Introduction, Overview and Importance of Valuation

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Valuation concepts

- Valuation means the procedure and technique of estimating the value of ***specific asset*** at a ***stated time*** and place and for a ***specific purpose***
- 'Value' from an economic /commercial perspective
- Valuation is not just a science, but an art. Though quantitative in nature, the valuation methods require inputs that are based on subjective judgment
- Imprecise nature of outcomes and degree of unpredictability; Value hovers within a range not a precise number
- Valuations impacted by external developments including regulatory and political

Valuation principles

- *Prices ~ = Value;* under free market conditions
- Concept of *risk/ risk free* rate of return
- *Financial assets* are claims on *real assets*
- Earnings value is the value of a *going concern*
- Tangible Assets + Intangible Assets = Business Enterprise Value
- Equity value = Business Enterprise Value - Debt

Why valuations?

Deal Related

- Merger/ Demerger
- Purchase/ Sale of Business
- Joint Venture

Regulatory

- RBI
- Tax
- Transfer pricing
- SEBI – Takeover code

Financial Reporting

- Purchase price allocation
- Portfolio value of investments
- Test of Impairment

Others

- Family settlement
- Litigation

Levels of Value

Key valuation opportunities under Companies Act, 2013

Issue of new shares
Section 62(1)(c)

Compromise, Arrangements and Amalgamations
Section 281 (1) ; 305(2)

Winding up of a company
Section 281 (1) (a), Section 305 (2) (d)

Non-cash transaction with Directors or related parties
Section 192

Issue of sweat equity to directors or employees
Section 54

Purchase of Minority shareholding
Section 236

Instances of Fair Valuation Services under IND AS

113 – Fair value measurements

- Fair value to be measured from a general market participant perspective and to exclude entity specific considerations;
- Assumes that a transaction is taking place in the principal market for the asset or liability, or in the absence of a principal market, the most advantageous market for the asset or liability;
- Takes into account the highest and best use of a non-financial asset;
- Fair Value should be before subtracting any transaction costs

102 – Share-based payments

- All types of share-based payments (equity and cash settled share based payment) to employees and others to be measured at fair value and recognized over the vesting period

103 – Business combinations

- Acquisition of a business (entity or an undertaking) to be reported in accordance with Ind AS 103. Business Combinations require:
  - tangible assets to be fair valued;
  - intangibles assets to be identified and fair valued;
  - residual purchase price forms an estimate of goodwill;
  - fair valuation of non controlling interest ('NCI')

Instances of Fair Valuation Services under IND AS

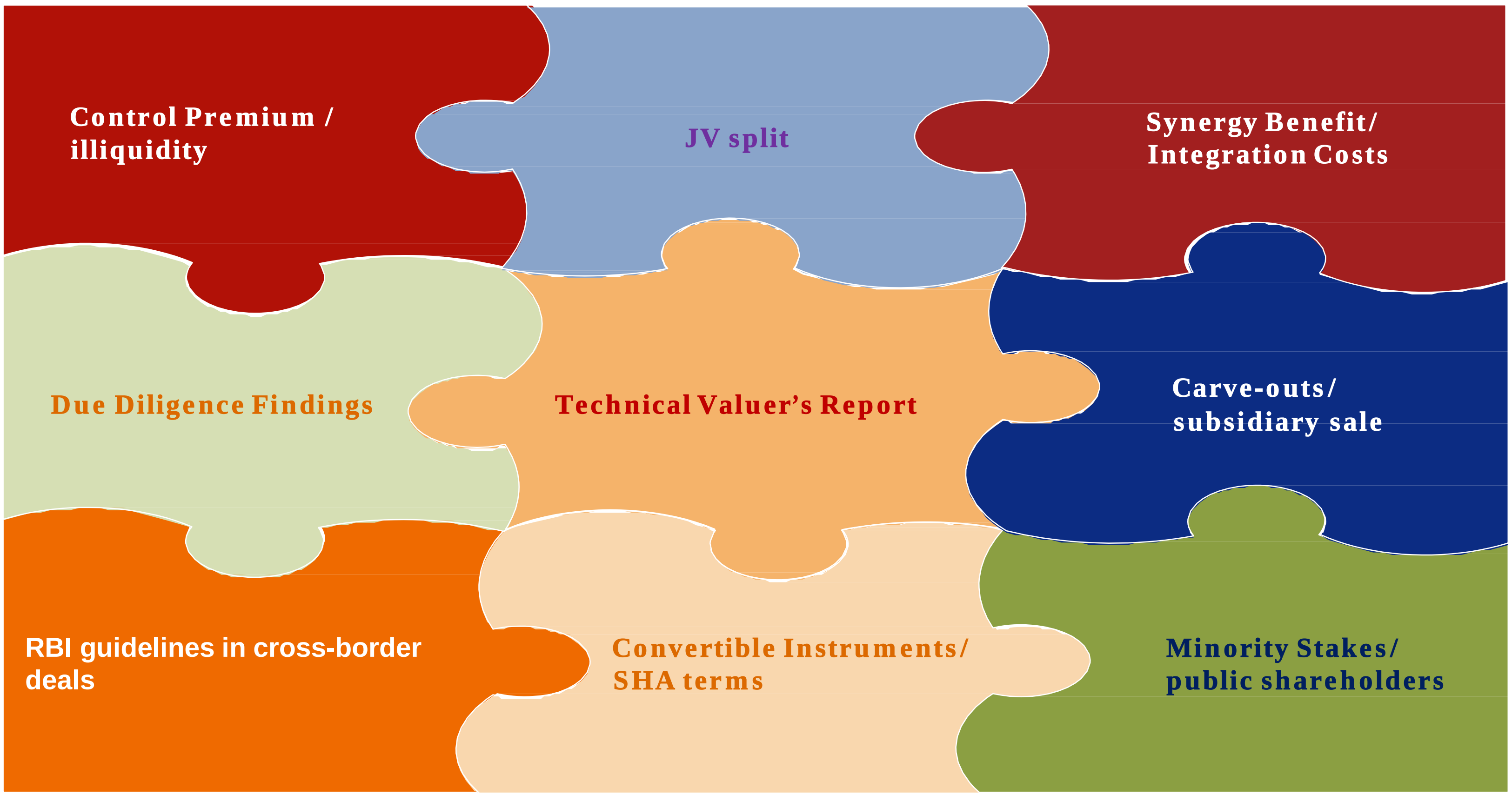
36 – Impairment testing/ 38 – Intangible assets

- Following to be tested for impairment on an annual basis:
- On certain triggers impairment testing to be undertaken for cash generating unit ('CGU')
- goodwill; and
- indefinite life intangible assets

109 – Financial instruments / 32 – Financial instruments: presentation

- Financial assets (debt and equity instruments and derivatives) and financial liabilities to be measured at fair value (except stakes held in JV, Associates and subsidiaries covered under relevant Ind AS pronouncements)
- Compound instruments (hybrid instruments) to be split into liability and equity components and both to be measured at fair value

Typical issues in Valuation



Issues in Valuation - Generic

Control Premium/ Illiquidity discount

- Control premium is embedded in the DCF approach
- Premium gets considered in Market Multiples approach which represents level of value of a minority liquid stake
- Premium can range from 20-30% based on empirical stock market data
- Illiquidity discount was earlier mandated under CCI guidelines @ 15%, typically ranges from 10-15%
- Usage of both depends on context of valuation

JV split

- Stakeholders typically have widely differing return expectations
- Conflicting business plans depending on the viewpoint of the stakeholder
- Valuer may end up getting questioned by all parties!

Issues in Valuation of Target Companies

Synergy Benefit / Integration Costs

- More applicable in the case of a strategic acquirer
- Valuation may consider more than one scenario based on alternative synergies / integration strategies; becomes a Management tool
- Can significantly impact the transaction price

Due Diligence Findings

- Key element of the deal process
- Quantified key deal adjustments typically lead to valuation adjustments
- Unquantifiable issues may also impact risk assessment, cost of capital, etc.

Issues in Valuation of Target Companies

Technical Valuer's Report

- Typical example would be fixed asset valuation
- Surplus assets usually reflected at fair value
- Fair value of operational assets typically considered vis-a-vis present value of free cash flows as part of sense check

Carve-outs/ subsidiary sale

- Determining maintainable profits key to valuation of a division / subsidiary of a large group
- Corporate overheads / shared service centre costs?
- Corporate guarantees - unusually low cost of debt?
- Costs of transferring business to new location?

Issues in Valuation of Target Companies

RBI guidelines in cross-border deals

- RBI mandates use of "internationally accepted pricing methodology" for cross-border issue or transfer of shares/equity instruments in an Indian company
- Such value forms 'floor' in case of inbound investment, and 'ceiling' in case of outbound investment
- Impact on exit plans? Agreed return on investment may not match such value at that time

Convertible Instruments

- Policy revised in July 2014
- Valuation guidance as stated above in case of investment in equity of Indian companies in cross border deals.
- The guiding principle will be that the non-resident investor is not guaranteed any assured exit price at the time of making such investment/agreement and shall exit at a fair price computed as above at the time of exit

Issues in Valuation of Target Companies

Minority Stakes/ public shareholders

- Premised on the lower control / access to information that a minority stakeholder may have
- Judgment to be exercised - % stake held need not indicate 'true' level of control
- Implication on public shareholders – not the valuer's clients, but interest needs to be protected
- Also relevant in portfolio valuations where the financial investor may hold a minority stake

Valuation methodologies

Approach	Income Approach	Market Approach	Cost Approach
Fair Value Estimation	***"Mark to Model"*** Income Approach considers the expected cash flows/ income the business is expected to generate and is considered most appropriate in case of a 'going concern'.	***"Mark to Market"*** Estimates the fair value based on market multiples or transactions involving sale of comparable assets.	***"Mark to Cost"*** Fair value is based on summation of net assets in the balance sheet/ replacement cost – adjusted for amortisation/ obsolescence.
Methods	**Discounted Cash Flow ('DCF')**	**Comparable Market/ Transaction Multiples**	**Summation of individual piecemeal values of assets less value of liabilities in the balance sheet/ Replacement Cost**

- considers the market price of the company/ comparable companies traded on the stock exchanges or prices implied by reported deals of comparable companies.

The theory to beat all other theories on valuation ….A business is worth what someone is prepared to pay for it!