2013

- For Valuing **further Issue of Shares**
- For Valuing **Assets involved in Arrangement of Non Cash transactions involving Directors**
- For Valuing **Shares, Property and Assets of the company under a Scheme of Corporate Debt Restructuring**
- For Valuation including Share swap ratio u**nder a Scheme of Compromise/Arrangement**, a copy of Valuation Report by Expert, if any shall be accompanied
- **Where under a Scheme of Compromise/Arrangement** the transferor company is a listed company and the transferee company is an unlisted company, **for exit opportunity to the shareholders of transferor company**, valuation may be required to be made by the Tribunal
- For Valuing **Equity Shares held by Minority Shareholders**
- For Valuing **Assets for submission of report by Company Liquidator**

Insolvency and Bankruptcy Code, 2016

The Liquidation Value is to be computed as per Regulation No 35
Regulation 35 prescribes *Liquidation value as the **estimated realizable value*** *of the assets if the company were to be liquidated on the insolvency commencement date.*

computed **in accordance with internationally accepted valuation standards, after **physical verification** of the inventory and fixed assets of the company;*

REGISTERED VALUER QUALIFICATION AND EXPERIENCE FOR DIFFERENT

Asset Classes	Qualification	Post Qualification Experience
Land and Building	Graduate in Civil Engineering, Architecture or Town Planning of a recognised university	5 years
	Post Graduate in Civil Engineering, Architecture or Town Planning of a recognised university	3 years
	Graduate in a discipline specified by the Authority for a RVO in its conditions of recognition and Post Graduate in Valuation of land and building or real estate from a recognised university	5 years
Plant and Machinery	Graduate in Mechanical or Electrical Engineering of a recognised university	5 years
	Post Graduate in Mechanical or Electrical Engineering of a recognised university	3 years
	Graduate in Valuation of machinery and plant from recognised university and Post Graduate in Valuation of machinery and plant from recognised university	3 years
Securities or Financial Assets	Graduate in any stream and Member of Professional Institute (CA/CS/CMA) or MBA/PGDBM specialisation in finance or Post graduate degree in Finance	3 years
	Any other graduate or post graduate level qualification as may be specified by Authority	5 year and 3 year respectively

CONDUCT OF VALUATION

Rule 8 – Conduct of Valuation

The registered valuer shall, while conducting a valuation, comply with the valuation standards

Provided that until the valuation standards are notified or modified by the Central Government, a valuer shall make valuations as per-

(a) internationally accepted valuation standards;
(b) valuation standards adopted by any registered valuers organisation.

The registered valuer may obtain inputs for his valuation report or get a separate valuation for an asset class conducted from another registered valuer, in which case he shall fully disclose the details of the inputs and the particulars etc. of the other registered valuer in his report and the liabilities against the resultant valuation, irrespective of the nature of inputs or valuation by the other registered valuer, shall remain of the first mentioned registered valuer.

CONTENTS OF VALUATION REPORT

The valuer shall in his report state the following-

- Background information of the asset being valued
- Purpose of Valuation and Appointing authority
- Identity of Valuer and any other experts involved in valuation
- **Disclosure of Valuer interest/conflict, if any**
- Date of appointment, valuation date and date of report
- Inspections and/or investigations undertaken;
- Nature and sources of the information used or relied upon;
- **Procedures adopted in carrying out the valuation and the valuation standards followed**
- Restrictions on use of the report, if any;
- Major factors that were taken into account during the valuation
- Conclusion and
- **Caveats, Limitations and Disclaimers to the extent they explain or elucidate the limitations faced by valuer, which shall not be for the purpose of limiting his responsibility for the valuation report.**

VALUATION GUIDANCE IN INDIA

- Business valuation principles and concepts, valuation approaches and methodologies in general and as prescribed under various statutes like Income Tax, RBI and SEBI for different purposes
- Valuation case laws
- ICAI business valuation standard
- ICAI Technical guide on Share Valuation
- erstwhile CCI guidelines,
- *Valuation reports and Fairness Opinions on Scheme of Arrangement (available in public domain)*

VALUATION GUIDANCE INTERNATIONALLY

Revenue Ruling 59-60

•**Revenue Ruling (RR) 59-60 is one of the oldest guidance available on Valuation in the world but still most relevant for Tax Valuations specifically for Valuing closely held common stock. It is the most widely referenced revenue ruling, also often referenced for Non Tax Valuations.**

- **While Valuing, it gives primary guidance on eight basic factors to consider-**
  - **Nature of the Business and the History** of the Enterprise from its inception
  - **Economic outlook** in general and outlook of the specific industry in particular
  - **Book Value** of the stock and the **Financial condition** of the business
  - **Earning Capacity** of the company
  - **Dividend-Paying** Capacity of the company.
  - **Goodwill** or other **Intangible value**
  - **Sales** of the stock and the **Size of the block of stock** to be valued
  - **Market prices** of stock of corporations engaged in the same or a similar line of business

International Valuation Standards

Further there are International Valuation Standards, 2017 issued by the International Valuation Standards Council (IVSC) which may be relied upon

Ind AS Valuation

- Emphasis on Fair Value
- Market-based measurement,
- NOT an entity-specific measurement
- Leading to use of Complex Valuation Methods

INTRODUCTION TO IND AS

Transition to Ind AS

Indian corporates are in the process of transitioning to a new set of accounting standards called the Indian Accounting Standards (Ind AS) which converge closely with the International Financial Reporting Standards (IFRS).

Advantages of Transition

- Improved Comparability
- Transparency
- Qualitative Financial Statements
- Global Acceptability

Fundamental changes due to Ind AS

Significant increase in focus on FAIR VALUE accounting (Approx. 75% of Balance Sheet size need Fair Value)

APPLICABILITY OF IND AS

Financial year	Mandatorily applicable to
2016-17	Companies (listed and unlisted) whose net worth is equal to or greater than 500 crore INR
2017-18	Unlisted companies whose net worth is equal to or greater than 250 crore INR and all listed companies
2018-19 onwards	When a company’s net worth becomes greater than 250 crore INR

IND AS USING FAIR VALUE AS THEIR GUIDING PRINCIPLE

- **Ind AS 113 – Dedicated Standard on Fair Value Measurement**
- **Ind AS 103 – Business Combination**
- **Ind AS 38 – Intangible Assets**
- **Ind AS 16 – Property Plant & Equipment**
- **Ind AS 36 – Impairment of Assets**
- **Ind AS 102 – Share based payment**
- **Ind AS 109 – Financial Instruments**
- **Ind AS 40 – Investment Property**

FAIR VALUE

The PRICE that would be RECEIVED TO SELL AN ASSET or PAID TO TRANSFER A LIABILITY in an ORDERLY TRANSACTION between M

- Fair Value is a market-based measurement, NOT an entity-specific measurement

- It is measured using the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. As a result, an entity's intention to hold an asset or to settle or otherwise fulfill a liability is NOT relevant when measuring fair value

FAIR VALUE HIERARCHY PRESCRI

Level -1

If there is principal market for asset or liability with Quoted Price

<u>Quoted Price</u> - <u>Unadjusted</u> (whether that price is directly observable or estimated using another valuation technique)

Level -2

If there is principal market for asset or liability <u>but quoted price is not available</u>

Quoted Price for Comparable Companies (CCM Method)

<u>Adjustments to Level-2 Inputs are permitted</u> including for condition or location of Asset; Volume of activity in markets within which inputs are observed

Level-3

Unobservable Inputs shall be used, where there is little, market activity for the asset/liability at the measurement date. An entity may begin with own data but shall adjust that if market participants would use different data (which is reasonably available).

Discounted Cash Flow Method

Black Scholes or Binomial models

Other methods

FINANCIAL VALUATION REQUIREMENT UNDER IND AS

On the date of Transition and also for comparative periods

- Fair Value of ESOP's is required as on Grant date (for unexpired ESOP's)
- Fair Value of Financial Instruments including Call and Put Options , if applicable
- Purchase Price Allocation (PPA) of all Assets is required as on Acquisition date including Call and Put Options, if applicable

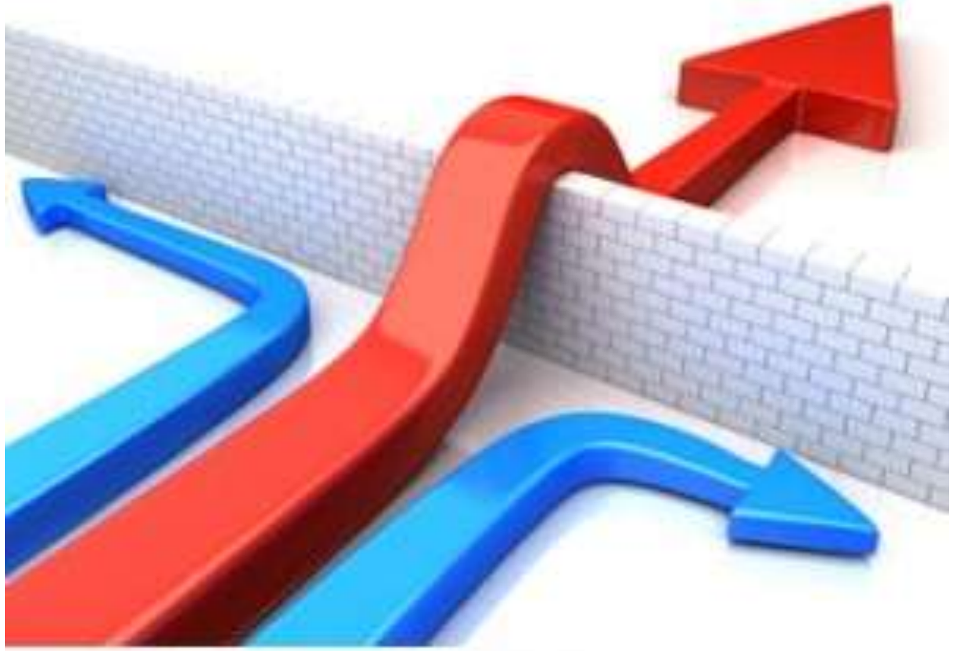
On each reporting date

- Fair Value of Financial Instruments
- Call and Put Options , if applicable

COMPLEX VALUATIONS UNDER IND AS

- Valuation of Compound/Convertible Instruments (CCPS/OCPS)
- Valuation of Embedded Derivatives
- Valuation of Equity Shares based on Preferred Shares having Liquidation Preferences
- Valuation of Options with conversion at any time upto Expiry
- Valuation of Corporate Guarantee
- Valuation of Redeemable Preference Shares

Tricky Issues



DISCOUNTS

Discounts & Premiums come into picture when there exist difference between the subject being valued and the Methodologies applied. As this can translate control value to non-control and vise versa , so these should be judiciously applied.

- **Discount for Entity Level** – Impact on entity as a whole
  - Key Person Discount
  - Discount for Contingent Liability
  - Discount for diversified company
  - Discount for Holding Company
  - Tax Payout

Global Studies over the years on diversified companies and holding companies has shown that companies trade at a discount in the range of 20%. to 40% each.

- **Discount for Shareholders Level** – Impact on specific ownership interest
  - Discount Lack of Control (DLOC)
  - Discount Lack of Marketability (DLOM)

DLOM: As per CCI Guidelines, 15% discount has been prescribed; however practically DLOM and DLOC depends upon following factors:

- % stake & special rights
- Size of distribution or dividends
- Dispute
- Revenue / Earning – Growth / Stability
- Private Company
- Shareholders Agreement Restrictions

EXCESS CASH AND NON OPERATING ASSETS

Excess cash is defined as 'total cash (in balance sheet) **–** operating cash (i.e. minimum required cash) to sustain operations (working capital) and manage contingencies

Key Issue: Estimation of Excess Cash ?

One of the solutions is to estimate average cash/sales or total balance sheet size of the company's relevant Industry and then estimate if the company being valued has cash in excess of the industry's average.

Non operating Assets are the Surplus assets which are not used in operations of the business and does not reflect its value in the operating earnings of the company. Therefore the fair market value of such Assets should be separately added to the value derived through valuation methodologies to arrive at the value of the company.

However when valuing a <u>non controlling ownership interest</u> under the income approach, the value of any non operating assets, non operating liabilities, or excess or deficient operating assets **may or may not be used** to adjust the value of the operating entity **depending on the Valuer's assessment of the influence exercisable by the non controlling interest (ICAI Business Valuation Standard)**

CROSS HOLDING & INVESTMENTS

Holdings in other firms can be categorized into:

Types of Cross Holding	Meaning
Minority, Passive Investments	If the securities or assets owned in another firm represent less than 20% of the overall ownership of that firm
Minority, Active Investments	If the securities or assets owned in another firm represent between 20% and 50% of the overall ownership of that firm
Majority, Active Investments	If the securities or assets owned in another firm represent more than 50% of the overall ownership of that firm

Ways to value Cross Holding and Investments:

- Investment Value
- Dividend Yield Capitalization or DCF based on expected dividends
- Separate Valuation (Preferred)

By way of Shareholders Agreement even less % holding may command control value

ACCOUNTING PRACTICES & TAX ISSUES

Most of the information that is used in valuation comes from financial statements. which in turn are made on certain Accounting practices considered appropriate.

- **Ind AS v. Ind GAAP**
- **Cash v. Accrual System**
- **Operating Lease v/s Financial Lease**
- **Notional Tax vs. Actual Tax**
- **Treatment of Intangible Assets**
- **Companies Paying MAT**
- **Treatment of Tax benefits and Losses**

CONTROL PREMIUM & TAKEOVER BID

“Beauty lies in the eyes of the beholder; valuation in those of the buyer”

- An investor seeking to acquire control of a company is typically willing to pay more than the current market price of the company. **Control premium** is an amount that a buyer is usually willing to pay over the fair market value of a publicly traded company to acquire controlling stake in a company.
- Control can be direct (shareholding or Authority to appoint Board) or indirect (veto power, casting vote etc)
- Research has shown that the control premium in India has widely ranged from 30-50% in the past few years having median of 40%.

Recent Transactions (2016)	Control Premium
Microsoft acquires LinkedIn	50%
Oracle acquires NetSuite	19%
Verizon acquires Fleetmatics Group	40%

QUALITATIVE FACTORS

- Industry Assessment
- Economy
- Management Competence and Experience
- Competitors and Entry Barriers
- Proprietary Assets (Tangible and Intangibles)
- Strategic relationships
- Financial Condition
- Risk Factors

TO SUM UP

- Understand Purpose of Valuation and Use of Report
- Ascertain Scope of Work
- Choose right Standard and Premise of Valuation
- Understand Business drivers, Industry trends and Competitors
- Validate Business Model and Projections, choose appropriate Discount rate
- Apply prescribed Valuation methodologies for Regulatory / contractual purposes
- In case of Business Valuation, consider all Valuation approaches and give weights to all Valuation methods. Also consider past performance and Sectoral trends (present and estimated). Make basis of selection/ignoring methods. Perform Scenario Analysis.
- Give suitable Discounts and Premium considering Minority/Control purpose
- Rely on empirical studies, Case Laws and form basis of Conclusion
- Clearly document and disclose all assumptions and limitations

Let's Learn…Unlearn…Relearn and make the most of Professional Opportunities

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