

Valuation – Overview & Methodologies



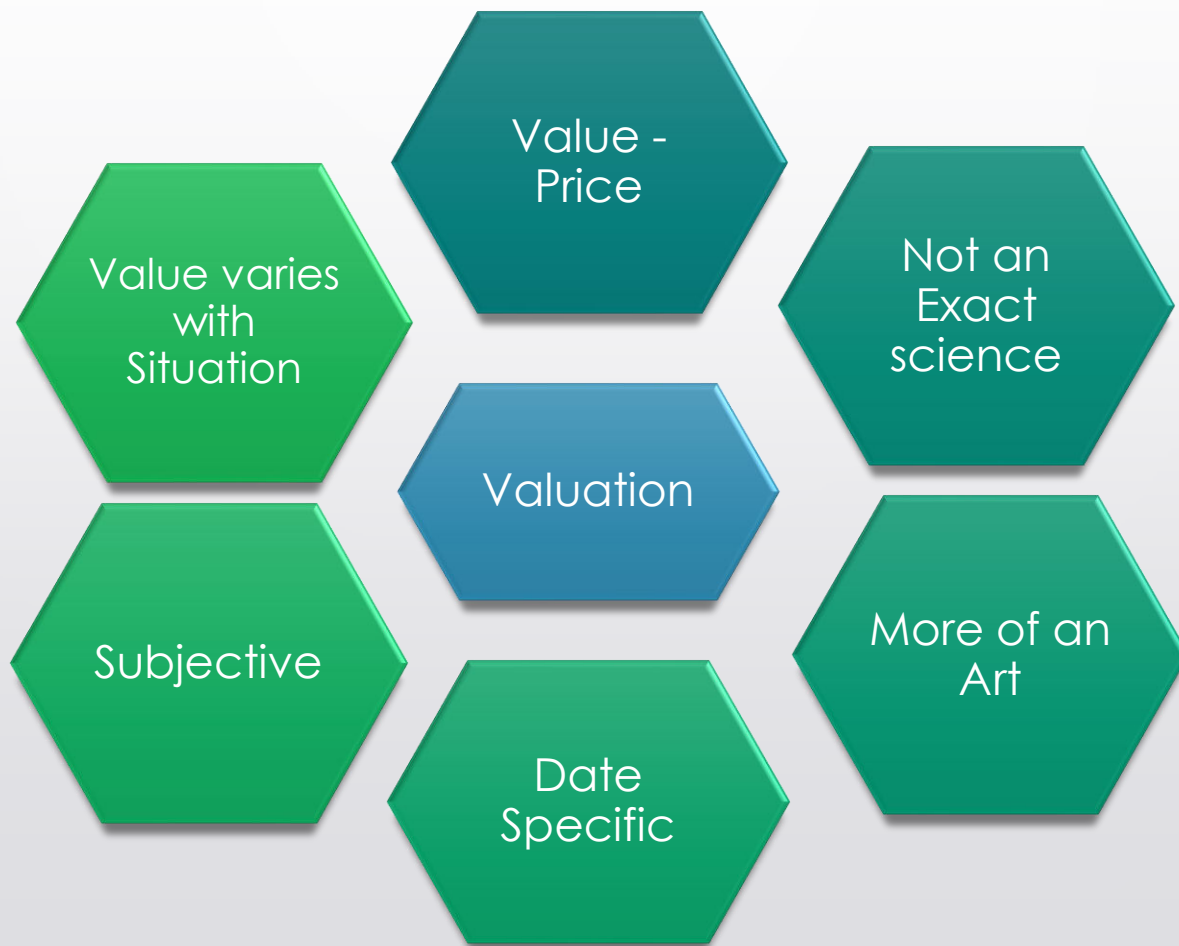
CA Sujal Shah & CA Bhakti Shah

18th November 2017

ICAI – Mumbai

Seminar on Valuation

VALUATION CONCEPTS



PURPOSE OF VALUATION

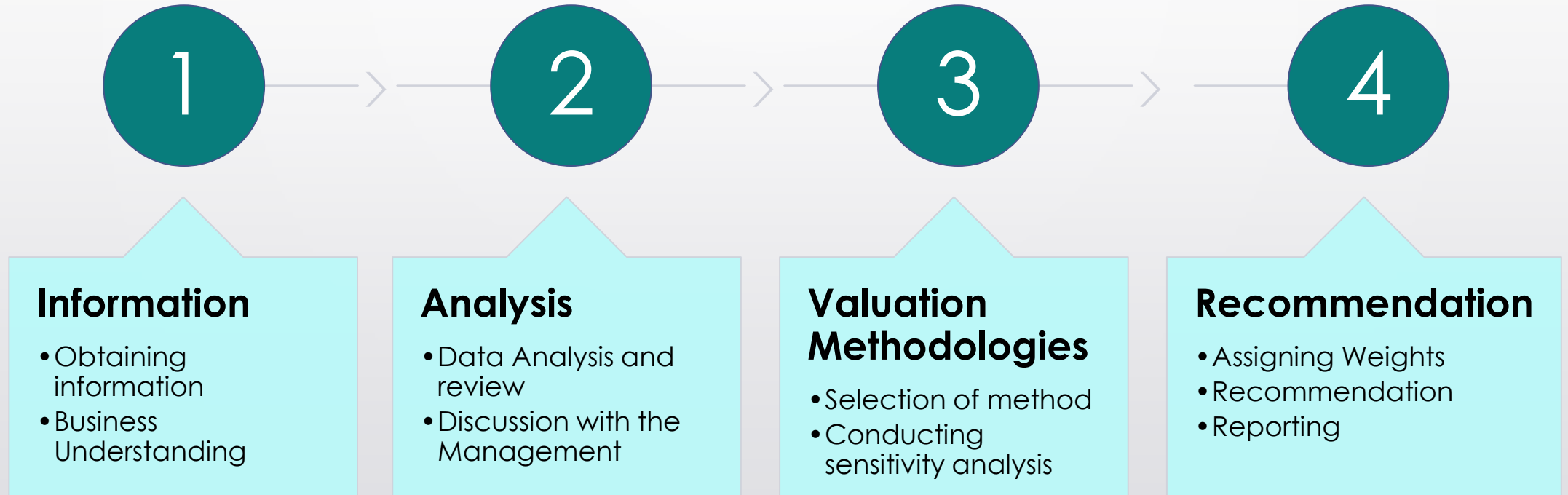


| Business Valuation | Regulatory | Intangibles | Financial Reporting |
|--------------------------------------|------------------|-------------------------|--|
| Restructuring | FEMA | Purchase / Sale | Purchase Price Allocation |
| Purchase / Sale of shares / business | Income Tax Act | Hypothecation | Private Equity/ Venture Capital Funds |
| Litigation / Family Settlements | SEBI Regulations | Accounting for purchase | Financial Instruments |
| Fund raising | Companies Act | Impairment | Ind AS reporting – Fair Value / Impairment |

VALUATION PROCESS



STEPS IN VALUATION



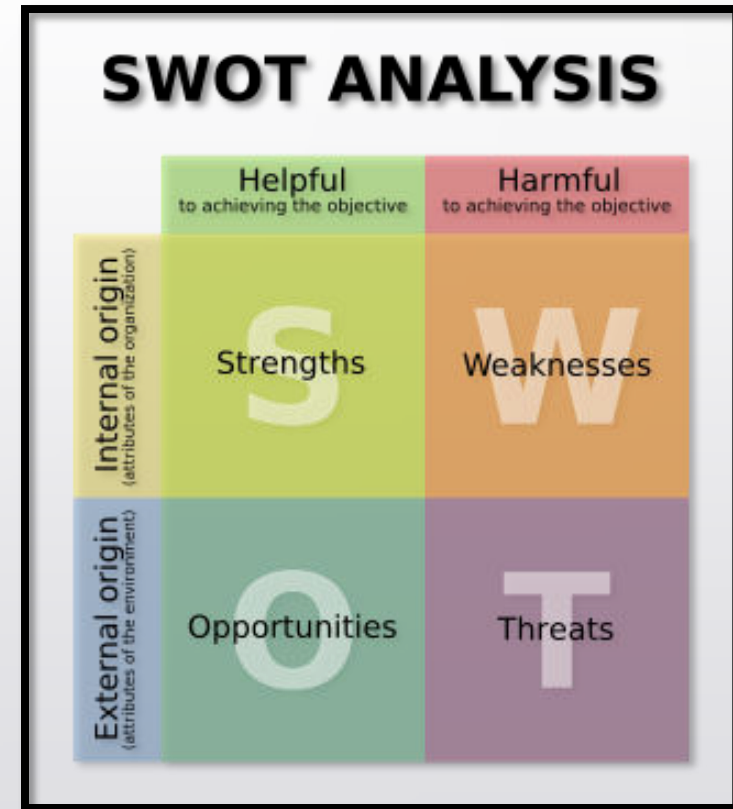
SOURCES OF INFORMATION



- Historical data such as audited results of the Company
- Industry & Company overview
- Future projections
- Management Discussion
- Stock market quotations / announcements
- Publicly available data on comparable companies
- Market surveys, news paper reports
- Representation by Management

ANALYSIS OF THE COMPANY

- Understanding of the Business
- Industry Analysis
- Existing policy/ legal framework
- SWOT Analysis
- Profitability Analysis
- Financial Ratio Analysis
- Projection analysis
 - Installed capacity
 - Revenue and Expenses ratio analysis
 - Capital expenditure – increasing capacities
 - Working capital requirements
 - Alternate scenarios / sensitivities



VALUATION METHODOLOGIES



VALUATION METHODOLOGIES

INCOME APPROACH

Discounted Cash Flow Method

MARKET APPROACH

Market Price Method

Comparable Companies Multiple Method

Comparable Transactions Multiple Method

ASSET APPROACH

Net Assets Value Method

Replacement Value/Realizable Value Method

INCOME APPROACH



DISCOUNTED CASH FLOW ('DCF') METHOD

1

Values a business based on the expected cash flows over a period of time

2

Considers cash flows and not accounting profit

3

Value of business is aggregate of discounted value of the cash flows for the explicit period and perpetuity

4

Involves determination of discount factor and growth rate for perpetuity

DCF - Parameters

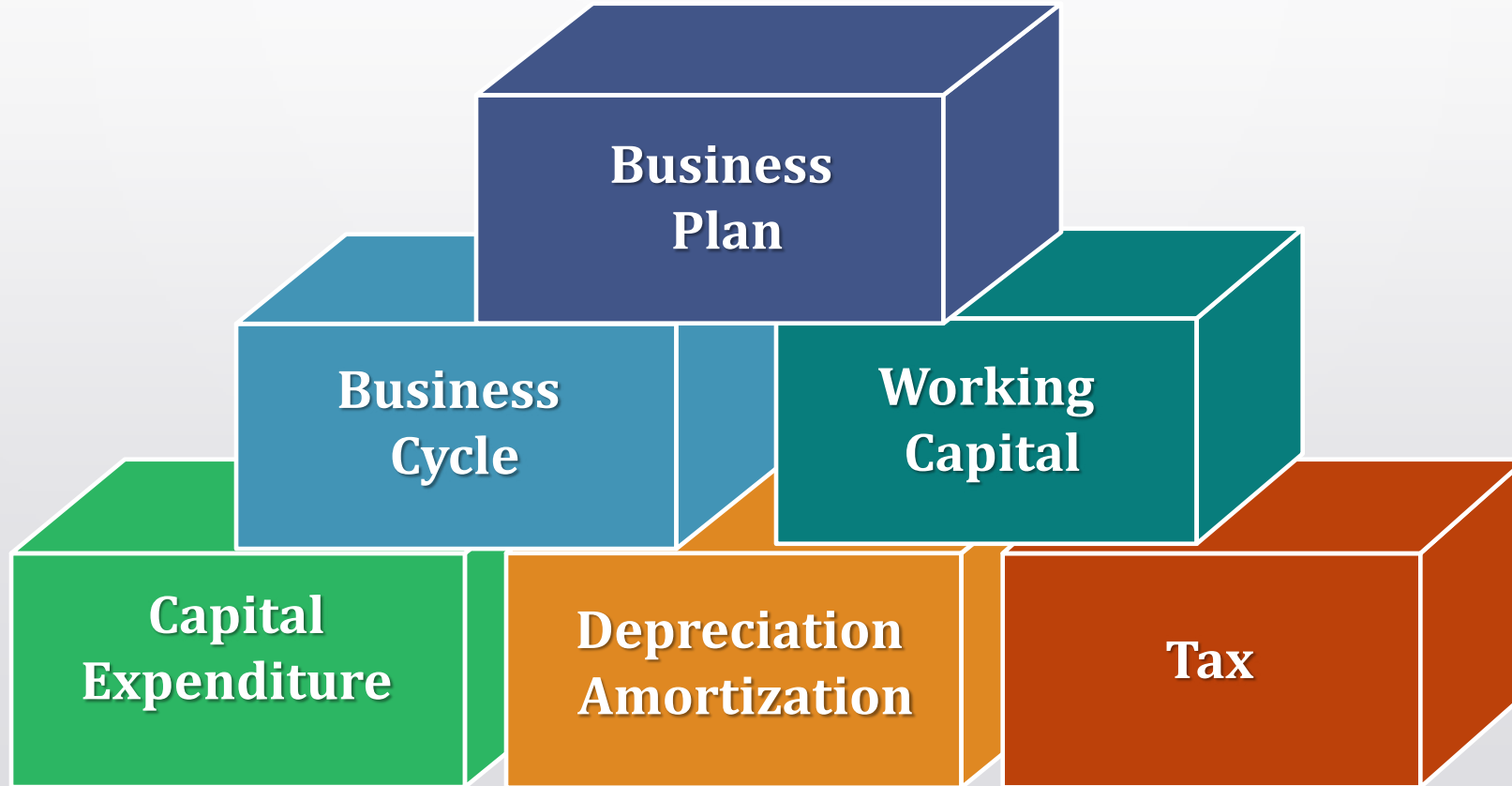
Cash Flows

- Projections
- FCF to Firm or FCF to Equity
- Horizon (Explicit) period
- Growth rate for perpetuity

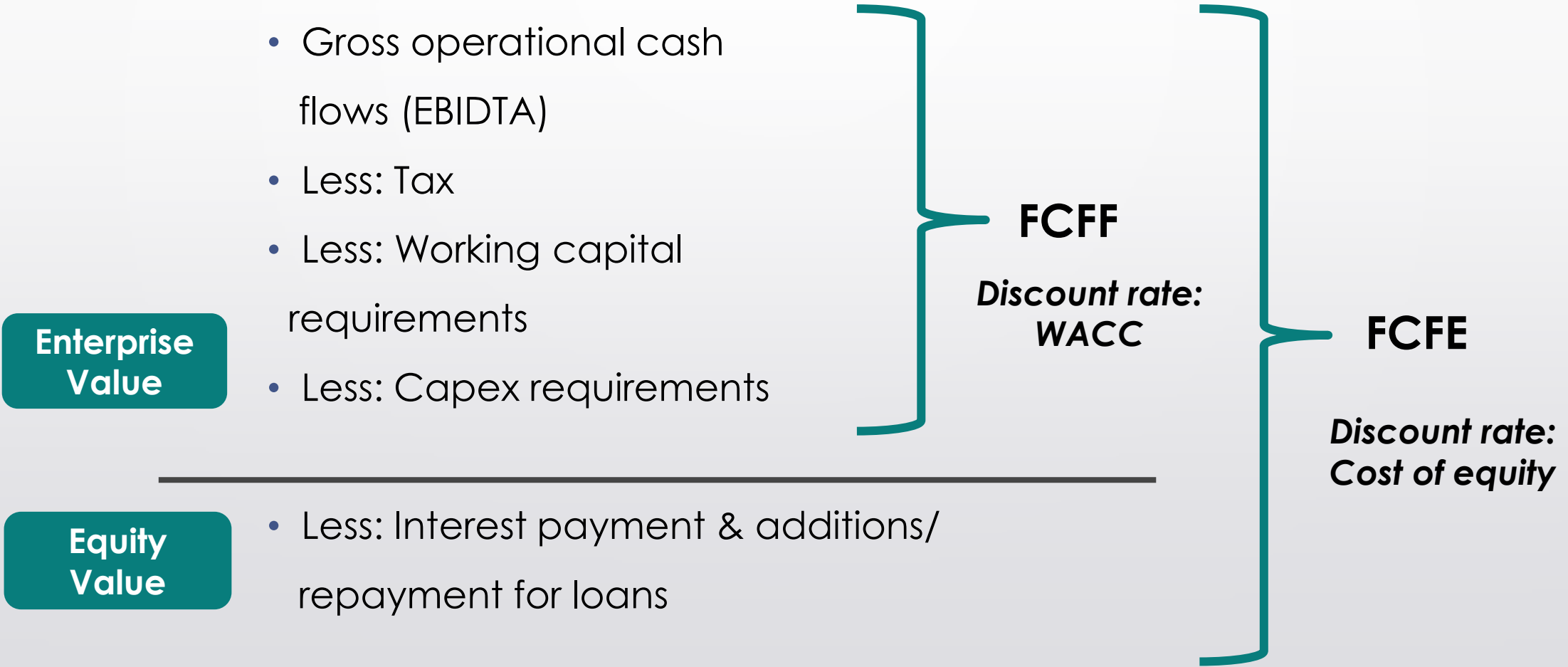
Discounting rate

- Cost of Equity
- Cost of Debt
- Debt Equity ratio

CASH FLOWS



CASH FLOWS



COST OF EQUITY

CAPITAL ASSET PRICING MODEL

$$K_e = R_f + (R_m - R_f) * \beta + \text{SCRCP}$$

Risk Free
Rate

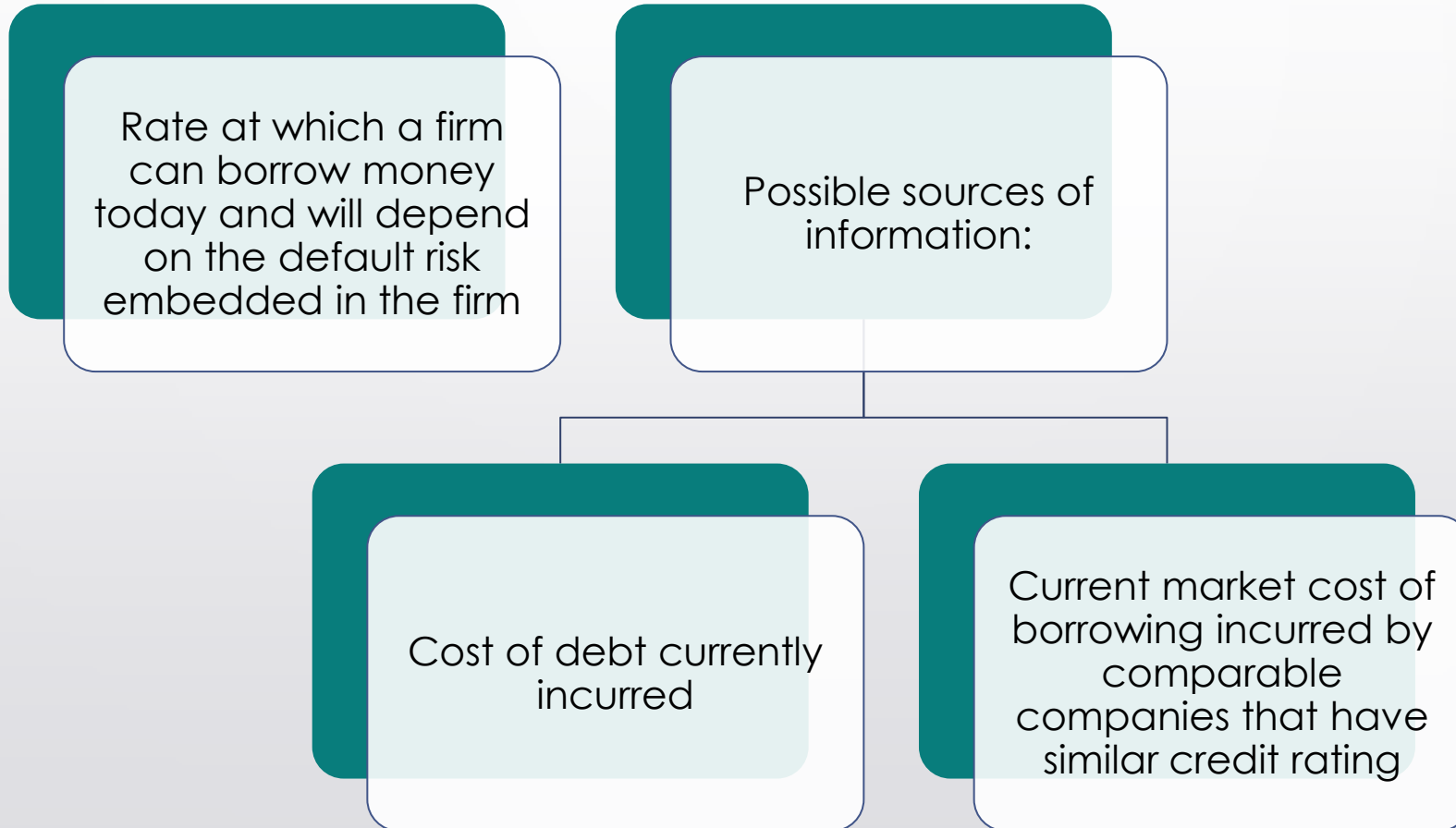
Equity
Market Risk
Premium

Beta (β)

Specific
Company
Risk
Premium
(SCRCP)

*Rm: Market Return

COST OF DEBT



DISCOUNTING FACTOR



Weighted Average Cost of Capital (WACC) =

$$\left\{ \frac{D}{(D + E)} \times K_d \right\} + \left\{ \frac{E}{(D + E)} \times K_e \right\}$$

D = Debt

E = Equity

K_d = Post tax cost of debt

K_e = Cost of equity

CALCULATION OF WACC



CALCULATION OF WACC

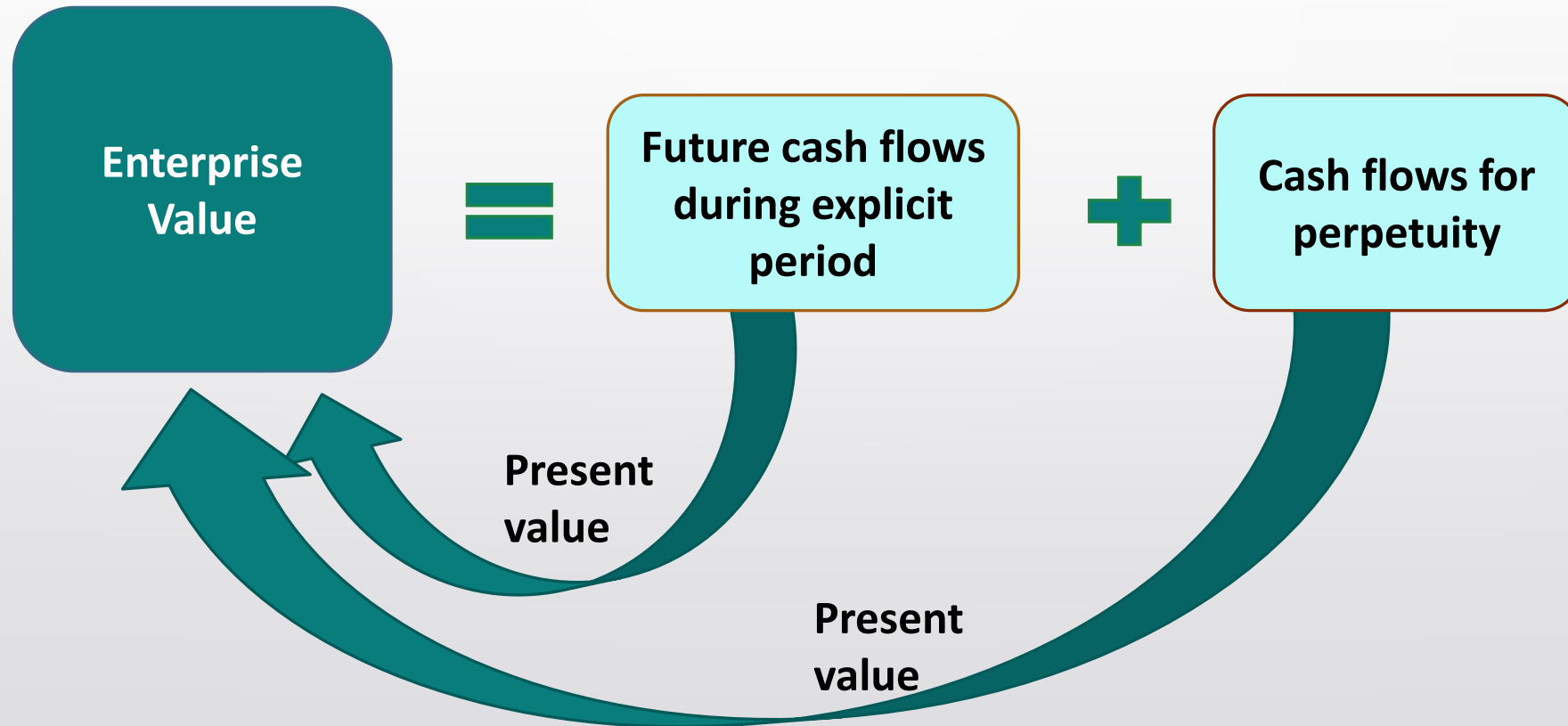
| <u>Cost of Equity</u> | Risk Free Return | Beta | Equity Risk Premium |
|--------------------------------|------------------|------|---------------------|
| | 7.00% | 0.60 | 8.00% |
| Cost of Equity | 11.80% | | |
| SCRP | 1.00% | | |
| Adjusted Cost of Equity | 12.80% | | |

| <u>Cost of Debt</u> | Interest Rate | Tax |
|---------------------|---------------|--------|
| | 10.50% | 34.61% |
| Cost of Debt | 6.87% | |

| <u>Debt - Equity</u> | Debt | Equity |
|----------------------|------|--------|
| | 25% | 75% |

| | |
|-------------|---------------|
| WACC | 11.32% |
|-------------|---------------|

DCF VALUE



ADJUSTMENTS



- Market value of the investments
- Other non-operating surplus assets
- Surplus cash
- Contingent liabilities / assets
- Loan Funds
- Preference Share Capital



EXAMPLE FREE CASH FLOW TO FIRM



(INR Lacs)

| Particulars | | 2016-17 | 2017-18 | 2018-19 | Perpetuity |
|---|-----|------------|------------|------------|--------------|
| Operating PBT | | 430 | 518 | 596 | |
| Add: | | | | | |
| Interest | | 56 | 44 | 46 | |
| Depreciation | | 70 | 80 | 86 | |
| EBITDA | | 556 | 642 | 728 | |
| Less: | | | | | |
| Capital Expenditure | | 45 | 45 | 45 | |
| Incremental Working Capital | | 20 | 30 | 40 | |
| Tax | | 158 | 182 | 208 | |
| Total Outflows | | 223 | 257 | 293 | |
| Free Cash Flow (FCF) | | 333 | 385 | 435 | |
| Growth Rate | | | | | 5% |
| Cash Flow for 2019-20 | | | | | 457 |
| Capitalised Value for Perpetuity | | | | | 5,709 |
| Discounting Factor | 13% | 0.88 | 0.78 | 0.69 | 0.69 |
| Net Present Value of Cash Flows | | 295 | 302 | 301 | 3,957 |
| Enterprise Value | | | | | 4,855 |
| Less: Loan Funds | | | | | (930) |
| Less: Preference Share Capital | | | | | (150) |
| Add: Surplus Cash | | | | | 150 |
| Less: Contingent Liabilities | | | | | (20) |
| Add: Value of Investments | | | | | 850 |
| Adjusted Value For Equity Shareholders | | | | | 4,755 |
| No. of Equity Shares (FV - INR 10 each) | | | | | 9,00,000 |
| Value per share (INR) | | | | | 528 |

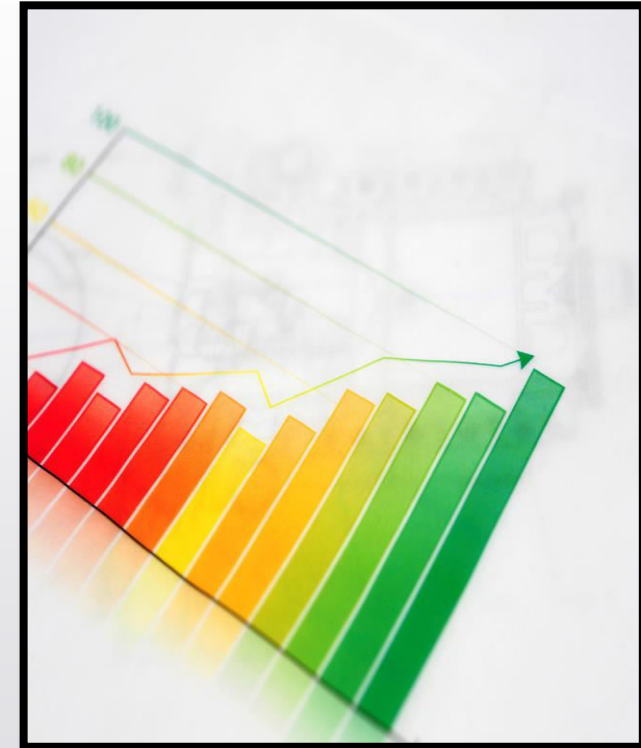
MARKET APPROACH



MARKET PRICE METHOD



- Evaluates the value on the basis of prices quoted on the stock exchange
- It is prudent to take weighted average of quoted price over a reasonable period
 - Significant and Unusual fluctuations in the Market Price
- Thinly traded / Dormant Scrip – Low Floating Stock
- Regulatory bodies often consider market value as important basis – Preferential allotment, Takeover code



EXAMPLE – MARKET PRICE METHOD



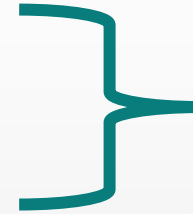
| Month | Volume | Turnover (INR) |
|------------------------------|---------------------|------------------------|
| April 2017 | 3,07,47,812 | 4,60,99,75,753 |
| May 2017 | 1,20,40,227 | 2,69,78,68,740 |
| June 2017 | 1,96,03,244 | 3,97,62,64,011 |
| July 2017 | 1,61,08,953 | 3,57,32,16,654 |
| August 2017 | 1,81,15,567 | 4,93,70,62,216 |
| September 2017 | 2,99,08,604 | 6,73,54,15,743 |
| Total | 12,65,24,407 | 26,52,98,03,117 |
| | | |
| Value per share (INR) | | 210 |

COMPARABLE COMPANIES MULTIPLE METHOD



Earnings Based

- EBITDA Multiple (EV / EBITDA)
- Revenue multiple (EV / Revenue)
- PE Multiple



Enterprise Value



Equity Value

Asset Based

- Book Value Multiple

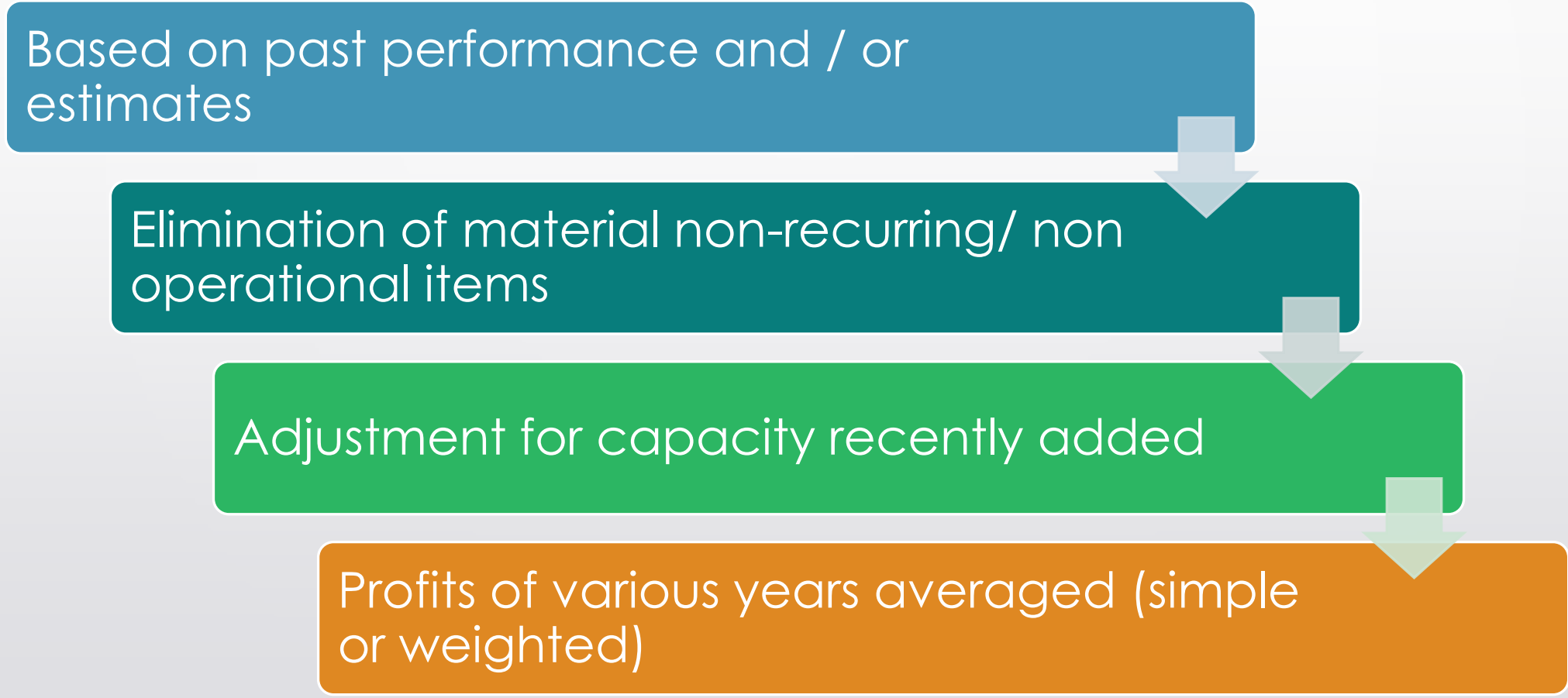


Equity Value

MARKET MULTIPLES

- 
- Generally applied in case of unlisted entities
 - Estimates value by relating an element with underlying element of similar listed companies
 - Based on market multiples of Listed Comparable Companies
 - PE Multiple
 - EV/EBITDA Multiple
 - Revenue Multiple
 - Book Value Multiple
 - Industry Specific Multiple
 - EV/ Tonne – Cement Manufacturing Companies
 - EV/ Bed – Hospital Business
 - EV/ Room Keys – Hotel Business
 - EV/ Tower – Telecom Tower Companies
 - % of AUM – Asset Management Companies

MAINTAINABLE PROFITS



MULTIPLE



1. • Historical multiples enjoyed on the Stock Exchange by the listed comparable companies
2. • Past and Expected Growth of the Earnings
3. • Performance vis-à-vis Peers
4. • Size, Location & Market Share

EXAMPLE – EV / EBITDA MULTIPLE

XYZ LTD

CALCULATION OF ADJUSTED PBT & EBITDA

(INR Lacs)

| Particulars | 2014-15 | 2015-16 | 2016-17 |
|--|------------|------------|------------|
| | Audited | Audited | Budget |
| Reported Profit before tax | 540 | 780 | 910 |
| <u>Less:Non recurring income</u> | | | |
| Dividend Income | 340 | 300 | 300 |
| Profit on sale of Fixed Assets | 10 | - | 120 |
| Profit on sale of Investments | 50 | 100 | - |
| Interest on Income tax refund | - | 40 | 50 |
| Interest Income | 10 | 18 | 30 |
| Total Non recurring Income | 410 | 458 | 500 |
| <u>Add:Non recurring expenses</u> | | | |
| Loss on sale of Fixed Assets | - | 10 | - |
| VRS Paid | 10 | 15 | 20 |
| Total Non recurring Expenditure | 10 | 25 | 20 |
| Adjusted PBT | 140 | 347 | 430 |
| Add: Interest | 165 | 113 | 56 |
| Add: Depreciation | 79 | 75 | 70 |
| Adjusted EBITDA | 384 | 535 | 556 |

EXAMPLE – EV / EBITDA MULTIPLE

(INR Lacs)

| Particulars | XYZ Ltd | | |
|---|------------|----------|--------------|
| | Adj.EBITDA | Weight | Product |
| 2014-15 | 384 | 0 | - |
| 2015-16 | 535 | 1 | 535 |
| 2016-17 | 556 | 1 | 556 |
| TOTAL | | 2 | 1,091 |
| Maintable EBITDA | | | 546 |
| EV/EBITDA Multiple | | | 9 |
| ENTERPRISE VALUE | | | 4,910 |
| Adjustments | | | |
| Add: Value of Investments | | | 850 |
| Less: Contingent Liabilities | | | (20) |
| Add: Surplus Cash | | | 150 |
| Less: Loan Funds | | | (930) |
| Less: Preference Share Capital | | | (150) |
| Adjusted Equity Value | | | 4,810 |
| No. of Equity Shares (FV - INR 10 each) | | | 9,00,000 |
| Value per share (INR) | | | 534 |

COMPARABLE TRANSACTION MULTIPLE METHOD



- Determines the value based on any recent transaction in the Comparable Companies
- Multiples derived from recent M&A transactions are considered
 - EV/EBITDA
 - EV/Sales
 - Book Value Multiple
 - Industry Specific Multiple
- Generally, used as a cross check

ASSET APPROACH



NET ASSETS VALUE ('NAV') METHOD



| |
|---|
| Total Assets (excluding Miscellaneous Expenditure and debit balance in Profit & Loss Account) |
| Less: Total Liabilities |
| NET ASSET VALUE |

OR

| |
|--|
| Share Capital |
| Add: Reserves |
| Less: Miscellaneous Expenditure |
| Less: Debit Balance in Profit & Loss Account |
| NET ASSET VALUE |

REPLACEMENT / REALISABLE VALUE METHOD



Replacement value of assets

- Cost of new asset
- Similar condition
- Equivalent utility
- Depreciation for obsolescence

Realisable value of assets

- Cost of disposal
- Tax on sale (STCG, LTCG etc.)
- Time required

EXAMPLE – NAV METHOD

(INR Lacs)

| Particulars | XYZ Ltd | |
|---|---------|--------------|
| Net Fixed Assets | | 1,000 |
| Current Assets | 2,450 | |
| Current Liabilities | (1,565) | |
| Net Current Assets | | 885 |
| Investments | | 500 |
| Deferred Tax Liabilities | | (100) |
| Loan Funds | | (930) |
| Net Assets Value | | 1,355 |
| Adjustments: | | |
| Add: Appreciation in the value of investments | | 350 |
| Less: Preference Share Capital | | (150) |
| Less: Contingent Liabilities | | (20) |
| Adjusted Net Assets | | 1,535 |
| No. of Equity Shares (FV - INR 10 each) | | 9,00,000 |
| Value per share (INR) | | 171 |

VALUATION – OTHER ASPECTS



COMMON ADJUSTMENTS

- Contingent Liabilities/Assets
- Investments
- Surplus Assets
- Redeemable Preference Shares
- ESOPs / Warrants
- Convertible Instruments
- Tax concessions
- Auditors Qualification
- Findings of Due Diligence Reviews



SELECTION OF METHODS



| Situation | Approach |
|-------------------------------|-----------------------|
| Knowledge based companies | Income/Market |
| Manufacturing Companies | Income/ Market/ Asset |
| Brand Driven companies | Income/Market |
| Start up companies | Income/Market |
| Limited life projects | Income |
| Investment/Property companies | Asset |
| Company going for liquidation | Asset |

REACHING A RECOMMENDATION



- Methods throw a range of values
- Consider the relevance of each methodology depending upon the purpose and premise of valuation
- Mathematical weightage
- Professional judgment
- Subjective Value

ISSUES IN VALUATION

- Availability of information
- Sustainability & Scalability of business model.
- Thinly traded/ Dormant script
- Start-up companies
- Loss making companies
- International companies
- Selection of methods
- Difficulty in obtaining comparable companies
- Discount rate – Hurdle rate
- Illiquidity discount & control premium
- Due Diligence issues



JUDICIAL PRONOUNCEMENTS



JUDICIAL PRONOUNCEMENTS



“Exchange Ratio not disturbed by Courts unless objected and found grossly unfair”

- Miheer H. Mafatlal Vs. Mafatlal Industries (1996) 87 Com Cases 792
- Dinesh v. Lakhani Vs. Parke-Davis (India) Ltd. (2003) 47 SCL 80 (Bom)

“Valuation will take into account number of factors such as prospective yield, marketability, the general outlook for the type of business of the company, etc. Valuation is an art, not an exact science. Mathematical certainty is not demanded, nor indeed is it possible”

- Viscount Simon Bd in Gold Coast Selection Trust Ltd. vs. Humphrey reported in 30 TC 209 (House of Lords)

“It is fair to use combination of three well known methods - asset value, yield value & market value”

- Hindustan Lever Employees ‘ Union Vs. HLL (1995) 83 Com. Case 30 SC

JUDICIAL PRONOUNCEMENT

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“It is not possible for a Court to go into the exercise of carrying out a valuation itself. Courts do not have the expertise, the time or the means to do this. I do not believe that they are expected to do it. What the Court’s approach must be to examine whether or not a valuation report is demonstrated to be so unjust, so unreasonable and so unfair that it could result and result only in a manifest and demonstrable, inequity or injustice. This injustice must be shown to apply to a class.”

“No valuation is to be disregarded merely because it has used one or the other of various methods. It must be shown that the chosen method of valuation is such as has resulted in an artificially depressed or contrived valuation well below what a fair-minded person may consider reasonable.”

- Cadbury India Limited Vs. Mrs Malati Samant and Mr Alok C. Churiwala (Samant Group and Churiwala Group) (2014) (Bom HC)

GEARING UP FOR VALUATIONS



COMPETENCE FOR VALUATION



- What we are taught in CA course is more than sufficient
- Books on valuation E.g. Hand book on Valuation by The Chamber of Tax Consultants, Damodaran, Mckinsey, etc.
- Broad knowledge of economy and industries
- Training with a valuation firm
- Use of Database E.g. Capitaline, Bloomberg etc.
- Newspapers, Business Magazines
- Understanding of Financial Statements



PROFESSIONAL CONDUCT



CODE OF CONDUCT

Internal code of conduct at office

- ✓ Confidentiality
- ✓ Restriction of trading in stocks
- ✓ Data secrecy

Internal peer review

Adherence to code of conduct of the Institute



REGISTERED VALUER RULES




VALUATION BY REGISTERED VALUERS



Section 247(1) of the Companies Act, 2013 ('Co. Act'):

- Valuation of property, stocks, shares, debentures, securities, goodwill or other assets/liabilities/networth
- To be done by a Registered Valuer
- Appointed by Audit Committee or in its absence, the Board of Directors

COMPANIES ACT PROVISIONS



| Section | Valuation Requirement |
|-----------|--|
| 54(1)(d) | Issue of Sweat Equity Shares in case of unlisted companies |
| 62(1)(c) | Issue of shares / convertible securities on preferential basis by unlisted company for cash or for consideration other than cash |
| 67(3)(b) | Provision of money by company for purchase of its own shares by employees or by trustees for the benefit of employees |
| 192(2) | Transactions involving transfer of assets for non-cash consideration to / from directors |
| 230 & 232 | Scheme of Compromise/Arrangement or Scheme of Corporate Debt Restructuring |
| 234 | Cross border merger of an Indian Co. into Foreign Co. or vice versa |
| 236 | Purchase of minority share holding |
| 281 | Winding up of a company |

REGISTERED VALUER RULES

On 18 October 2017, the MCA issued Companies (Registered Valuers and Valuation) Rules, 201

Insolvency
and
Bankruptcy
Board of
India
(‘IBBI’)

Specified by the Central Government as the authority to administer & perform the functions under these Rules

Registered
Valuer
Organization
(‘RVO’)

Organization that meets specified requirements
RVO shall be granted a ‘certificate of recognition’ by IBBI

Registered
Valuer
(‘RV’)

RV can be an Individual, Firm, LLP or Company
RV should be a member of a RVO
RV shall be a person registered with IBBI
RV shall be granted a ‘certificate of registration’ by IBBI

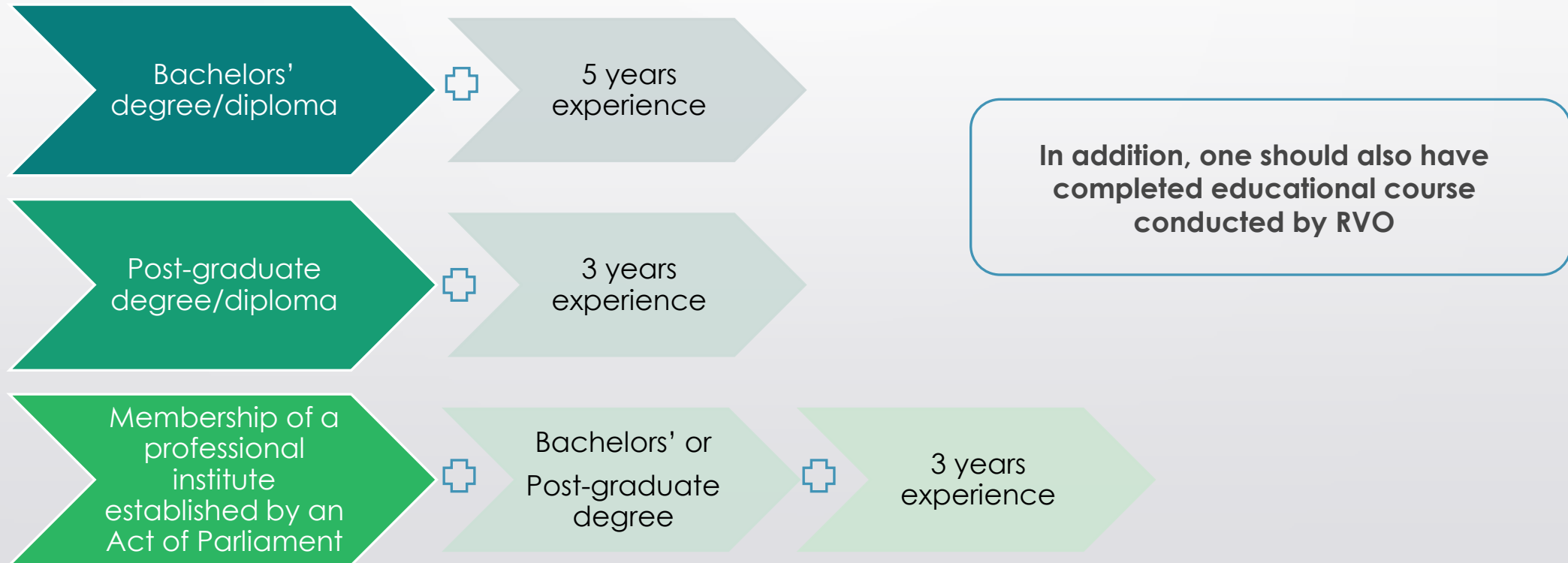
TO BE A REGISTERED VALUER

- 1 Obtain Educational Qualifications and Experience
- 2 Appear for Valuation Examination
- 3 Satisfy other Specified Eligibility Criteria

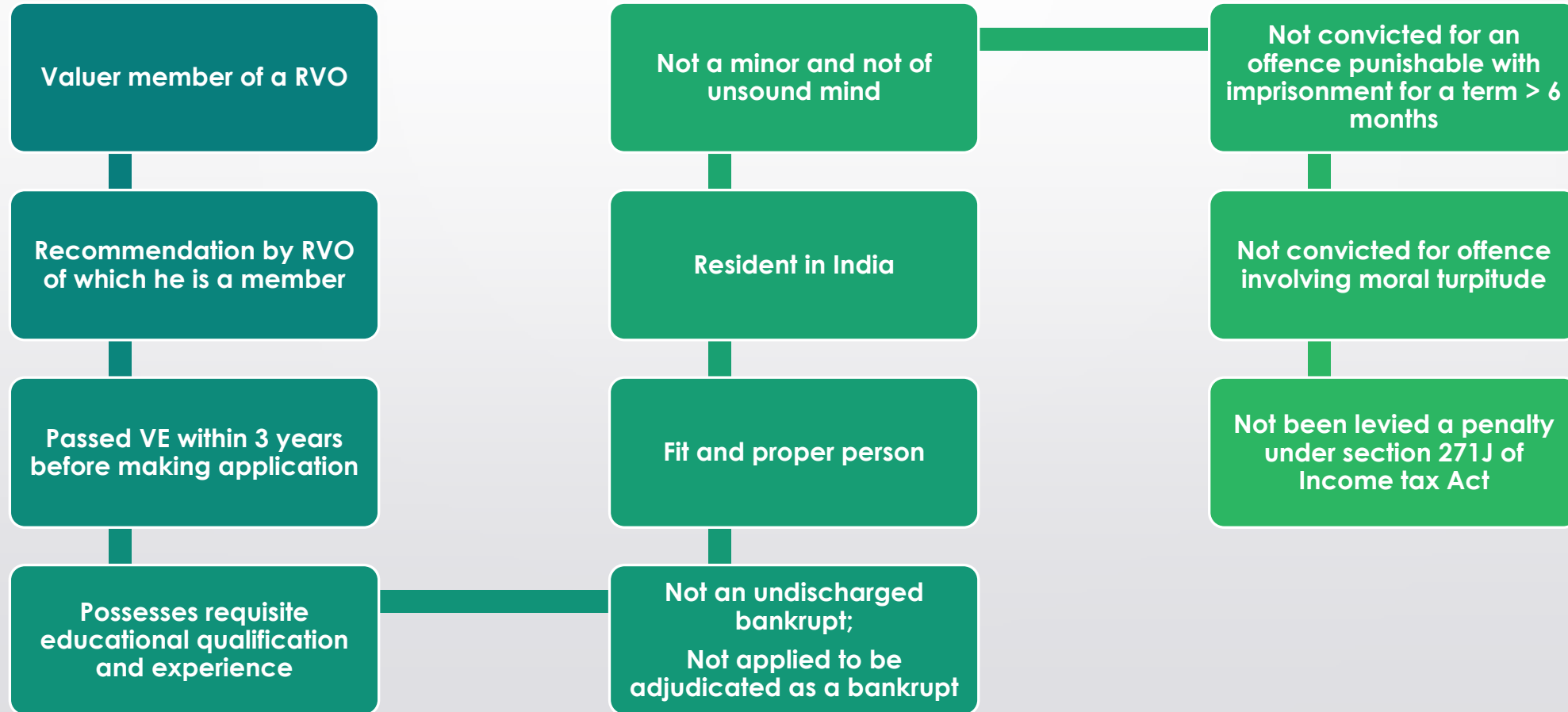
EDUCATIONAL QUALIFICATIONS AND EXPERIENCE



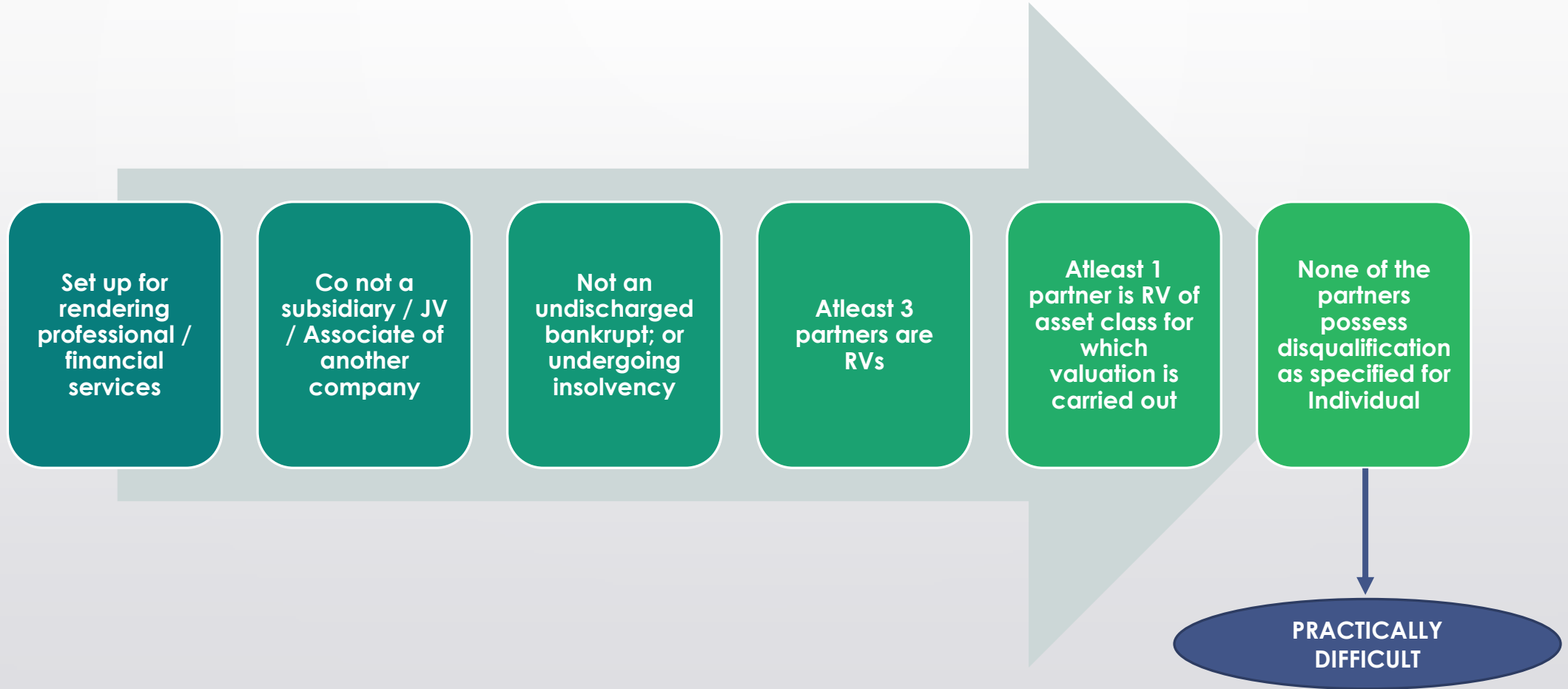
To be a RV, an individual must have the following educational qualifications and experience in the specified discipline:



ELIGIBILITY CRITERIA - INDIVIDUAL



ELIGIBILITY CRITERIA – OTHERS





Thank You