Overview of Valuation

For Pune Branch of WIRC of ICAI
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CA. Aalhad Deshmukh

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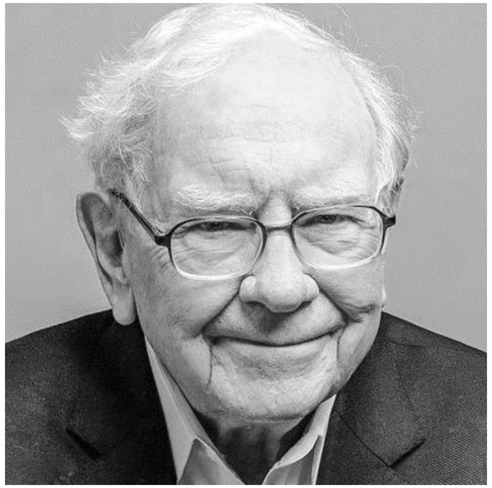
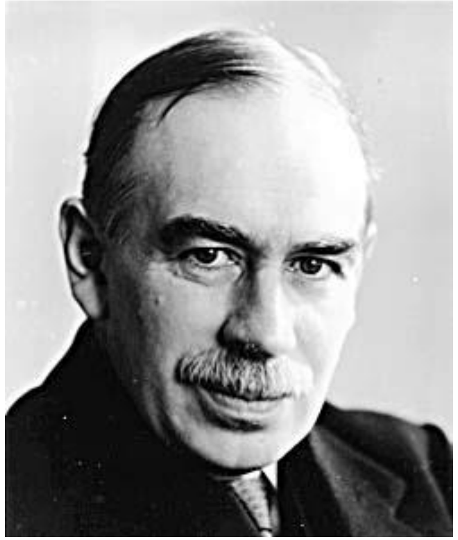
Introduction to Valuation

Meaning of Value and Valuation



Price is what you pay…
Value is what you get!
~ Warren Buffet
Chairman of Berkshire Hathaway

"It's better to be roughly right
than to be precisely wrong"
~ J. M. Keynes
British Economist



Definition of Valuation

The International Glossary of Business Valuation Terms

Business Valuation is an act or process of determining the value of a business, business ownership interest, security or intangible assets.

Alternate Definition

Business Valuation is a logical, defendable process of arriving at the opinion as to the worth of a business given the information available, assumption & limiting conditions as on the valuation date.

Definition of Fair Value

Value is a measure of how much an asset is worth!

As defined by International Valuation Standards Council in IVS 104, Fair Value is 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.

~ IFRS 13 and Ind-AS 113

Value vs. Price

Does price of an asset define its Value?

Price of an asset is:

- Amount of money or other consideration paid / received
- A Post-facto measure, an outcome of a transaction

Price may or may not have any relationship with the underlying value.

Value vs. Price (Contd.)

Value

- Cannot be measures precisely
- Not a Static Figure – Not an outcome of a transaction
- Measure of an economic worth

Price

- Can be measured precisely
- Static figure – defined by transaction
- Considers non-economic factors as well

Valuation Myths vs. Facts

Myths	Facts
Since Valuation models are quantitative, valuation is objective	Valuation models are quantitative; but inputs are subjective
A well-researched valuation model is timeless	Values will change as any new information is revealed
A good valuation provides precise estimate of value	A valuation exercise necessarily involves many assumptions
More quantitative the model is; better are the valuation results	Valuation Quality is directly proportional to time spent in collecting data and understanding the business

Important Valuation Principles

- Price ~ = Value (under free market conditions)
- Concept of Risk / Risk Free Return
- Earnings Value is the Value of a Going Concern
- Tangible Assets + Intangible Assets = Business Enterprise Value
- Equity Value = Business Enterprise Value – Net Debt

Purpose of Valuation

Valuation for Transactions

- Business Purchase / Sale / M&A
- Capital Reduction / Buy-back
- Corporate Restructuring

Valuation for Court Cases

- Insolvency and Bankruptcy
- Divorce / Family Settlement Cases
- Ownership Disputes

Valuation for Compliances

- Fair Value Accounting
- Taxation Issues
- FDI / FEMA Compliances

Valuation for Planning

- Personal Finance
- Capital Budgeting
- Project Finance Planning

Valuation Approaches

Valuation Methodologies

Basis for all valuation approaches

The use of all valuation models are based upon:

- A perception that markets are inefficient
- An assumption about how and when these inefficiencies will get corrected

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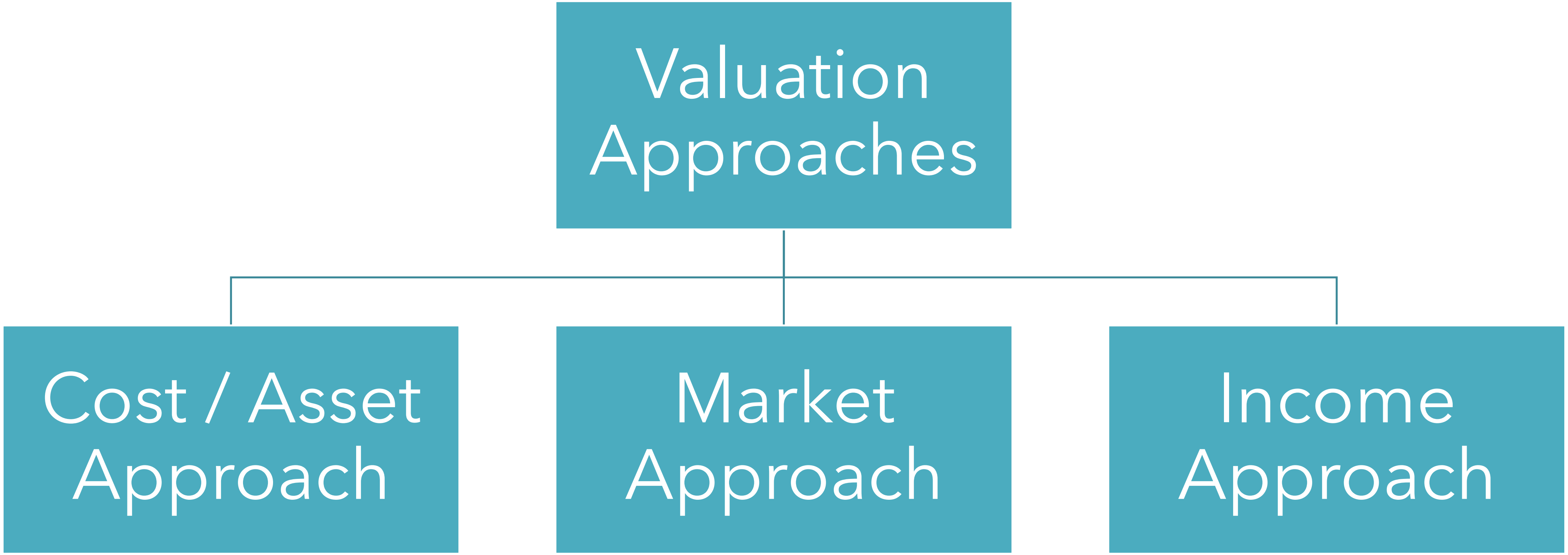
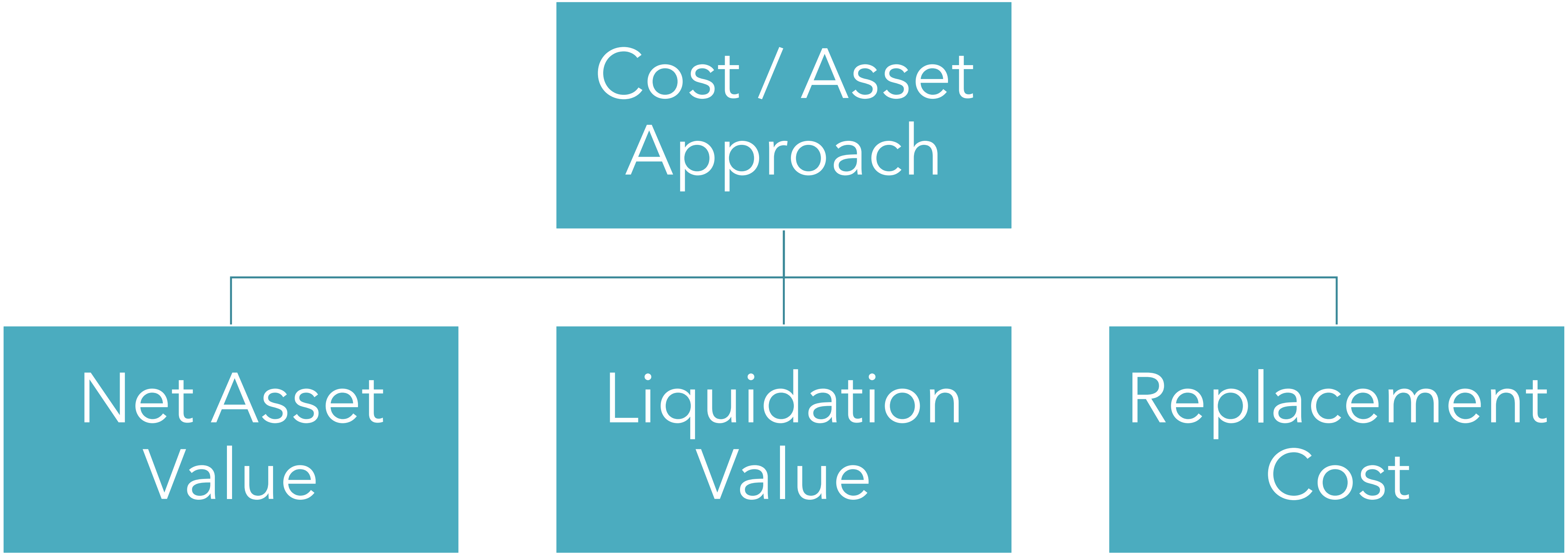
In an efficient market, the market price is the best estimate of value. The purpose of any valuation model is then the justification of this value.

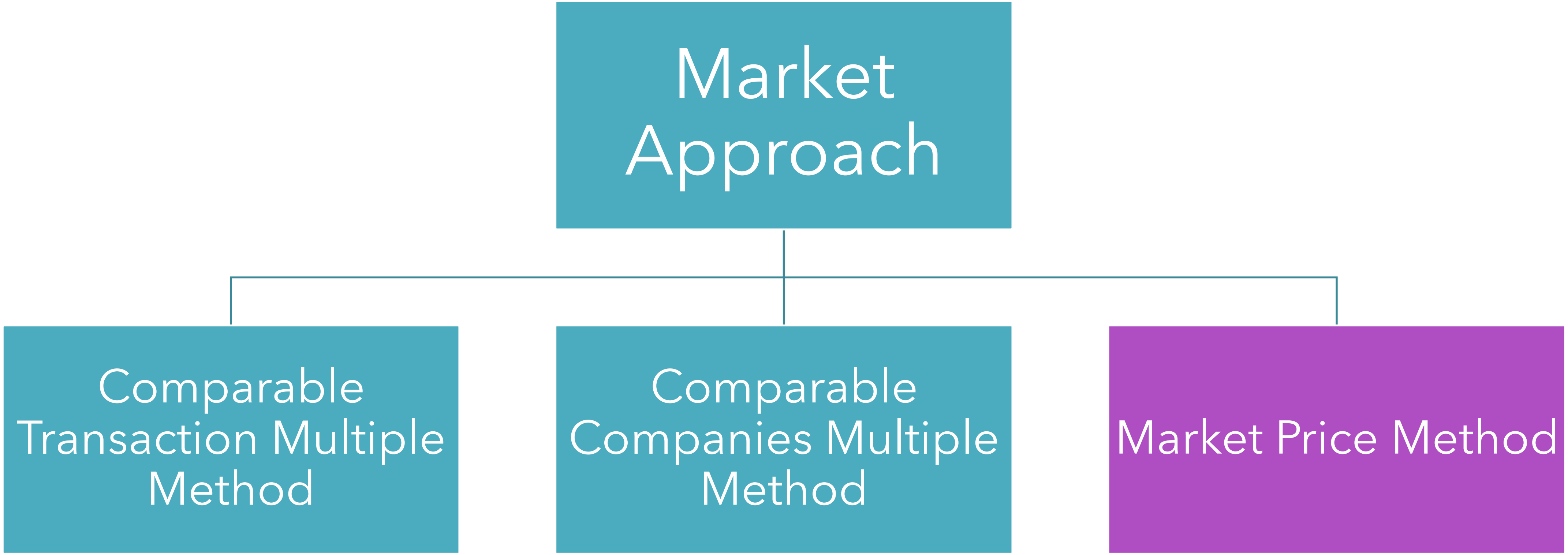
Valuation Approaches



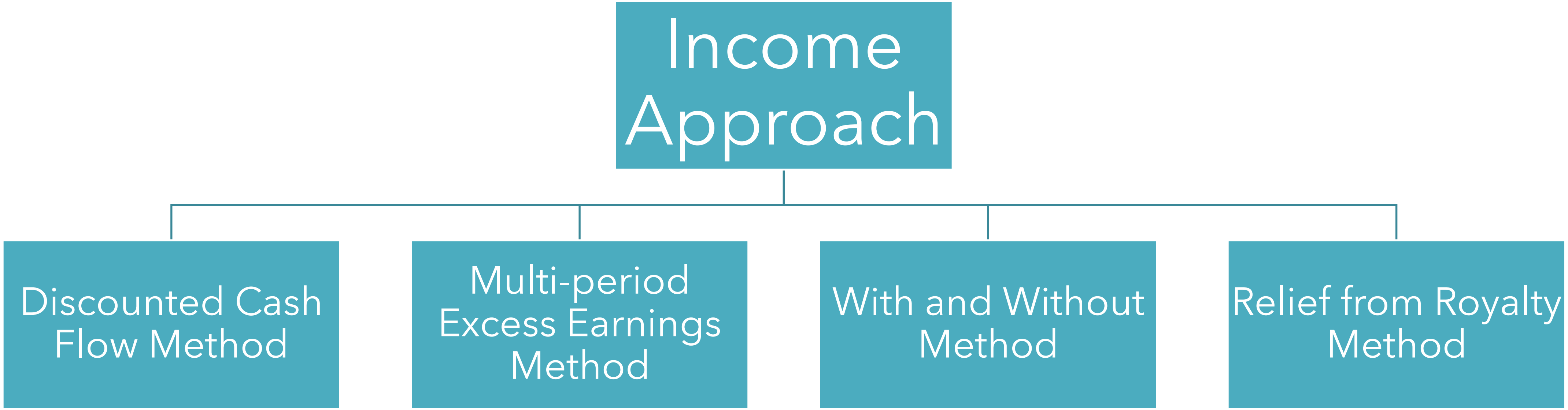
Valuation Approaches: Cost Approach



Valuation Approaches: Market Approach



Valuation Approaches: Income Approach



Cost Approach

Net Asset Value

- Simplest method of valuation
- Important Consideration:
  - Restate Tangible Assets to their Realisable Values
  - Treatment of Intangible Assets
  - Adjustment of Contingent Liabilities

Liquidation Value

- Net Realisable Value of the Asset on the assumption of liquidation
- Important Consideration:
  - Liquidation Costs, Taxation, Stamp Duty >> Net Amount Realisable should only be considered
  - Discount for forced sale and time factor needs to be factored in
  - Impairment in case of assets are charged with creditors

Replacement Cost

- Market Value of Similar Assets or
- Amount to be spent / Cost to be incurred for recreating the asset
- Useful for:
  - Valuation of Projects under implementation

Asset Based Valuation – Disadvantages

- Disregards Company's Income generating potential
- Does not consider prospective earnings
- Actual Value can be much higher than cumulative realisable values of the individual assets
- Fails to address other economic considerations

Market Approach

Comparable Transaction Multiple Method

- Also known as Guideline Transaction Multiple Method
- Valuation based on transaction multiples derived from comparable transactions
- Steps include are:
  - Identify Comparable Transactions and calculate transaction multiples
  - Compare assets to be valued with market comparable
  - Make adjustments for parameters like size, nature of business etc.
  - Arrive at fair value of the asset

Market Price Method

- Evaluates the value on the basis of prices quoted on the stock exchange
- Challenges:
  - Infrequently traded stock
  - Unusual Fluctuations in the market price
- Good practice to take average of quoted price for a reasonable period

Comparable Companies Multiple Method

- Also known as Guidance Companies Multiple Method
- Involves valuing an asset based on market multiples derived from prices of market comparables traded on active market
- Commonly used Multiples are:
  - EV to Sales
  - EV to EBITDA
  - Price to Book Value
  - Price to EPS

CCM Method - Example

We are valuing A Ltd. B Ltd. is a listed entity which is considered to be A Ltd.'s comparable company. Following is the key financial information of both companies: (Amt. in Rs.)

Particulars	A Ltd.	B Ltd.
No. of shares of Face Value Rs. 10 each	10,000	80,000
Market Price per share	-	150
Sales	25,00,000	95,00,000
EBITDA	4,25,000	9,75,000
EPS	1.25	1.50
Book Value Per Share	15.00	25.00

CCM Method – Example Contd.

Solution:

Valuation of A Ltd. From above multiples	Absolute	Per Share
EV / Sales	31,57,895	126.32
EV / EBITDA	52,30,769	209.23
Price to Book Value	25,65,789	102.63
Price to EPS	31,25,000	125.00
Average		**140.79**

Multiples - Variations

- Equity Value vs Firm Value
- Scaling Variables
  - Earnings (EBITDA / EBIT / EAT)
  - Book Value
  - Sales / Revenue

Multiples - Variations

- Periodic Variables
  - Most Recent FY
  - Last Four Quarters
  - Average
  - Forward - Estimates

Market Approach – Important Considerations

- Elimination of non-recurring / extraordinary items
- Averaging out profits of different years
- Selection of Comparable based on
  - Past and Expected Future Growth
  - Size and Market Share
  - Nature of the Business
- Differences in GAAP / Tax Regimes may be adjusted

Multiples – Pros and Cons

Can be used for Loss-making companies where other multiples cannot be applied

Not impacted by differences in Accounting Policies

Does not consider Capital Structure and thus, eliminates impact of financial leverage

EV / Sales

EV / EBITDA

P / BV

P / E

EBITDA is the closest proxy >> measure of performance in P&L

Cannot be used if the EBITDA is negative

Eliminates impact of financial leverage

Not impacted by Accounting Policies

Multiples – Pros and Cons

Difference in Book Value of Assets and Book Value of Liabilities

Can be used even if the earnings are negative or there is no income

Cannot be used when book value is negative

Only intuitive measure of fair value

EV / Sales

EV / EBITDA

P / BV

P / E

Widely used method due to simplicity and availability of information

Cannot be used if the EPS is negative

Need to be cautious of there are changes in accounting policies

Income Approach

Discounted Cash Flow Method

- Value based on expected cash flows over a given period of time and not accounting profits
- Value if the aggregate of discounted cash flows over the explicit period and perpetuity
- Involves determination of:
  - Discounting Factor
  - Long-Term Growth Rate in Perpetuity

DCF Parameters

Cash Flows	Discounting Rate
• Financial Projections • Calculation of FCFF or FCFE • Time Horizon – Explicit Period • Growth Rate in perpetuity	• Capital Structure • Cost of Equity • Cost of Debt • Cost of other components capital if any • Debt – Equity Ratio

DCF Parameters Contd.

EBITDA (Gross Operational Cash Flows)

Less: Tax

Less: Working Capital Changes

Less: Capital Expenditure (CAPEX)

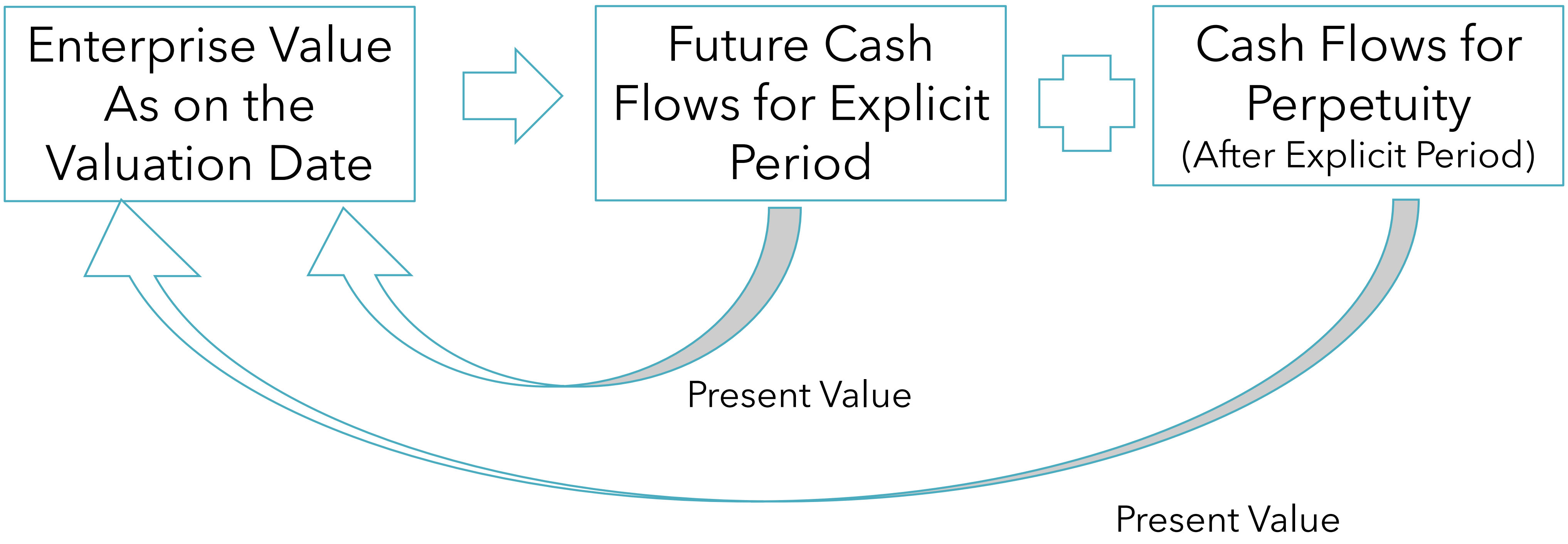
FCFF

Less: Interest (Debt Service)

FCFE

DCF – Value

Valuation Date



Use of DCF Method

- Use of DCF Method is the most appropriate in the following cases:
    - Projects with Limited Life
    - Projects having huge initial investment and predictable cash flows
    - Projects where profit / losses are not stabilised
    - Where valuation is not possible on the basis investment in assets

Selection of Most Appropriate Approach

Knowledge Based Companies	Income / Market
Manufacturing Businesses	Income / Market / Asset
Investment Companies / Real Estate Companies	Asset
Company into Liquidation	Asset

Adjustments required

- Discount for Lack of Marketability (DLOM), Control Premium or Discount for Lack of Control (DLOC)
- Contingent Liabilities / Assets
- Surplus Assets
- ESOPs / Warrants
- Tax concessions
- Observations in Auditor's Report / Qualification
- Findings of Due Diligence Reviews

Valuation Challenges

- Forecasting and Validation of Financial Projections
- Selection of the Most Appropriate Method
- Type of Instrument – Equity / Preference / Debentures
- Characteristics of Instrument – Redeemable / Convertible
- Growth Rate and Terminal Value
- Regulatory Requirements

Regulatory Requirements of Valuation

Valuation required under various regulatory / statutory provisions

Valuation Requirements under

- Companies Act, 2013
- Insolvency and Bankruptcy Code, 2016
- Income-tax Act, 1961
- Foreign Exchange Management Act, 1999
- SEBI Guidelines

Companies Act, 2013

Section 247. (1) Where a valuation is required to be made in respect of any property, stocks, shares, debentures, securities or goodwill or any other assets (herein referred to as the assets) or net worth of a company or its liabilities under the provision of this Act, it shall be valued by a person having such qualifications and experience, registered as a valuer and being a member of an organisation recognised, in such manner, on such terms and conditions as may be prescribed and appointed by the audit committee or in its absence by the Board of Directors of that company.

Important Provisions of the Companies Act

Section	Provision
54	Valuation of Sweat Equity Shares
56	Transfer of Shares
62(1)(c)	Further issue of shares
230	Compromises and Arrangements
232	Merger and Amalgamation
236	Purchase of Minority Shareholding

Insolvency and Bankruptcy Code, 2016

Provision	Particulars
CIRP Reg. 27	Appointment of Registered Valuers
CIRP Reg. 35	Fair Value and Liquidation Value
VLP Reg. 3(1)	Voluntary Liquidation

Important Provisions of the Income-tax Act

Section	Provision
17(2)(vi)	Value of shares / securities treated as perquisites
49(2AA)	Capital Gains on sale of shares / securities obtained as perquisite u/s 17(2)(vi)
50CA	FMV of shares to be treated as consideration
56(2)(viib)	Excess of consideration over FMV – Income
56(2)(x)	Excess of FMV over Consideration for transfer

Foreign Exchange Management Act, 1999

The price of shares should be:

the valuation of capital instruments done as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a SEBI registered Merchant Banker or a practicing Cost Accountant

Important SEBI Regulations

- Recently updated SEBI Regulations have introduced definition of Registered Valuers in line with section 247 of the Companies Act, 2013
- Valuation required for:
  - Preferential allotment where shares are not frequently traded
  - Takeover – open offer price for not frequently traded shares
  - Merger / Demerger Cases

Other Valuation Opportunities

Other than regulatory requirements as discussed earlier

Fair Valuation under Ind-AS

- Ind-AS 113: Fair Value Measurement
- Total Companies in India ~ 18,94,146; Closed Companies ~ 6,83,317 >> Around 12 lakh active companies today
- Listed Companies [BSE~5,155] and [NSE~1,622]
- Companies having NW > 250 Cr in Phase 2 of Implementation
- All Banks, NBFCs, Insurance Companies

Allied Areas

Mergers and Acquisitions

Structured Corporate Finance

Transaction Advisory

Thank You!

Stay Home, Stay Safe and Keep Learning!

Aalhad Deshmukh

Chartered Accountant | IBBI Registered Valuer (SFA)

Email: aalhad.deshmukh@experity.co.in