Business Valuation in India & Emerging Opportunities

December 6th 2016

Chander Sawhney
FCA, ACS, Certified Valuer (ICAI)
Partner & Head – Valuation & Deals
Corporate Professionals

AGENDA

-Overview of Valuation

-History of Valuation in India

-Startup Valuation

-Preferred Stock Valuation

-Valuation Process

-Valuation under different Statutes

- M&A
- RBI
- Income Tax
- SEBI / Stock Exchanges
- Companies Act, 2013

-Emerging Opportunities in Valuation in India

- Registered Valuer
- Ind AS
  - DCF
  - Relative Valuation

-Tricky Issues

“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

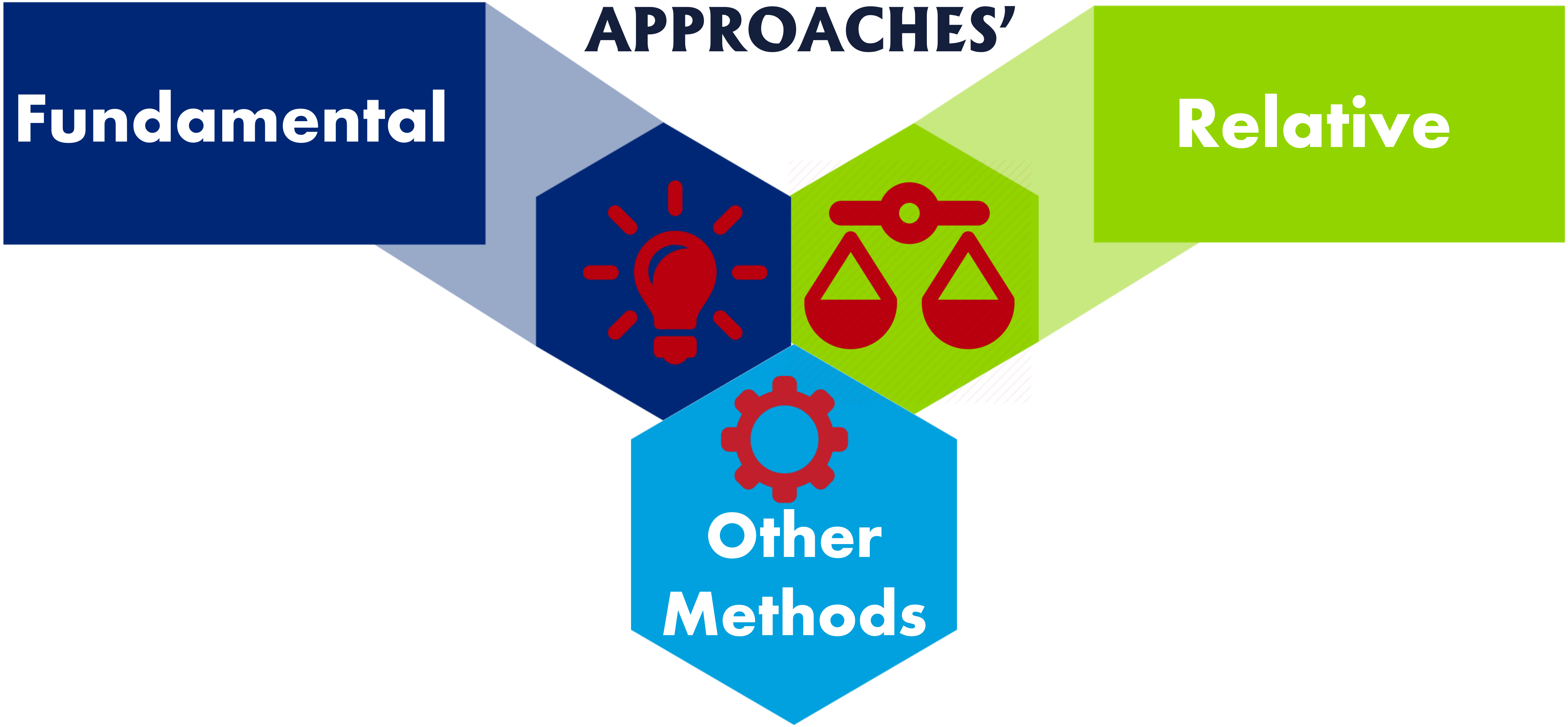
Regulatory

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

Accounting

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

'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'

Relative

Market Based Approach

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

‘VALUATION APPROACHES’

Other Methods

- Contingent Claim Valuation (Option Pricing)
- 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

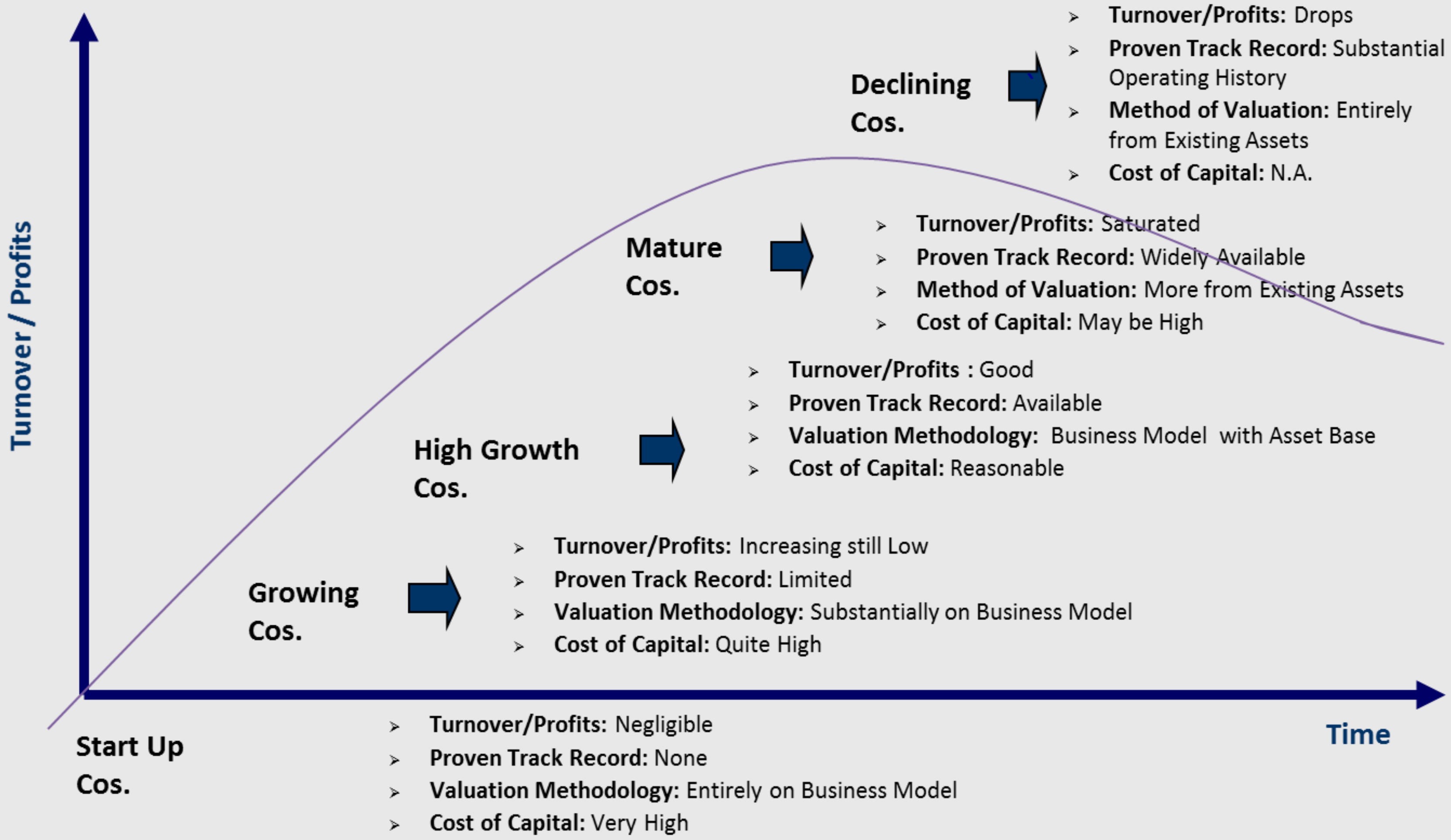
In General, Income Approach is preferred;

- 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

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 PROMINENT VALUATION METHOD

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
- <u>Investors generally do not give much value to such assets and Structure modification may be necessary</u>

NEED FOR RESTRUCTURING

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)

13.7.1990 - 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 21st 2010 – March 31st 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)

1.10.2009 ; 1.6.2010

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 but its still in Draft stage (Expected to be fully Operational in 2017)

2016

From 1.4.2016, Ind AS comes into play for certain big companies; will be applicable to all companies in 2 years

STARTUP VALUATION RECENT TREND

India taking a center stage in global markets because of high growth & reform expectations, demographic dividend and large market, many Indian startups have come out, especially in the last couple of years, building scalable businesses (substantially Tech-enabled) to solve a multitude of problems we face in our daily life.

Till 2015, Indian digital retail and e-Commerce companies and their valuations were being closely linked to the soaring valuation of US tech start-ups and investors are under the fear of missing out. The online retail companies were relying on a different metric of valuations – "GMV" gross merchandise value which is defined to indicate total sales value for merchandise sold through a marketplace over a period. <u>However, it must be noted that GMV is not reflected on their financial statements and their actual revenues are just a fraction of GMV</u>. The GMV or sales (as per financial statement) was then multiplied by a multiple (x times) to get the Valuation of the entity.

Interestingly the trend of Investments has remained difficult and different in 2016. Many e-tailers have reported decline in number of orders significantly as they cut discounts leading to drop in their GMV raising eyebrows on their fresh funding rounds and valuations.

STARTUP VALUATION RECENT TREND (CONT.)

“Topline is vanity, Bottomline is Sanity, Cashflow is reality”

While we fully appreciate the way startup revolution has taken in India but we recall how the best and most innovative companies in the world like Apple, Microsoft etc. were formed. Yes, they were bootstrapped !

But in recent times, we have seen mad rush for Investor Funding and focus is much more on Valuation than Value and Scale then having a biz model with stable profitability.

Start-up Funding has dried Up with Investors looking when and if ventures would turn Profitable? This is also driving more M&A as consolidation is taking place, striving for consistency -

- Morgan Stanley marks down “Flipkart” valuation 3rd time to 5.6Bn $ - Nov 2016. It was 15Bn$ in June 2015 when it last raised funds
- Jabong sold to Flipcart for just $70M in July 2016; Got Valued at approx. 0.5 times of its reported 2015 Topline. It was expecting 1.2Bn$ about 18 months back
- Jabong parent raises $339M; valuation plunges by 68% - April 2016
- Hyperlocal delivery start-up – “PepperTap” shuts operations in six large cities – Feb 2016
- “Grofers” decides to close operations in nine cities-Jan 2016

There are others like Yebhi, Bestylish and many others who are half dead…….

PE ACTIVITY AND DEALS TRENDS

As per latest research reports –

1. Overall Deal Value and Volume is on downside in 2016. In first 11 months Deal value was reported as 10,799 Mn $ compared to 22,286 Mn $ in 2015. No of deals also reduced to 1181 from 1661 in this period

2. M&A has emerged as the preferred exit route for PE exits in 2016. There were 89 M&A exits worth 2.42 Bn$ constituting 50% of total Deal value

3. Deal values continue to slip across early-stage rounds. Cautious investors are writing smaller cheques, indicating a measured flow of "cautious money" available.

VALUATION OF PREFERRED STOCK V. EQUITY SHARES

Example, presume an Investor Invests 10$ for 10% Preferred Stock stake (say CCPS with Dividend and Liquidation preferences) in a company. In this case it cannot be said that the Equity Value of Company is 100$ (10$/10%). Actual Company Value will actually be much lower as rest 90% Equity does not carry any preferred rights. The same can be computed using complex Option Pricing (BackSolve method). As a ballpark number, the difference can be 30-40% signifying the value of preferences / control depending on a no. of factors.

The first step in valuing a company with complex capital structure is to value the company itself using a combination of the Income, Market and Asset approaches depending on its Nature and Stage of Business, Business Model, Purpose of Valuation etc.

The second step is to allocate the value of the company among different classes of securities like Equity Shares, CCPS, OCPS etc. (including their different series). It is important to understand terms of each of the series of securities including the conversion option, liquidation preference, participation in profits etc.

The Backsolve OPM is a form of market approach which derives the implied equity value for one type of equity security (Common Stock) from derived value of another form of equity security (Preferred stock).

In this method, each share class only has value if the funds available for distribution to shareholders exceed the value of the liquidation preferences at the time of a liquidity event for each of the prior share classes in a company's cap table.

VALUATION OF PREFERRED STOCK V. EQUITY SHARES

Break points are created in this model (based on the claim each security has in company) and then each class of security is valued as a call option using Black Scholes OPM. The incremental call option value is then allocated amongst each breakpoint. based on the relative liquidation value and thereafter based on the outstanding no of shares.

OPM Inputs

The OPM relies on following inputs:

- the total equity value of the enterprise^
- expected time to exit
- expected risk-free interest rate as of the valuation date
- expected volatility derived from similar publicly traded companies
- expected dividend yield

Exercise price of each breakpoint is based on liquidation preferences and conversion value of different securities. Incremental call option at each breakpoint is then allocated based on no of outstanding securities.

^The Equity value of company is computed (by trial and error) such that the value of recent preferred stock investment equals the price paid for such investment as per the backsolve method

According to the AICPA, the backsolve is the most reliable indicator of enterprise value for early-stage customers, provided the following:

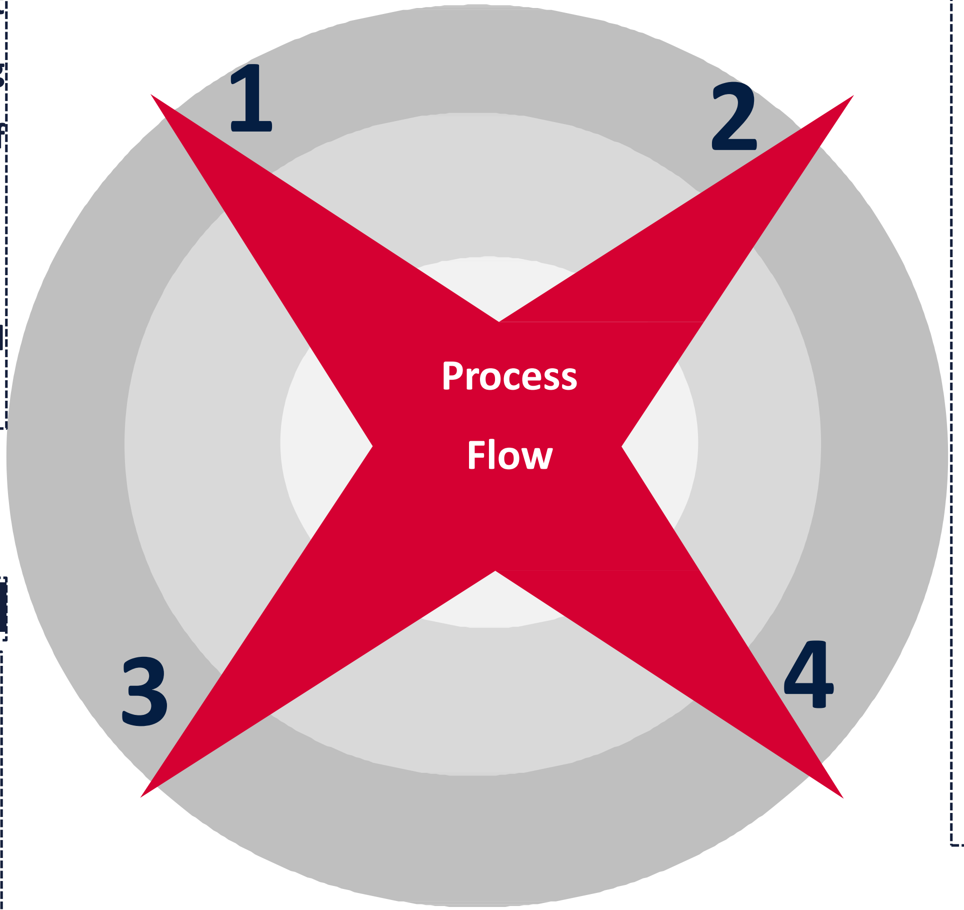
- transactions in the enterprise's shares have occurred at arm's length
- **the most recent transaction occurred within <u>ninety days</u> of the date of valuation date.**

Valuation Process

VALUATION PROCESS FLOW

Planning & Data Collection

- Submit information request list after understanding Standard & Premise of Valuation
- Business understanding
- Understanding of market and analysis of Biz



Data Analysis & Valuation

- Analysis of revenue and cost
- Perform trend analysis
- Complete a high level review of assumptions
- Industry analysis & understanding of key value drivers of the business
- Review valuation model
- Conclude Company Value and allocate it to different securities
- Apply discount / premium
- Value Conclusion

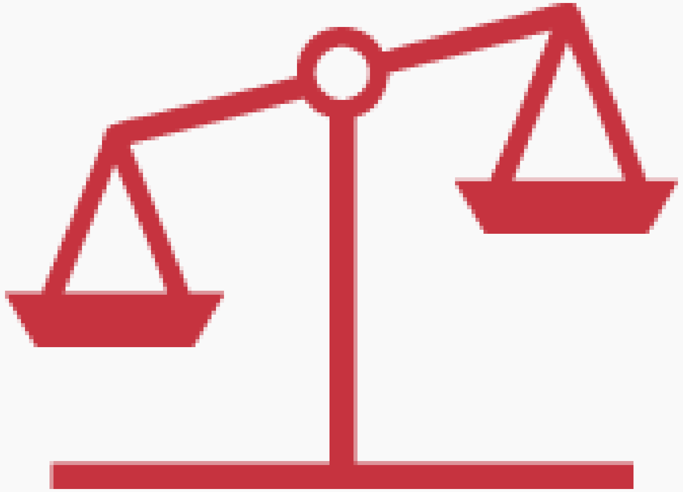
Reporting

- Submit draft valuation working sheet
- Confirmation on draft valuation working sheet
- Incorporate the suggestions
- Submit draft valuation report
- Discuss the draft valuation report

Project Closure

- Submit the final report

TYPES OF VALUATION ENGAGEMENTS



VALUATION ENGAGEMENT

CALCULATION ENGAGEMENT

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

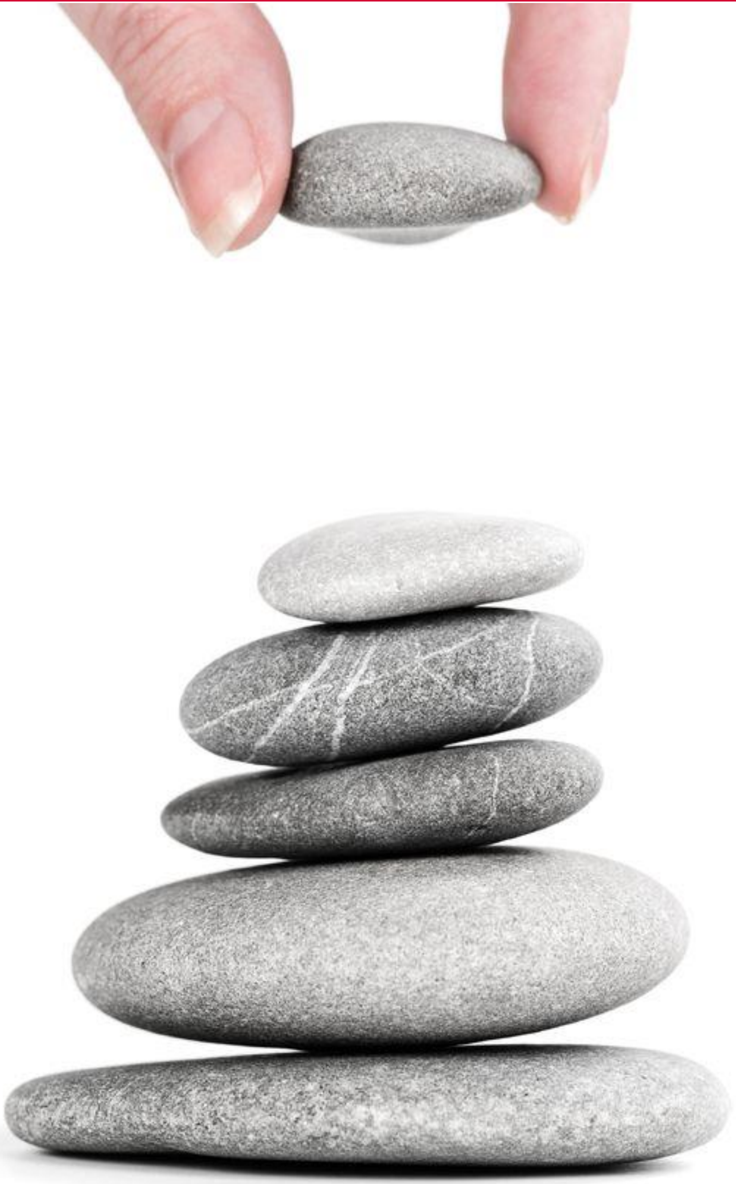
Premise of value relates to the assumptions upon which the valuation is based.

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**

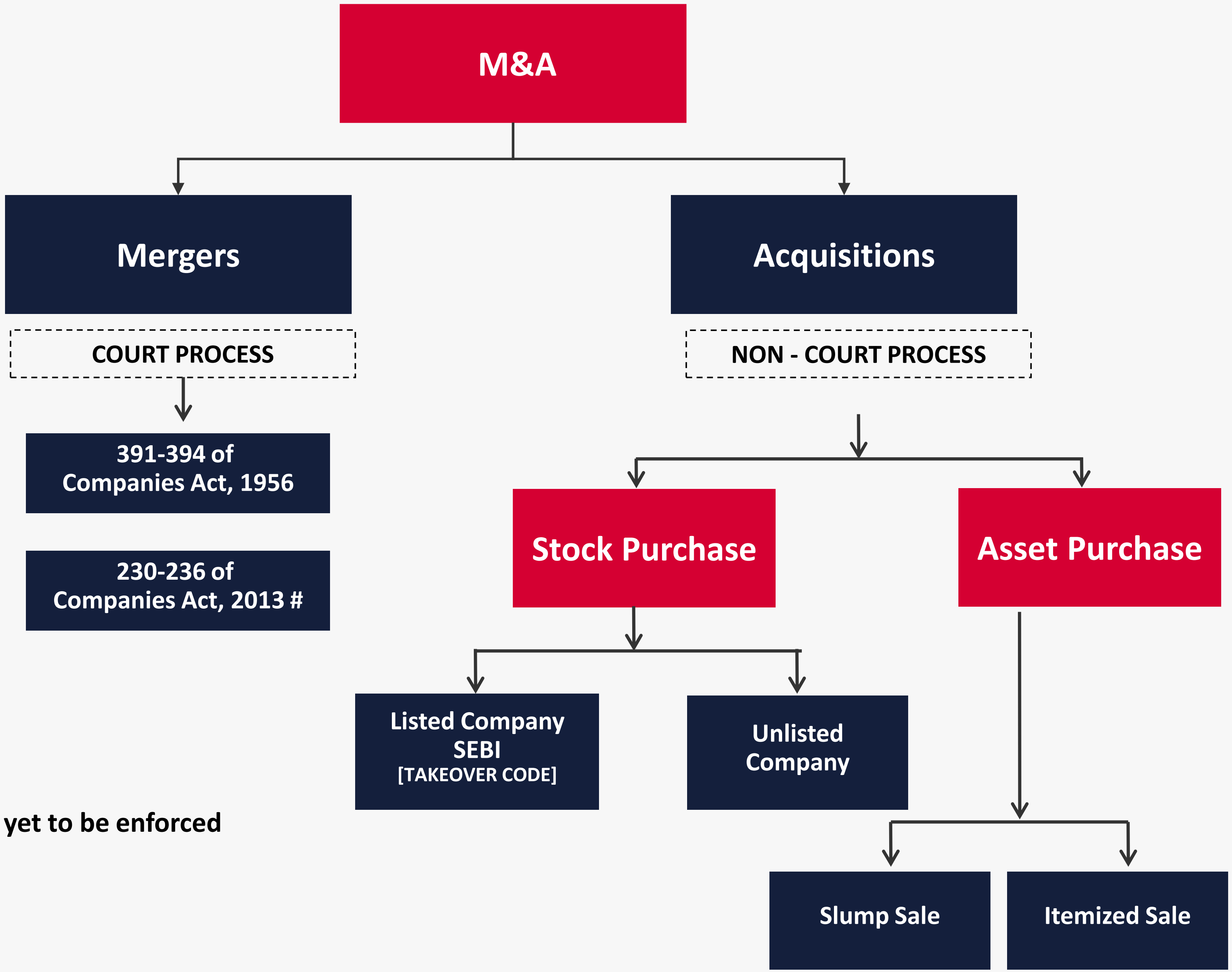
KEY DELIVERABLES OF VALUATION REPORT

1. Discussion of the date, purpose, premise, scope and limitations of the valuation;
2. Business overview and group overview (if relevant)
3. Analysis of historical statements
4. Analysis of the Business Plan
5. Summary of Comparable Companies and Similar Transaction Multiples
6. A description of and justification for each of the valuation methodologies considered and ultimately used;
7. The value conclusions
8. Supporting Exhibits



Valuation under different Statutes

M&A – SITUATIONS AND VALUATIONS



yet to be enforced

M&A VALUATION CASE LAWS

WHETHER VALUATION IS REQUIRED FOR MERGER?

In the matter of ***Shreya's India (P) Ltd.*** **v.** ***Samrat Industries (P) Ltd.*** the Regional Director (RD) raised an objection that no valuation report has been filed and that the exchange ratio for amalgamation has not been worked out by an independent valuer.

"The Hon'ble High Court of Rajasthan overruled this objection and sanctioned the scheme of amalgamation by holding that there was no legal or factual impediment to grant sanction to the scheme of amalgamation."

Same ratio in Advance Plastics (P) Ltd vs Dynamic Plastics (P) Ltd - Bombay High Court

WHETHER ANY VALUATION METHODOLDY IS REQUIRED FOR MERGER?

Though there are no specific methodology prescribed for valuation under Merger, however **In Hindustan Lever Employees Union v. Hindustan Lever Ltd and Others, Bombay High Court -**

"*accepted the* ***ratio of 2:2:1 as Income, Market and Asset Approach on which the valuation was based."***

VALUATION OF INFREQUENTLY TRADED SHARES

In G.L. Sulatnia and another the parameters expressly laid down therein must be considered by the valuer since they are basic and essential. If the valuation report discloses non consideration of any of the enumerated parameters, the report shall stand vitiated for that reason. That however does not prevent the valuer from considering other relevant factors according to accepted principles of valuation of shares".

VALUATION FOR MERGERS

"VALUATION IS GENERALLY THE STARTING POINT OF THE M&A PROCESS"

APPLICABLE LAW FOR VALUATION FOR MERGERS:

1. Companies Act, 1956 [Section 391- 394];
2. Fairness Opinion [Regulation 37 of the LODR];
3. SEBI Notification [CIR/CFD/CMD/16/2015], dated 30th November, 2015

Under SEBI Notification, Valuation by independent chartered account mandatory other than those specifically exempted. "Valuation Report from an Independent Chartered Accountant" is not required in cases where there is no change in the shareholding pattern of the listed company / resultant company.

None of the aforesaid laws provide **for specific valuation approaches under Mergers - Valuation Standards under Registered Valuation provisions are proposed under Companies Act, 2013 (not yet operational)**

DETERMINATION OF SWAP RATIO

- <u>**In case of a merger valuation, the emphasis is on arriving at the “relative” values of the shares of the merging companies to facilitate determination of the “swap ratio”**</u>

  Hence, the purpose is not to arrive at absolute values of the shares of the companies

- **The key issue to be addressed is that of fairness to all shareholders**

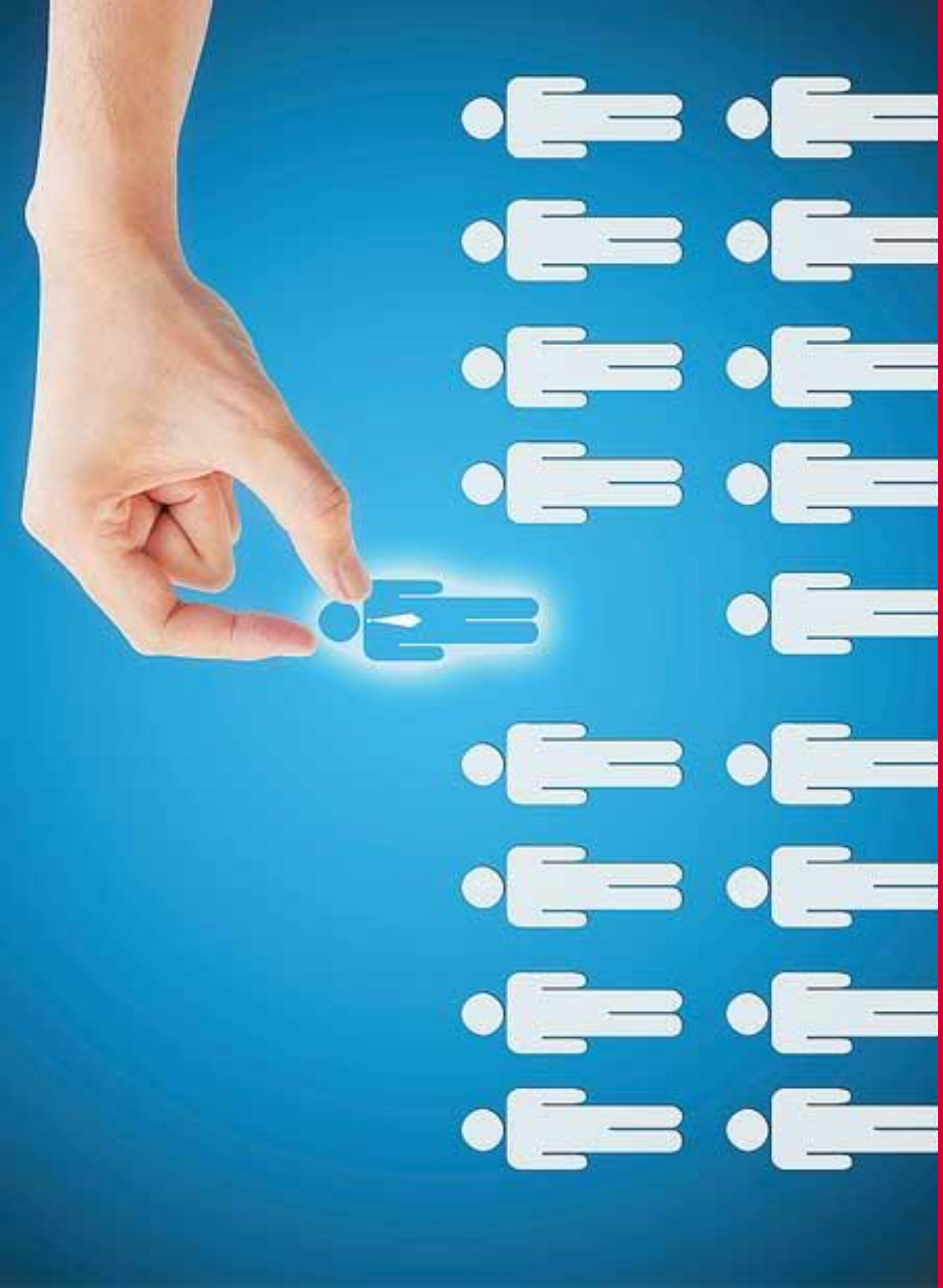
  This is particularly important where the shareholding pattern and shareholders vary between the two companies

- **There are established legal precedence for merger valuation methodologies**

  Valuer’s role is to incorporate case specific factors and use appropriate methodologies so as to determine a fair ratio

  Usually, best to give weight ages to valuation by all methods

  Market price method and Earnings methods dominate.



PREFERENTIAL ISSUE – UNLISTED COMPANY

APPLICABLE LAW:

Sec 62 of Companies Act, 2013 read with Rule 13 of Share Capital Rules, 2014

Sec 42 of Companies Act, 2013 read with Rule 14 of Companies (Prospectus & Allotment of Securities) Rules, 2014

Applicable to which Instruments

Valuation of **Equity Shares and Convertible Instruments – fully or partly** (including Non Cash Consideration, if any for Issue of Shares)

Method of Valuation

The price of equity shares to be issued on preferential basis shall be determined by the valuation report of **SEBI registered Merchant Banker or CA in practice having ten years of experience.**

Minimum Valuation

Further, rule 13(3) of the Share Capital Rules provides that the price of shares to be issued on preferential basis shall not be less than the price determined on the basis of the valuation report.

SWEAT EQUITY VALUATION

APPLICABLE LAW:

Sec 54 of Companies Act, 2013 read with Rule 8 of Companies (Share Capital) Rules, 2014

SEBI (Issue of Sweat Equity) Regulations, 2002

As per rule 8(4) of the Share Capital Rules, the Company shall not issue sweat equity shares for more than 15% of the existing paid up equity share capital in a year or shares of the issue value of Rs. 5 crores, whichever is higher. the issuance of sweat equity shares in the Company shall not exceed 25% of the paid up equity capital of the Company at any time.

Valuation of IPR / Know How (For Listed Companies)

The valuation of IPR or know or other value additions shall be carried by a Merchant Banker. The Merchant Banker shall obtain a certificate from an Independent CA that such valuation is in accordance with the relevant Accounting Standards

Valuation of IPR / Know How (For Unlisted Companies)

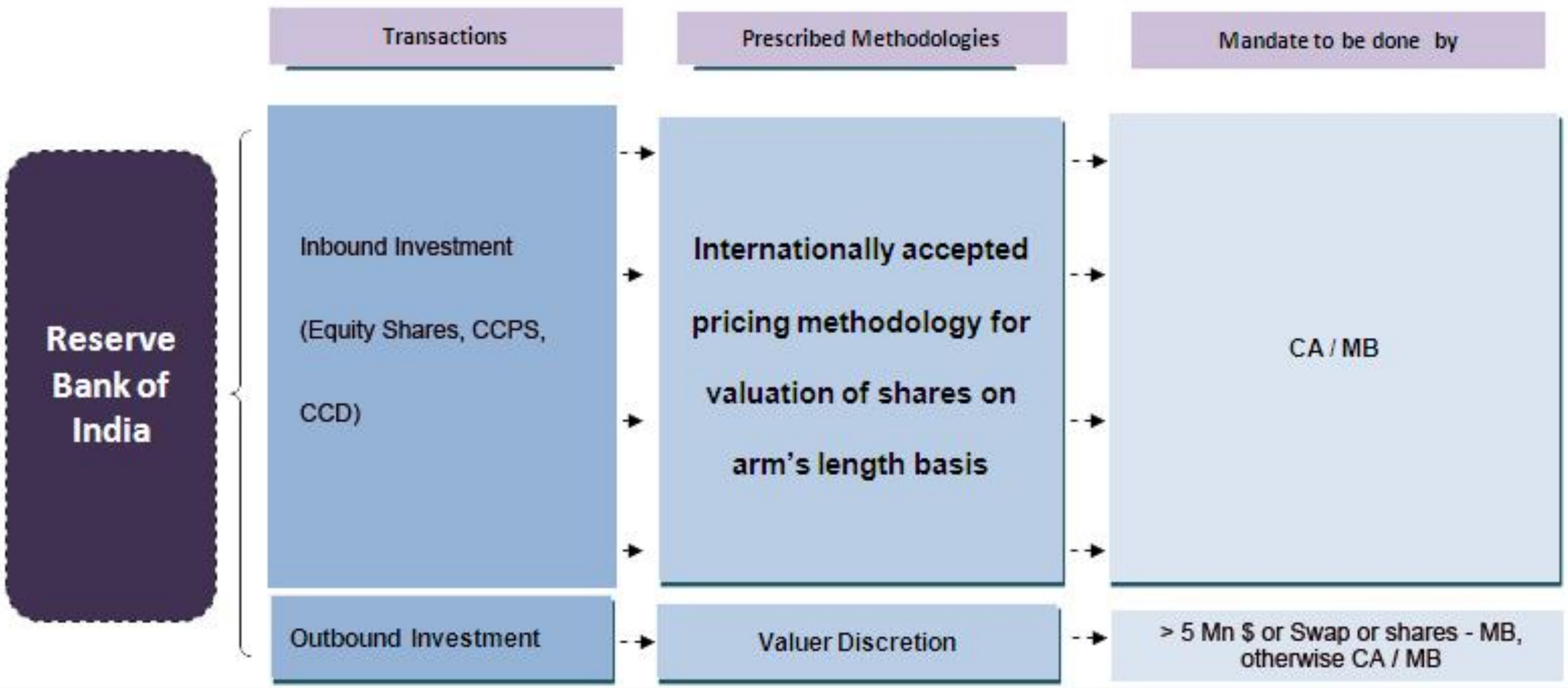
A registered valuer (SEBI registered Merchant Banker or CA in practice having ten years of experience). Registered valuer shall provide a proper report addressed to the Board of directors with justification.

Valuation of Sweat Equity Shares

For Listed Companies – Average of weekly high and low of closing prices during last 6 months or 2 weeks preceding relevant date shall be considered.

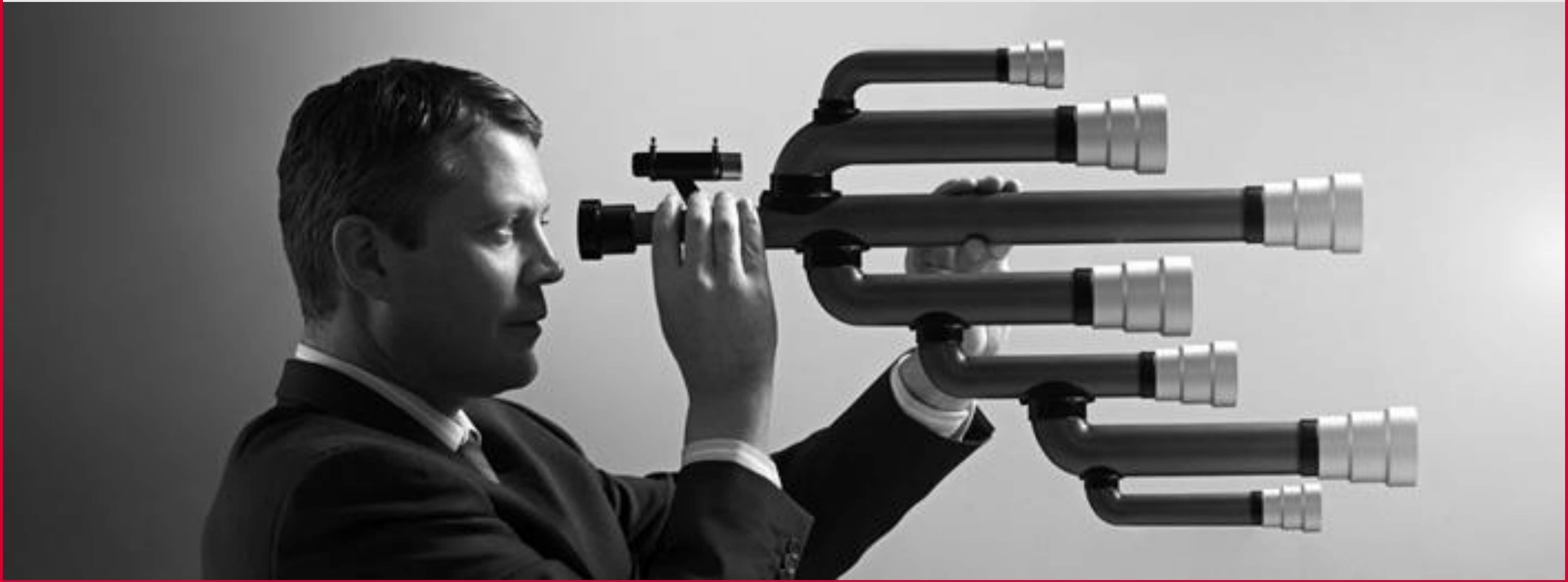
For Unlisted Company, Merchant Banker or CA in practice having ten years of experience will value

RBI VALUATION GUIDELINES



- Subscription to MOA at Face Value allowed
- RBI vide RBI/201415/129 A. P. (DIR Series) Circular No. 4 dated15th July, 2014 has replaced DFCF methodology with internationally accepted pricing methodology in case of Unlisted Companies
- No fixed IRR can be committed to Foreign Investor
- The price/ conversion formula of compulsory convertible capital instruments should be determined upfront at the time of issue of the instruments.
- **In case of Listed Companies – Pricing shall be done as per SEBI Preferential Allotment Guidelines.**
- Valuation Guidelines applicable to Downstream Investments also
- Right Issue to NR allowed but at price not less than as made to Resident Shareholder

SEBI / Stock Exchange Valuation Guidelines



TAKEOVER REGULATIONS

APPLICABLE LAW:

SEBI (Substantial Acquisition of Shares & Takeovers) Regulations, 2011

FREQUENTLY TRADED SHARES	**Traded Turnover of Shares ≥ 10%** **[In the Last Twelve Calendar Months preceding the Month of Public Announcement (P.A.)]**

Method of Valuation

1. **Highest Negotiated Price Per Share under agreement attracting the obligation to make P.A.**
2. **The volume weighted avg. price paid or payable by acquirer or PAC during the 52 Weeks;**
3. **The Highest volume weighted avg. price paid or payable by acquirer or PAC in last 26 Weeks;**
4. **<u>Volume weighted average Market Price of Shares for a period of 60 trading days</u>**

HIGHEST PRICE AMONG ALL IS THE VALUE PER SHARE FOR P.A.

INFREQUENTLY TRADED SHARES	**Traded Turnover of Shares < 10%** **[In the Last Twelve Calendar Months preceding the Month of Public Announcement (P.A.)]**

Method of Valuation

1. **Book value,**
2. **Comparable Trading Multiples;**

Such other Parameters as are customary for valuation of shares of such companies

*As per Regulation 76A, Valuation to be done by a Merchant Banker or CA with 10 year experience

PREFERENTIAL ISSUE – LISTED COMPANY

APPLICABLE LAW:

SEBI (ICDR) Regulations, 2009

Equity shares of issuer have been listed on recognized stock exchange and are frequently traded

Method of Valuation

The average of the weekly high and low of the **Volume Weighted** Average Price of the related equity shares quoted on the recognized stock exchange* during 26 weeks or 2 weeks preceding the relevant date WHICHEVER IS HIGHER

*In which highest trading volume has been recorded

Equity shares of issuer have been listed on recognized stock exchange and are not frequently traded

Method of Valuation

As per SEBI SAST Regulations, 2011i.e. after taking into account parameters including Book Value, Comparable Trading Multiples and such other parameters as are customary for valuation of such companies

Note - In case of valuation for Delisting also, where shares are infrequently traded, above valuation method is prescribed.

VALUATION OF ASSETS (BUSINESS) IF CONSIDERATION OTHER THAN CASH IS ISSUED TO PROMOTERS OR PAC

APPLICABLE LAW:

Regulation 73 (3) of SEBI (ICDR) Regulations, 2009

Where specified securities are issued on a preferential basis to promoters, their relatives, associates and related entities for consideration other than cash, the valuation of the assets in consideration for which the equity shares are issued shall be done by an independent qualified valuer, which shall be submitted to the recognized stock exchanges where the equity shares of the issuer are listed.

Method of Valuation

No Method for Valuation has been prescribed.

Valuer

Chartered Accountant or a Merchant Banker

ESOP ACCOUNTING VALUATION

APPLICABLE LAW:

Sec 62 of Companies Act, 2013 read with Rule 12 of Share Capital Rules, 2014

SEBI (Share Based Employee Benefits) Regulations, 2014

ICAI Guidance Note

Purpose of Valuation
Determination of compensation cost for amortization over the vesting period

Impact of Valuation
Being P&L item, it impacts Profitability and reduces EPS. The expense may or may not be allowed by the Tax authorities

Method of Valuation : If a Company listed on recognized stock exchange in India and issued shares under an ESOS / ESPS, the fair value of stock option shall be estimated using an option pricing model (Black-Scholes or a binomial model) which shall be treated as employee compensation cost for the Company.

If company is unlisted, Intrinsic value method is allowed with disclosure of Fair Value

Valuer: Not Prescribed

EXIT OPPORTUNITY TO SHAREHOLDERS OF EXCLUSIVE LISTED COMPANIES

APPLICABLE LAW:

SEBI Circular SEBI/HO/MRD/DSA/CIR/P/2016/110 dated October 10, 2016 and notice (20161104 – dated November 4, 2016)

The Promoter of such companies in consultation with the Designated Stock Exchange shall appoint an independent valuer from panel of expert valuers.

Purpose of Valuation
Providing Exit Opportunities to Shareholders of Exclusively Listed Companies of De-recognized Stock Exchanges placed in Dissemination Board

Impact of Valuation
Promoters will have to buyout the exiting Shareholders based on the Valuation of the valuer and this would entail a cost. Being Minority Shareholders, SEBI is protecting there rights and regulating the process.

Method of Valuation: BSE and NSE are in process of finalizing the valuation reporting format and also the process guidance

Valuer: BSE and NSE have recently empaneled Valuation Firms for this purpose

Income Tax Act – 1961

TAX IMPLICATIONS OF ESOP IN INDIA

Stages	Tax Treatment
Grant of Options	Nil
Vesting of Options	Nil till Exercised
Exercise of Options Section -17 (2)(vi) Income Tax Act, 1961 read with Rule 3(8)(i) of Income Tax Rules 1962	Taxed as perquisite in the hands of Employees which is computed as the difference between the FMV of the share on the date of exercise and the exercise price. The employer is required to withhold tax at source in respect of such perquisite. No Method has been prescribed for Valuation (In case of Unlisted Companies, Valuation to be done by a SEBI Registered (Cat-I) Merchant Banker For Listed companies, Average of Opening and Closing Market Price on Exercise date is prescribed
Sale of Options Section -45 read with Section – 49(2AA) of Income Tax Act, 1961	The incremental gain (i.e. difference between **sale consideration** and the **FMV on the date of exercise**), on sale of shares is considered a capital gain for the employee. For computing capital gains, the FMV on the date of exercise becomes the cost base.

FMV of Unquoted Shares other than Equity shares of an Unlisted Company - Valuation shall be price it would fetch if sold in Open Market on Valuation date and Valuation shall be done by a Merchant Banker or CA.

Sec 56 not applicable on issue of Bonus or Right Issue of Shares Sudhir Menon HUF vs. ACIT (ITAT Mumbai)

Analysis of Applicability of Section - 56 of Income Tax Act, 1961			
Particulars	56(2)(vii)	56(2)(vii)(a)	56(2)(vii)(b)
Allotment / Issue of Shares			
Transfer of Shares			
Resident			
Non Resident			
NAV Method	Minimum Value		
DCF Method			Maximum Value
Recipient	Individual / HUF	Firm / Closely held Company	Any Person being resident of India
Issuer	Any Person	Any Person	Closely held Company
Taxability in hands of	Recipient of Share	Recipient of Share	Issuer of Share
Exemptions		This clause shall not apply to Sec 47 (via) (vic) (vicd) (vid)	Venture Capital Company, Venture Capital Fund, Venture Capital Undertaking
Basis of Valuation Valuation to be done by	NAV (Adjusted) based on Audited Balance Sheet as on Valuation Date CA		DCF or NAV (Adjusted) based on Audited Balance Sheet as on Valuation Date or else last Audited Balance Sheet FCA or MB

TRANSFER PRICING VALUATION

As per sec 92C of Income Tax Act, 1961 any international transaction between associated entities needs to be done at Arms Length Price. In case where issue or transfer of shares, business or certain rights (intangibles) is involved in such a case, it requires Valuation.

Why to Obtain Tax Valuation?

Tax Valuation is required to meet with the regulatory guidelines in this respect. In recent past we have seen Indian Income Tax Department challenging valuation of Vodafone in the Transfer Pricing Case. The Transfer Pricing Officer is questioning on the use of comparables, validation of Business Model, Actual achievement of projected results and what not. Tax valuation is critical in any Deal transaction as it could lead to huge tax outgo and frivolous litigation.

Approaches and Methodologies for Transfer Pricing Valuation

The following methods are used in determination of Arms length price namely comparable uncontrolled price method, profit split method and most importantly transactional net margin method.

Courts have recently upheld use of DCF method while valuing Shares in Transfer Pricing matters (Ascendas (India) Pvt Ltd. - Chennai ITAT)

Emerging Opportunities in Valuation in India

- Legal Recognition
- Requires Judgement
- Introduces Volatility
- Requires Skill set

REGISTERED VALUER (SECTION 247 OF COMPANIES ACT – 2013) OBJECTIVE IS TO REGULATE THE PRACTICE OF VALUATION

Registered Valuers

Financial Valuer

Stock, Shares, Debentures, Securities, Goodwill

Technical Valuer

Property

Persons eligible to apply for being Registered as Valuer

Financial Valuer:

- A Chartered Accountant, Company Secretary or Cost Accountant in whole time practice or retired member of Indian Corporate law Service or any other person as prescribed.
- A Merchant Banker registered with SEBI and which has in employment under it CA/CS/CWA for carrying out (signing) Valuation by such qualified persons.

Shall have 5 Years of Continuous Experience, Post Qualification

Technical Valuer:

- Member of the Institute of Engineers or Member of the Institute of Architects in whole time practice.
- *A person or firm or LLP or Merchant Banker possessing both qualifications may act in dual capacity.*

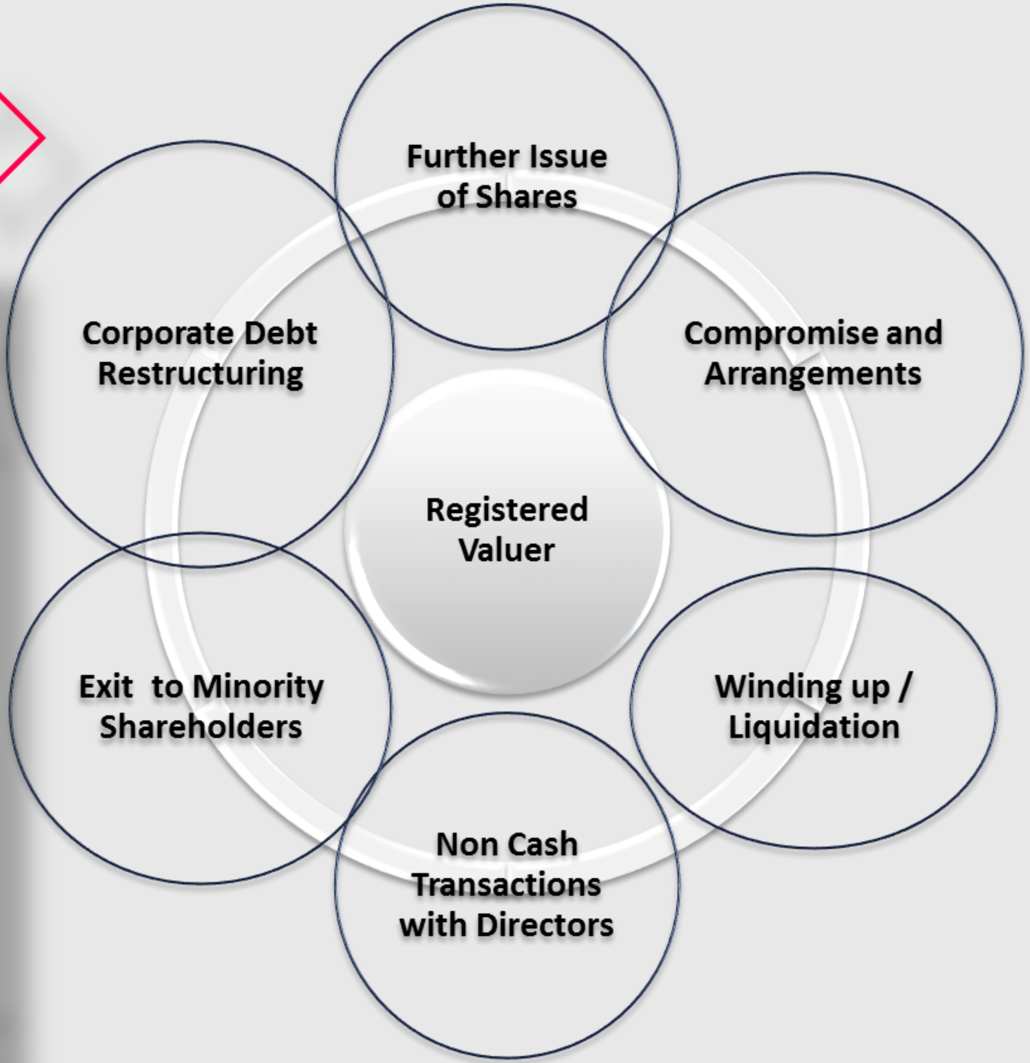
Shall have 5 Years of Continues Experience, Post Qualification

Registered Valuer to be appointed by Audit Committee or in its absence by the Board of Directors.

Note – SEBI vide its circular dated November 30th 2016 has defined Valuer in respect of Financial and Technical valuation in REIT and INVEIT regulations. The criterion is same as above.

Registered Valuers (Financial Valuation)

Value



Responsibilities

- Valuer to make impartial, true and fair valuation
- Not undertake valuation if directly or indirectly interested
- Exercise **due diligence**
- Valuation to be done as per rules

Upon contravention

- Fine – 25,000 to 100,000

With intention to defraud

- Imprisonment upto 1 year and
- Fine- 1,00,000 to 5,00,000

Additionally upon contravention, to refund remuneration received and also liable for damages.

SECTION WISE REQUIREMENT OF REGISTERED VALUER

Section 62(1)(c) – For Valuing **further Issue of Shares** *

Section 192(2) – For Valuing **Assets involved in Arrangement of Non Cash transactions involving Directors**

Section 230(2)(c)(v) – For Valuing **Shares, Property and Assets of the company under a Scheme of Corporate Debt Restructuring**

Section 230(3) and 232(2)(d) – 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

Section 232(3)(h) - **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

Section 236(2) – For Valuing **Equity Shares held by Minority Shareholders**

Section 260(2)(c) – For preparing Valuation report in respect of **Shares and Assets to arrive at the Reserve Price or Lease rent or Share Exchange Ratio for Company Administrator**

Section 281(1)(a) – For Valuing **Assets for submission of report by Company Liquidator**

*To be valued by a Merchant Banker or CA with 10 year of experience till Registered Valuer provisions are notified (as per MCA clarification)

REGISTERED VALUER DRAFT RULES – METHOD OF VALUATION

Relates to IRS Revenue Ruling (1959-60),USA

I. Before adopting methods, decide Valuation Approach-

- Asset Approach
- Income Approach
- Market Approach

II. Valuer to consider following points while undertaking Valuation-

- **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
- **Contingent Liabilities or substantial legal issues, within India and Abroad, impacting business**
- **Nature of Instrument proposed to be issued, and nature of transaction contemplated by parties**

REGISTERED VALUER DRAFT RULES – METHOD OF VALUATION (CONT.)

III. Registered Valuer shall make valuation of any asset in accordance with any one or more of the following methods-

a. Net Asset Value Method (NAV)
b. Market Price Method
c. Yield Method / PECV Method
d. Discounted Cash Flow Method (DCF)
e. Comparable Companies Multiples Method (CCM)
f. Comparable Transaction Multiples Method (CTM)
g. Price of Recent Investment Method (PORI)
h. Sum of the parts Valuation Method (SOTP)
i. Liquidation Value
j. Weighted Average Method
k. Any other method accepted or notified by RBI, SEBI or Income Tax Authorities
l. Any other method that valuer may deem fit provided adequate justification for use of suh method (and not any of the above methods) is provided

IV. Registered Valuer shall make valuation of any asset as on the Valuation date and in accordance with applicable standards, if any stipulated for this purpose.

V Contents of Valuation report shall contain information as contained in Form 17.3

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 MARKET PARTICIPANTS at the MEASUREMENT DATE.

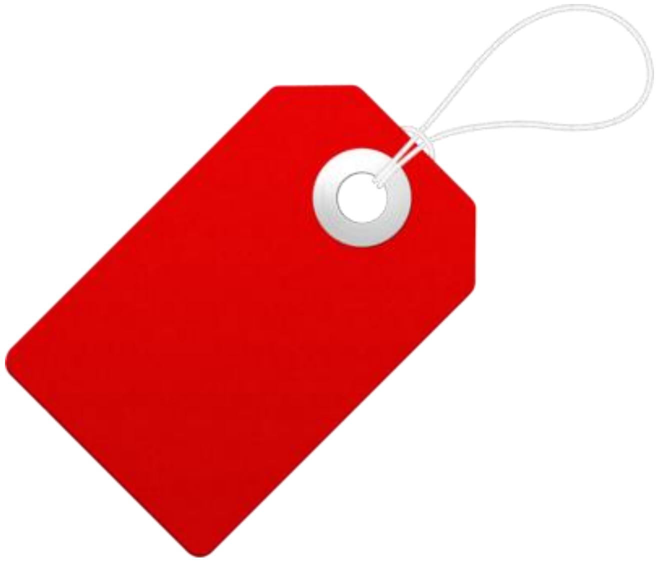
- Fair Value is a market-based measurement, NOT an entity-specific measurement

- 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

THE PRICE

Directly Observable

Estimated using another valuation technique



FAIR VALUE HIERARCHY PRESCRIBED IN IND AS - 113

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

FAIR VALUE TECHNIQUES PRESCRIBED IN IND AS - 113

Market Approach
Market Approach uses prices and other relevant information generated by market transactions involving comparable assets/liabilities/business, considering qualitative and quantitative factors (*Comparable Companies Valuation Method*)

Cost Approach
Cost Approach reflects the amount that would be required currently to replace asset (Replacement Cost method)

Income Approach
Income Approach converts future amounts to current (i.e. Discounted) amount (ex-Cash Flows or Income and Expenses) resulting in the current market expectations about those future amounts.

Income Approach Techniques could include-

- Present Value Techniques (*Discounted Cash Flow Method*)
- Option Pricing Models (*Black Scholes or Binomial models*)
- Multi period excess earning method (used for Intangibles)

COMPONENTS OF PRESENT VALUE MEASUREMENT (DISCOUNTED CASH FLOW)

- An estimate of **future cash flows** for the asset/liability being measured;
- Expectations about possible variations in **amount and timing of cash flows** representing uncertainty inherent in cash flows;
- Time value of money, represented by the rate on Risk Free Monetary Assets having maturity coinciding with period of cash flows **(Risk Free rate)**
- Price for bearing the uncertainty inherent in cash flows **(Risk Premium)**
- Other factors that market participants would take **(CSRP)**

Notes

1. An entity shall develop unobservable inputs using best information available in circumstances. An entity may begin with own data but shall adjust that if market participants would use different data (which is reasonably available).

Discount rates should reflect assumptions consistent with those inherent in Cash Flows.

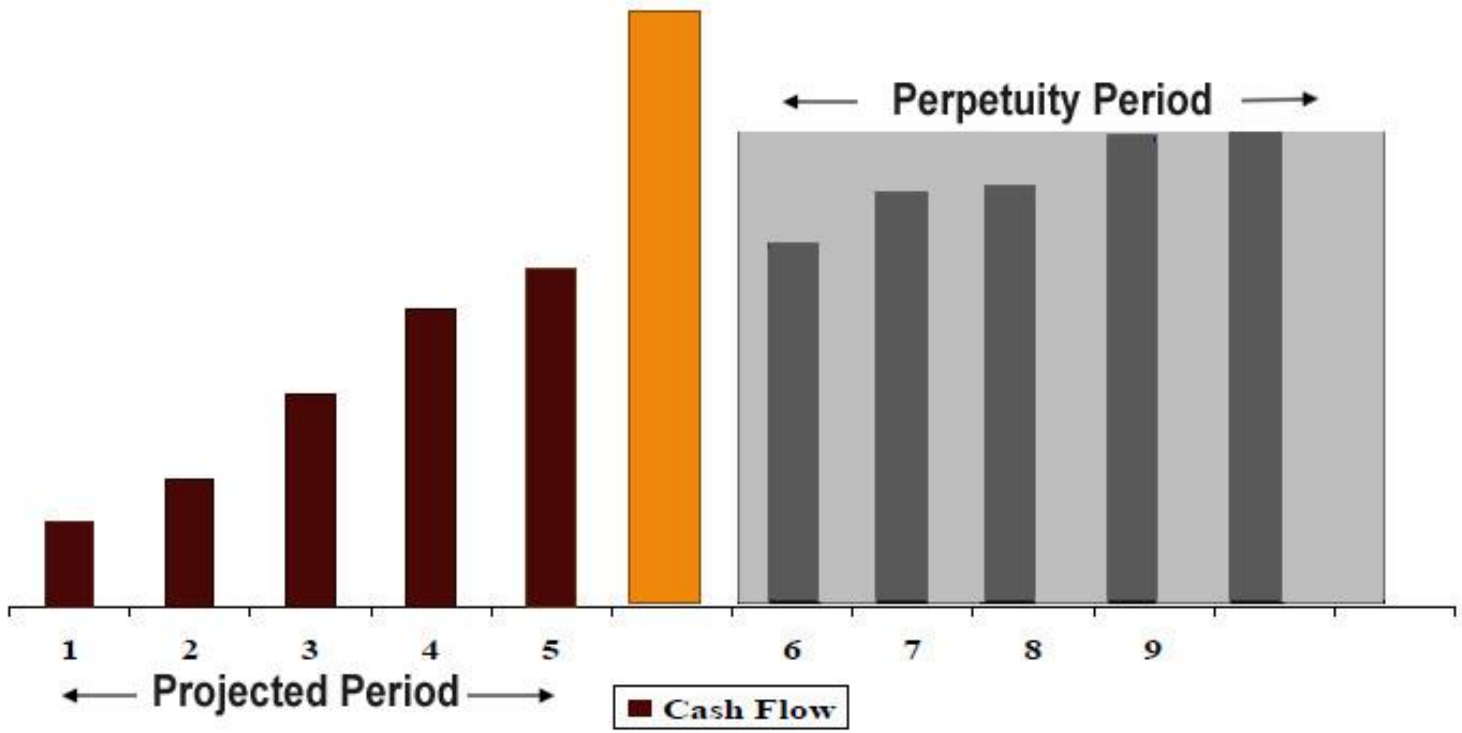
2. Assumptions about Cash Flows and Discount rates should be internally consistent (Nominal Cash Flows v, Real Cash Flows, Tax adjustments etc.)

3. Discount rates should be consistent with underlying economic factors of currency in which cash flows are denominated

VALIDATION OF PROJECTIONS (DISCOUNTED CASH FLOW)

- **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**

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.

FREE CASH FLOW CALCULATION

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**

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).

COST OF CAPITAL CALCULATION

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 CALCULATION

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.

RULE OF THUMB

However, Exclusive use of Rule of Thumb is not recommended

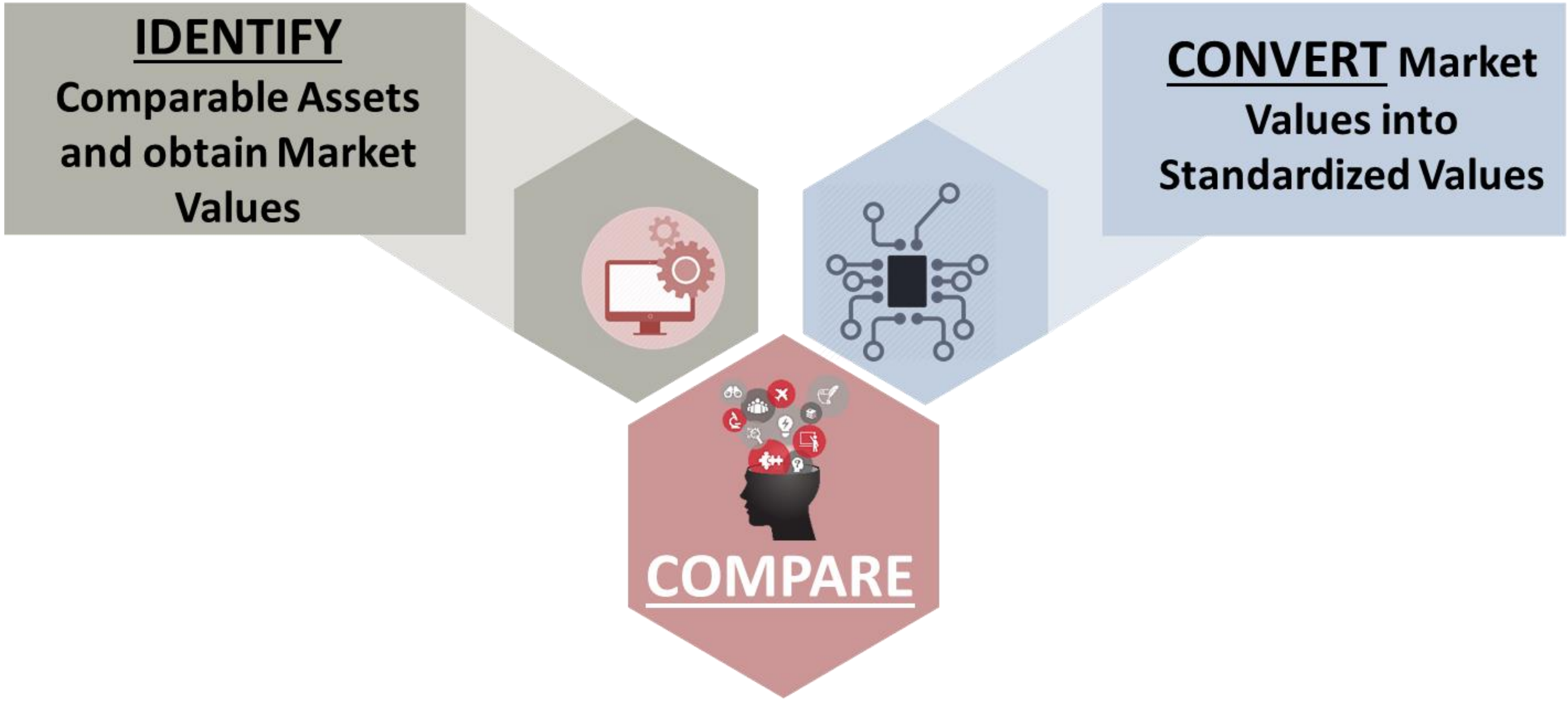
A rule of thumb or benchmark indicator is used as a reasonableness check against the values determined by the use of other valuation approaches.

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

Relative Valuation

WHAT IS RELATIVE VALUATION

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



Relative Valuation is Pervasive

STANDARDIZING VALUE

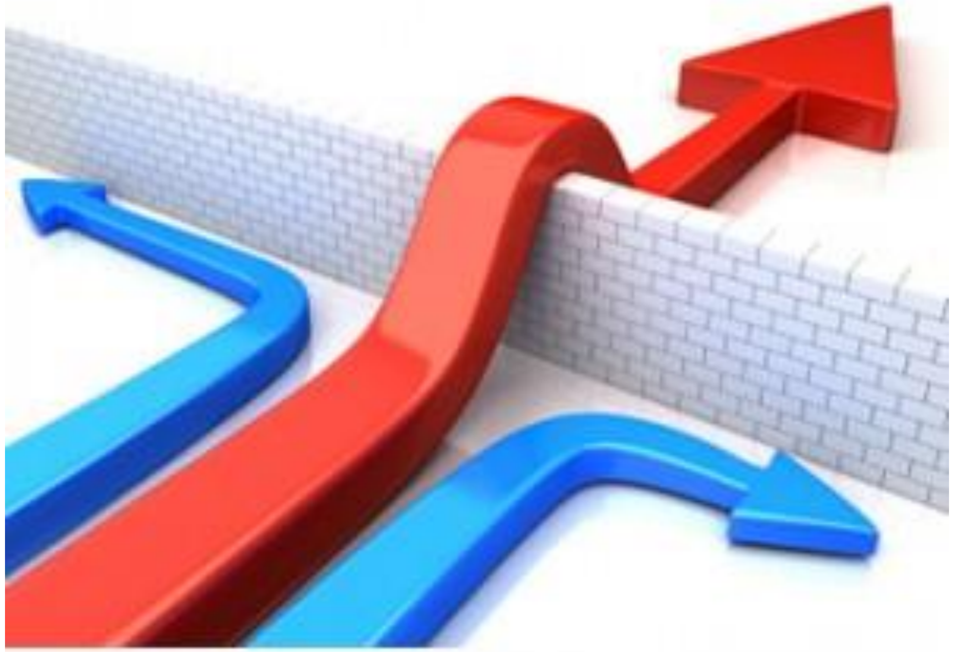
The valuation ratio typically expresses the valuation as a function of a measure of Key Financial Metrics

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”

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

“We must analyze all Corporate Actions and take necessary steps to Align them with new Regulatory Valuation requirements”

Let’s Learn…Unlearn…Relearn

Chander Sawhney

FCA, ACS, Certified Valuer (ICAI)
Partner & Head – Valuation & Deals

Corporate Professionals Capital Pvt. Ltd.

SEBI Registered (Cat-I) Merchant Banker

M: +91 9810557353; E: chander@indiacp.com

D-28, South Extension, Part-I, New Delhi-110049

www.corporateprofessionals.com
www.corporatevaluations.in