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Corporate Valuations
"Techniques & Application"

A compilation of research oriented valuation articles

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Contents

PREFACE

Knowing what business is worth and what determines its value is prerequisite for intelligent decision making. John Maynard Keynes said, "There is nothing so dangerous as the pursuit of a rational investment policy in an irrational world." 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. Most treatises and court decisions encourage valuers to consider more than one method which must be reconciled with each other to arrive at value conclusion.

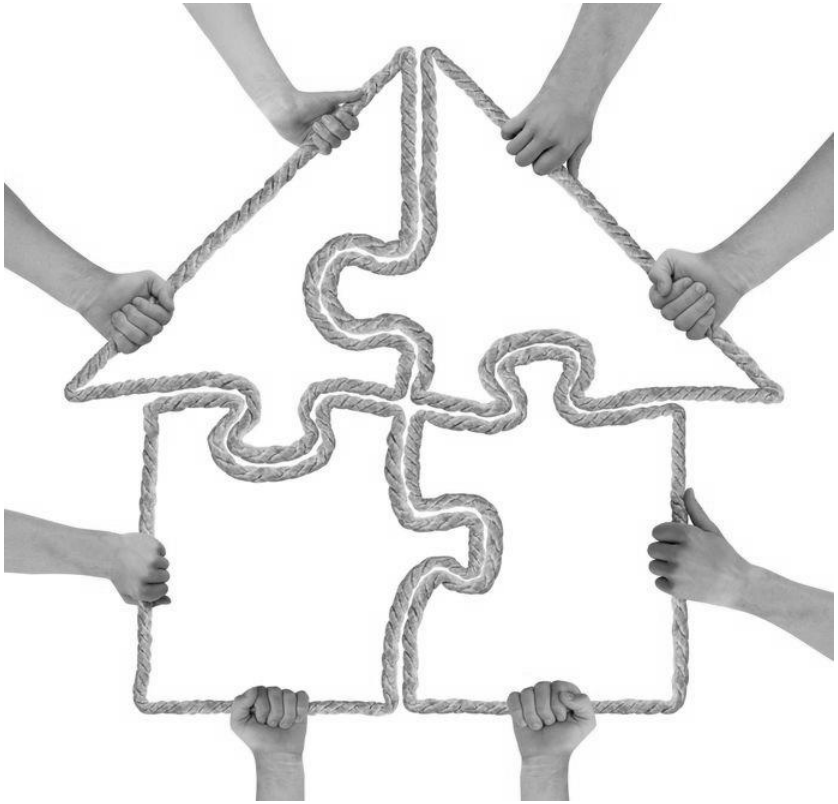
However, as of now there is not much guidance on standards for business valuation in India specifically for unlisted and private companies, numerous conceptual controversies still remain, even among the most prominent valuation practitioners. www.corporatevaluations.in by virtue of its extensive promoters capital markets experience, dedicated valuation team, in-house research wing and proven expertise in corporate transaction advisory has made an attempt by identifying, preparing and compiling research oriented articles on such debated issues on business valuation, relative valuation, SOTP valuation, ESOP valuation, DCF valuation, Enterprise valuation, holding company discounts, valuation in IT sector, RBI valuation and regulatory valuations which will guide you how to apply the range of valuation techniques, including their appropriate application, advantages and disadvantages.

www.corporatevaluations.in is an online venture on valuation promoted by Corporate Professionals Capital Private Limited, the Merchant Banking arm of Corporate Professionals, a fast mounting consultancy group in India providing integrated financial and legal services.

We hope this compilation of research oriented articles will give its readers rich insight and adequate knowledge about key valuation issues. We shall be happy to receive any comments /suggestions @ info@corporatevaluations.in

With warm wishes,

Valuation Team
Corporate Professionals



Business valuation

Valuation is more on an art based on the professional experience of the valuer rather than a science based on empirical studies and logics. Though internationally business valuations are governed by broadly various standards like: Valuation Standards of American Institute of CPAs (AICPA), American Society of Appraisers (ASA), Institute of Business Appraisers (IBA), National Association of Certified Valuation Analysts (NACVA), The Canadian Institute of Chartered Business Valuators (CICBV), Revenue Ruling 59- 60 (USA), ICAI Valuation Standard (recommendatory) however keeping in view the growing relevance and importance of valuation in business and investment decisions as well as in regulatory compliance processes the development of practice of valuation as a discipline and profession in the present context has become a necessity because of imperatives of financial markets, emerging global economy, and changing framework of accounting and financial reporting.

An insight into business valuation

Knowing what business is worth and what determines its value is prerequisite for intelligent decision making. It is pertinent to mention that valuation of a business is not an exact science and ultimately depends upon a number of factors like the purpose, stage of business, assets, income and liabilities, industry scenario, market recognition, promoters and management background and intangibles etc.

Standard and Premise of value?

To determine the value of any business, the **reasons for** and **circumstances surrounding** the business valuation must be pre ascertained. These are formally known as the "**Standard of value"** and "**Premise of value"**.

*To be precise, the **"Standard of Value"** is the hypothetical conditions under which the business is valued **and** the "**Premise of Value"** relates to the assumptions upon which the valuation is based.*

Key facts of business valuation

- Price is not the same as value
- Value varies with person, purpose and time
- Transaction concludes at negotiated prices
- Valuation is hybrid of art & science

Some reasons to get business valuation

Purpose	Regulatory	Accounting	Dispute Resolution
• Mergers • IPO • Acquisitions / Investment • Voluntary Assessment	• RBI • Income Tax • SEBI • Stock Exchange • Companies Act	• ESOP • Purchase Price Allocation • Impairment / Diminution	• Company Law Board/ Courts • Arbitration • Mediation

Generally acceptable methodologies of valuation

There are broadly three approaches to valuation which need to be considered in any business valuation exercise. A number of business valuation models can thus be constructed that utilize various methods under the broad business valuation approaches. Most treatises and court decisions encourage the valuer to consider more than one method, which must be reconciled with each other to arrive at a value conclusion. Understanding of the internal resources and intellectual capital of the business being valued is as important as the economic, industrial and social environment.

- Asset approach
- Income approach
- Market approach

- **Asset approach (NAV) -** Generally the Net Asset Value reflected in books do not usually include intangible assets enjoyed by the business and are also impacted by accounting policies which may be discretionary at times. NAV is not perceived as a true indicator of the fair business value. However, it is used to evaluate the entry barrier that exists in a business and is considered viable for companies having reached the mature or declining growth cycle and also for property and investment companies having strong asset base.
  - **Book value method -** It is based on the balance sheet review of assets and liabilities;
  - **Replacement cost method -** It is based on current set up cost of plant of a similar age, size and capacity;
  - **Liquidation value method -** It is based on estimated realizable value of various assets.

- **Income approach -** The Income based method of valuations are based on the premise that the current value of any business is a function of the future value that an investor can expect to receive from purchasing all or part of the business.

  - **Discounted Cash Flow Method (DCF)** - DCF expresses the present value of the business as a function of its future cash earnings capacity. In this method, the appraiser estimates the cash flows of any business after all operating expenses, taxes, and necessary investments in working capital and capital expenditure is being met. Valuing equity using the free cash flow to stockholders requires estimating only free cash flow to equity holders, after debt holders have been paid off.
  - **Capitalization of earning method -** The capitalization method basically divides the business expected earnings by the so-called capitalization rate. The idea is that the business value is defined by the business earnings and the capitalization rate is used to relate the two.

- **Market based approach -** In this method, value is determined by comparing the subject, company or assets with its peers or Transactions happening in the same industry and preferably of the same size and region. This is also known as relative valuation method.

  - **Comparable companies multiples approach-** Market multiples of comparable listed companies are computed and applied to the company being valued to arrive at a multiple based valuation.
  - **Comparable transaction multiples method -** This technique is mostly used for valuing a company for M&A, the transaction that have taken place in the industry which are similar to the transaction under consideration are taken into account.
  - **Market value approach -** The Market value method is generally the most preferred method in case of frequently traded Shares of companies listed on stock exchanges having nationwide trading as it is perceived that the market value takes into account the inherent potential of the company.

Other valuations approaches -

- **Contingent claim approach -** Under this valuation approach, option pricing model is applied to estimate the Value. Generally ESOP valuation for accounting purpose is done using the black scholes method. Now even Patent Valuation is also done using black scholes method.
- **Price of recent investment approach -** Under this valuation approach, the recent investment in the business by an independent party may be taken as the base value for the current appraisal, if no substantial changes have taken place since the date of such last investment. Generally the last investment is seen over a period of last 1 year and suitable adjustments are made to arrive at current value.
- **Rule of thumb approach -** Although technically not a valuation method, a rule of thumb or benchmark indicator (like EV per room in hotel business) is used as a reasonableness check against the values determined by the use of other valuation approaches.

Valuation - Indian considerations

For so long, valuation has been debated in India as an art or science and substantial part of the litigation in Mergers & Acquisitions (M&A) takes place on the issue of valuation as it involves an element of subjectivity that often gets challenged. More so, as in India, there are not much regulator prescribed standards for business valuation specifically for unlisted and private companies so in many cases the valuation lacks the uniformity and generally accepted global valuation practices. Even limited judicial guidance is available over the subject in India. Further, absence of any stringent course of action and non regulation under any statute is also leading to loose ends.

- Institute of Chartered Accountants of India (ICAI) has recently developed and recommended Business Valuation Practice Standards (BVPS) aiming to establish uniform principles, practices and procedures for valuers performing valuation services in India.
- The introduction of concept of Registered Valuer in the Companies Bill, 2012 (yet to be enacted) could now set the Indian valuation standards for standardizing the use of valuation practices in India, leading to transparency and better governance.

Concluding thoughts

Valuation is more on an art based on the professional experience of the valuer rather than a science based on empirical studies and logics. Though Internationally Business Valuations are governed by broadly various standards like: Valuation Standards of American Institute of CPAs (AICPA), American Society of Appraisers (ASA), Institute of Business Appraisers (IBA), National Association of Certified Valuation Analysts (NACVA), The Canadian Institute of Chartered Business Valuators (CICBV), Revenue Ruling 59- 60 (USA), ICAI Valuation Standard (recommendatory) however keeping in view the growing relevance and importance of valuation in business and investment decisions as well as in regulatory compliance processes the development of practice of valuation as a discipline and profession in the present context has become a necessity because of imperatives of financial markets, emerging global economy, and changing framework of accounting and financial reporting.

Relative valuation

A key benefit of relative valuation analysis is that the methodology is based on the current market stock price. The current stock price is generally viewed as one of the best valuation metrics because markets are considered somewhat efficient. But applying multiples is not a straight forward technique and many considerations have to be kept in mind when valuing a company. Sanity check is advised by using other valuation methods as well.

What is relative valuation?

Relative valuation uses the valuation ratios of comparable publicly traded companies and applies that ratio to the company being valued subject to necessary adjustments. The valuation ratio typically expresses the valuation as a function of a measure of financial performance or book value multiples (e.g. Revenue, EBITDA, EBIT, earnings per share or book value).

This technique hinges upon the efficient market theory which indicates that the price of exchanged securities in the market reflects all readily available information, as well as the supply and demand effects of educated and rational buyers and sellers. In other words, the market is continuously evaluating each company and expressing that valuation in bids and offers for its stock.

Advantages of using relative multiples

- **Usefulness:** Valuation is about judgment, and multiples provide a framework for making value judgments. When used properly, multiples are robust tools that can provide useful information about how similar assets are placed in the market.
- **Simplicity:** Their very simplicity and ease of calculation makes multiples an appealing and user-friendly method of assessing value.
- **Relevance:** Multiples focus on the key statistics that other investors use. Since investors in aggregate move markets, the most commonly used statistics and multiples will have the most impact. These factors, and the existence of wide-ranging comparables, help explain the enduring use of multiples by investors despite the rise of other methods. Most valuations in stock markets are done through this method.

Disadvantages of using relative multiples

- **Simplistic:** A multiple has a great deal of information into a single number. By combining many value drivers into a point estimate, multiples may make it difficult to disaggregate the effect of different drivers, such as growth, on value. The danger is that this encourages simplistic – and possibly erroneous – interpretation.

- **Static:** A multiple represents a snapshot of where a firm is at a point in time, but fails to capture the dynamic and ever-evolving nature of business and competition.

- **Difficult to compare:** Multiples are primarily used to make comparisons of relative value. But comparing multiples always challenging, because there are so many reasons that multiples can differ, not all of which relate to true differences in value. For example, different accounting policies can result in diverging multiples for otherwise identical operating businesses.

Key issues in relative valuation

- Peer selection
- Current multiples or forward multiples
- Adjustments to the value

Issue 1 - Peer selection

For relative valuations, identification of appropriate peers is a prerequisite. Peers taken should be as close as possible to the company being valued. It is preferred that the peer companies should have a similar:-

- Business model,
- Accounting practices,
- Growth pattern
- Return on capital invested
- Financial and operational risk.

In case peers in the domestic country are not available, then global peers can also be taken but subject to certain adjustments which are discussed in Issue 3.

Therefore, to select the peer group of a company, it is important to understand the business of the company being valued. Normally the peer group will be based on companies from the same industry. Selecting the most appropriate peer group is thus not easy task.

Issue 2 - Current or forward multiples

Generally to the latest financials of the company a prevailing market multiple of the comparable companies is applied to arrive at the value of the company being valued. However while valuing early stage companies whose values of financials in future years provide a much better picture of the true value potential of the firm, forward financials may be more appropriate to consider.

- **Current multiple of peer companies –** Incase the peer companies are mature as on the valuation date, their prevailing valuation multiple may be applied to the forward stabilized financials of the company being valued.

  This will yield value of the company for the year for which earnings are taken. Therefore this value has to be discounted back to get the forward present value of the company.

  (Discounting can be done using the cost of capital of the company or the cost of equity for the time period for which forward earnings are taken.)

- **Forward multiple of peer companies-**Forward multiple of peer companies is applied when the entire industry is in evolving stage and no comparable mature company exist on the valuation date. In this case there is no need for discounting. Forward looking Earnings are generally preferred for valuation purposes. Valuation is generally done with a forward looking view and the value of a company depends more upon how much in the future could the company/business earn than how much it has earned till date. Therefore forward multiples are preferred more than current multiples.

Issue 3 - Adjustments to the value

Valuation derived from relative valuation method is based on a certain multiples like EBITDA/Sales or Profit etc. It does not take into consideration other factors which are not reflected by the earnings such as:-

- **Surplus/Non operating assets**

  Surplus assets/ Non operating assets 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 other valuation methodologies to arrive at the value of the company.

  However it is pertinent to mention herein that the investors may not be willing to pay for these surplus/ non operating assets which may call for reorganization of the company.

- **Adjustments for global peers**

  If the valuation of a company is based on comparison with the global peers, then it should be adjusted for some differences such as:-

- Difference of tax rate in the 2 countries.
- Difference in growth & Inflation rate of the 2 countries
- Difference between the levels of competition in the 2 countries.
- Difference in the country risk of the 2 companies
- Difference of accounting treatment in the 2 companies

Thus there are many changes that are required to be made when choosing global peers & therefore domestic peers are always preferred for relative valuations since they are more comparable.

Concluding thoughts

A key benefit of relative valuation analysis is that the methodology is based on the current market stock price. The current stock price is generally viewed as one of the best valuation metrics because markets are considered somewhat efficient. But applying multiples is not a straight forward technique and many considerations have to be kept in mind when valuing a company. Sanity check is advised by using other valuation methods as well.

Sum of the parts (SOTP)

Valuation and Value Creation

The sum of parts valuation (SOTP) technique is used to find the embedded value in different parts of businesses. Strategic change and operational excellence creates investor curiosity and lead to value creation. However it is observed that the market is unwilling and unable to unlock value on its own and that's reflective of market disconnect between fair value and value being paid by the market. While doing SOTP Valuation, assessment of any strategic or operational management activity is essential to understand the structure modifications before concluding value. While valuing any Company having diversified business interest, it also makes sense to analyze the upside potential rather than downside risk.

Sum Of The Parts Valuation (SOTP)

"Company A is doing sugar Business with Value of Say Rs 100 and company B is doing Cement Business with Value of say again Rs. 100 then what should be the value of company C doing both the above business by itself, On unitary basis it should be Rs 200 i.e.

Value of C company = Value of A company + Value of B company

It seems so simple; however it is not the way how valuation actually happens in the real life scenarios. That's where the role of a valuer becomes significantly important. A corporate valuer always focus on the risk involved while undertaking any SOTP valuation and gives appropriate discounts accordingly. In the transaction history and the empirical research carried by various researchers it being well laid that the market gives discount to the sum of parts value of businesses not complimenting each other which is known as diversification discount or portfolio discount or conglomerate discount.

In real life scenario there are companies which are engaged in diversified business, and each business has different product line, profit margin etc, so to value diversified companies on a consolidated level, like consolidated sales and consolidated profit may not able to give a true value of the company as some business segment may fetch a high comparable companies multiple and some low Multiple. Similarly the cash flow generating components of each Biz would also be different.

What is Sum of the Parts Valuation?

It is the Value of a company by determining what its divisions would be worth if it was broken up and spun off or acquired by another company.

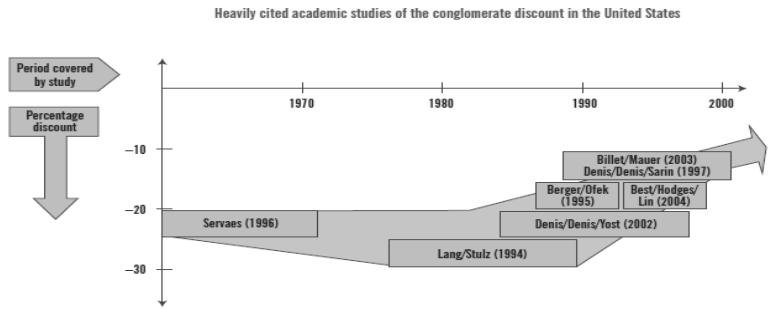
Why is SOTP Valuations done?

SOTP method is used to value a company with business segments in different industries that have different valuation characteristics. SOTP analysis is useful for:-

- Computing the fair value of a company that is trading at a discount to the sum of its parts.
- Restructuring a company's value through a spin-off, or reorganization to unlock the value of business segments to their potential.

Diversification Discount

Diversification discount arises from sum of part valuation, due to multiple businesses, non clarity of business specifics and lack of management focus, market tends to give discount to the SOTP. This is known as diversification discount or portfolio discount. Global Studies over the years on diversified companies has shown that these companies trade at a discount in the range of 10% to 30%. In the Indian context, sometimes this discount is even higher around 50%.



Source: - BCG analysis

Diversified business discounts results in sub optimal businesswise valuation and also there remains difficulty in raising funds for a particular business. Due to such issues and value creation potential, India has also seen demerger of companies in diversified businesses resulting in value unlocking which has resulted in gain in shareholders' wealth. Different business groups over the years have segregated unrelated businesses for value unlocking. There are number of companies which have unlocked their value through demerger in Indian context like Reliance Industries Ltd, NIIT Ltd, JK Lakshmi Cement Ltd, SRF LTD, Siemens Ltd, Larsen & Toubro Ltd etc.

Can SOTP valuation be realized?

Value realization for diversified companies can be achieved primarily by the management action research has shown that If the management wants to realize the true value of the whole company, then a break-up is the most obvious way to realize the company's sum of the parts valuation.

Two facts and challenges have been noted in this respect-

- There has been observed a direct nexus in the "Size of Company" and "management remuneration" and this may be one of the reason why not much of the spin off happens.
- It is also observed that very big companies attract more discounts as there is difficult to reorganize them due to mega complex structures. However mid level companies can reduce this discount significantly through Management action and reorganization.

Concluding thoughts

The sum of parts valuation (SOTP) technique is used to find the embedded value in different parts of businesses. Strategic change and operational excellence creates investor curiosity and lead to value creation. However it is observed that the market is unwilling and unable to unlock value on its own and that's reflective of market disconnect between fair value and value being paid by the market. Thus while doing SOTP Valuation, assessment of any strategic or operational management activity is essential to understand the structure modifications before concluding value. While valuing any Company having diversified business interest, it also makes sense to analyze the upside potential rather than downside risk.

ESOP Valuation

ESOP valuation (both for accounting of "compensation expense" by company and for perquisite tax payable by the employees) plays a significant role in the success of any ESOP scheme.

The compensation expense reduces the EPS of the company and the possibility of excess tax payout by employees may turn the ESOP scheme unattractive. Thus proper planning of ESOP is inevitable.

What is ESOP

Employee Stock Option Plan (ESOP) is a plan through which a company awards stock options to the employees based on their performance. An employee stock option is a call option meaning that under an ESOP the employees have the right and not an obligation to buy the shares of the company on a predetermined date at a predetermined price. The objective of ESOP is to motivate the employees to perform better and improve shareholders' value. Apart from giving financial gains to the employees, ESOP also creates a sense of belonging and ownership amongst the employees.

How is ESOP Valuation done

A) Accounting valuation

The Accounting valuation is needed for working out the employee compensation cost at the time of ESOP grants Itself which is apportioned over the vesting period of ESOP.

There are two methods of doing ESOP valuations- Intrinsic value method & Fair value method.

- **Intrinsic value method**

”Intrinsic Value” is the excess of the market price of the share under ESOP over the exercise price of the option (including upfront payment, if any) Example: - A company grants an ESOP to its employees whose current market price (CMP) of the share is Rs 100 which can be exercised after 2 years for Rs 70. In this case the intrinsic value of options shall be Rs 30/- (100 – 70).

However if the CMP was Rs.50 instead, there would be no intrinsic value of the option since the exercise price is more than CMP and in this case options could not be explained and instead stand lapsed.

- **Fair Value Method**

The fair value of an ESOP is estimated using an option-pricing model like, the Black-Scholes or a binomial model. For undertaking fair valuation of ESOPs, the Fair value method considered more appropriate as it takes into account the various other factors like time value, interest rate, volatility, dividend yield etc. These factors are not considered under Intrinsic Value method which may lead to under estimation of employee compensation cost.

The black scholes model considers various external factors that affect the value of the ESOP whereas the intrinsic value method considers only factors internal to the option offered. To compute the value of ESOP options through black- scholes the following variables have to be considered:-

- Expected life of the option
- Exercise price
- Fair value per share
- Expected volatility of share price
- Expected dividend yield
- Risk-free interest rate

Key issues in valuation of ESOPs through black-scholes model

Issue 1: - Expected life or total life of the option

For the purpose of valuations we need to consider the likely life of option and not the total life of the option. For calculation of expected life it is recommended to use the Average of the maximum life of option and the minimum life of option for each vesting of a particular grant.

Issue 2: - Volatility of unlisted companies

For listed companies historical volatility in their own share prices is taken, the problem arises on how to compute volatility of unlisted companies.

Indian accounting guidance norms recommends unlisted companies to consider volatility as zero since there is no market price of the unlisted companies. This may however lead to incorrect value of the ESOPs.

An alternative for computation of the Fair Value of an ESOP option of unlisted company is to consider historical volatility in the share prices of other similar listed comparable companies should be considered and taken as the expected volatility for the unlisted company.

Issue 3: - Dividend Yield

Payment of dividend reduces the price of a share. Dividend paid during the ESOP period is not cumulated for ESOP holders; therefore dividend paid before the ESOP is exercised may be reduced while computing ESOP value.

Thus companies are required to estimate the future dividend yield rate (i.e. dividend per share divided by value per share). The company's historical dividend yield rate can be used to estimate its expected future dividend yield.

Issue 4: - Risk-free interest rate

The Risk free rate being considered for the calculation is the interest rate applicable for a maturity equal to the expected life of the options based on the zero-coupon yield curve for Government Securities or 10 years Government bonds.

B) Tax Valuation

This valuation is required for determination of value of perquisite taxable in hands of employees, to comply with applicable provisions of Indian Income Tax Act, 1961 and notification issued by CBDT in this respect.

Notification no. 94/2009 dated 18.12.2009 issued by CBDT, provides that for the purpose of clause (vi) of sub-section (2) of section 17, the fair market value of any specified security or sweat equity share, being an equity share in the company not listed at any recognized stock exchange, shall be such value of the share in the company as determined by a merchant banker on the specified date. No method has been prescribed for undertaking such valuation. This also includes shares of companies listed on overseas stock exchange as the Overseas Exchanges do not qualify as the Recognized stock exchanges in India.

Concluding thoughts

ESOP valuation (both for accounting of "compensation expense" by company and for perquisite tax payable by the employees) plays a significant role in the success of any ESOP scheme.

The compensation expense reduces the EPS of the company and the possibility of excess tax payout by employees may turn the ESOP scheme unattractive. Thus proper planning of ESOP is inevitable.

Discounted Cash Flow Valuation

Discounted Cash Flow (DCF) method is one of the most important finance tools to derive value of a company based on the future cash flows of business. However it needs to be used with great care as it's a very sensitive model where the values get affected significantly with a small change in assumption like beta value, terminal growth rate, risk free rate of return and market return. It is strongly recommended to do sanity check with the market approach to valuation like CCM and asset approach i.e. net asset value before concluding the DCF value.

Discounted Cash Flow –The Prominent income approach to valuation

While undertaking the valuation of any company there are three broad approaches to valuation namely Asset approach, Income approach and Market approach. Discounted cash flow (DCF) is one of the prominent income approaches to valuation and is used to estimate the attractiveness of any investment opportunity on the basis of future cash flow projections of business. So far DCF is considered as the most scientific financial tool to derive the value of any company based on parameters like projected cash flows, cost of capital, growth cycle of business, perpetual growth rate etc. This method mostly yields control valuation result and is sensitive to even minor changes in these parameters.

"The Discounted Cash Flow method expresses the present value of the business attributable to its stakeholders as a function of its future cash earnings capacity. This methodology works on the premise that the value of a business is measured in terms of future cash flow streams, discounted to the present time at an appropriate discount rate".

Discounted Cash Flow can be used to derive the value of equity shareholders of company and also the value of the firm/company.

Discounted Cash Flow to equity

This method uses the Free Cash Flows to Equity (FCFE) and values the benefits that accrue to the equity shareholders of the company. The value of the equity is arrived at by estimating the FCFE and discounting it at the cost of equity (Ke).

This methodology is considered to be the most appropriate basis for determining the earning capability of a business. It expresses the value of a business as a function of expected future cash earnings in present value terms.

FCFE = Net Income - Net Capital Expenditure - Change in Non Cash Working Capital + New Debt – Debt Repayment

Discounted Cash Flow to firm

Discounted Free Cash Flow to Firm (FCFF) measures the enterprise value of a company i.e. (Value of Equity + Value of Debt), no adjustment is separately needed for debt (inflows and outflows) for arriving at the FCFF. Here the discounting of free cash flow to firm is made by weighted average cost of capital ('WACC') to arrive at the enterprise value.

FCFF = EBITDA – Taxes- Change in Non Cash Working Capital- Capital Expenditure

Key Issues and challenges in Discounted Cash Flow Methodology

- Cost of equity calculation
- Weighted average cost of capital calculation
- What should be the terminal growth rate

How is cost of equity (Ke) calculated?

Cost of equity (Ke) is the required rate of return of a shareholder who invests in the equity of a company. Cost of equity is generally calculated using the Capital Asset Pricing Model (CAPM)

According to CAPM

Cost of equity = Risk free rate + Beta*(Market return – Risk free rate)

Where,

Beta of a stock is the relation of its returns with those of the capital market (BSE/NSE) as a whole. However there are certain risk like small company risk (SCRP) and specific company risk (CSRP) which affect the cost of equity so it is recommendatory to add these risk premiums and factor these in CAPM, which is detailed below

Modified CAPM

Cost of Equity = Risk Free Rate + Beta*(Market Return – Risk Free rate) + SCRP+ CSRP

Issues while computing Ke through CAPM

- How is Risk free rate calculated
- How to calculate Beta of an unlisted company whose shares are not traded.
- How to account for small company risk & company specific risk

What is risk free rate

It is the theoretical rate of return of an investment with zero risk. The risk-free rate represents the interest an investor would expect from an absolutely risk-free investment over a specified period of time.

What should be taken as risk free rate

The 10 Year Yield on Indian Government Bond is currently taken as the risk free rate by most analysts but since the India Government Bond is a coupon/interest paying bond, it also carries some risk called the Reinvestment Risk (i.e. the risk that coupons/interest paid by the bonds might not be able to be re-invested at the same rate as off today)

Since there are no Zero Coupon bonds of the Indian government, the National Stock Exchange of India has developed a 'Zero Coupon Yield Curve' (ZCYC) that helps in valuation of sovereign securities across all maturities. With the help of this ZCYC, an estimate rate of return on 10 year Indian Government Zero Coupon Bond can be calculated. The rate calculated through ZCYC i.e. Yield of a Zero Coupon Bond should be taken as the risk free rate since it does not have any reinvestment risk as there is no payment before the bond matures. As of February 2012, Zero Coupon Yield is around 8.29%

How to calculate Beta of an unlisted company

Beta which measures the systematic risk is calculated by finding the correlation of the return of a company with those of the financial market i.e. Sensex in Indian context. Since unlisted companies do not have any trading price, thus it is difficult to calculate the beta of an unlisted company.

The beta of an unlisted company can however be calculated on a relative basis by adjusting the average beta of its comparable companies for differences in Capital Structure of the unlisted company with the listed peers.

Adjustment to Beta

The beta of an unlisted company taken from the average of its comparable listed companies must be adjusted for difference in the debt

structure of the company & its peers but un-levering the average beta values of its listed peers and then levering the average calculated beta of listed peers with the unlisted companies Debt Structure.

How to un-Lever Beta and then Lever it again?

Unlevered Beta = levered beta / [1+ (1- tax rate)* comparable company's avg. debt/equity ratio]

Therefore to Un-lever the beta, we have take into account the average tax rate of the comparable companies and their average debt-equity ratio.

Levered Beta = Unlevered beta * [1+ (1- tax rate)*company debt/equity ratio]

To Lever the beta again we use the actual tax rate & debt equity Structure of the Unlisted Company whose beta we had to estimate.

Why to account for Small Company Risk & Company Specific Risk

Small Companies are generally more risky than big companies. CAPM model does not take into consideration the size risk and specific company risk (management quality, forex risk etc.) as Beta measures only systematic risk and Market Risk Premium. These risks should also be taken into account while computing the cost of equity. Therefore instead of CAPM, modified CAPM should preferably be used for calculating the Cost of Equity.

How is weighted average cost of capital calculated?

Weighted average cost of capital is the cost of capital of the firm i.e. the providers of finance of a firm including equity share holders, preference share holders & providers of long term debt.

Calculation of WACC

WACC is calculated using the Proportionate cost of Equity & Cost of Debt (after tax)

The formula for WACC is:-

$$\text{WACC} = \frac{MV_e}{MV_d + MV_e} \cdot R_e + \frac{MV_d}{MV_d + MV_e} \cdot R_d \cdot (1 - t)$$

MVe = Total market value of equity,
Re = cost of equity,
MVd = The Total market value of debt,
Rd = cost of debt,
T = tax rate

Issue 1:- Market Value or book value of equity

The important point to note in the calculation of WACC is it **requires the market value of equity**, rather than its book value. Taking the book value might result in heavy overestimation of the value derived through DCF since book value of equity might lead to a lower WACC and in turn a low discounting rate. Here Market value of equity can be estimated through Comparable Company Analysis

Issue 2:- Does change in Debt have any Impact on calculation of DCF to Firm?

A big misconception while computing Discounted Cash Flow to Firm is that it does not get affected due to change in debt in the projected years.

Yes, it is true that change in debt does not change the cash flow for a firm. But a change in capital structure due to increase or decrease in debt in projected years changes the WACC in the projected years. Therefore a major change in capital structure of a company in future projections must be taken into account by changing the WACC for the projected years.

What should be the terminal growth rate?

The terminal growth rate is long term average growth rate of a company which estimates the rate at which a company would perpetually grow when its business stabilizes. Since it is tough to estimate the perpetual growth rate of a company, it is preferred to take the perpetuity growth rate factoring in long term estimated GDP of the country, which assumes that the company would grow at pace with economy. The terminal growth rate should also factor in the type of industry as well as the number of years for which discount period has been considered.

Concluding thoughts

Discounted Cash Flow (DCF) method is one of the most important finance tools to derive value of a company based on the future cash flows of business. However it needs to be used with great care as it's a very sensitive model where the values get affected significantly with a small change in assumption like beta value, terminal growth rate, risk free rate of return and market return. It is strongly recommended to do sanity check with the market approach to valuation like CCM and asset approach i.e. net asset value before concluding the DCF value.

Enterprise Valuation

Enterprise Valuation (EV) is the total value of any business which represents all stakeholders and often looked at while acquiring/ selling any business or making any strategic decision and is dependent on the standalone value of the company, its subsidiaries and the Value of surplus assets. All the above issues are relevant for working out EV.

Enterprise Valuation : The market value of the whole business?

Enterprise valuation (EV) is an economic measure which reflects the market value of the whole business. It is a sum of claims of all the security-holders: common equity holders, debt holders, preference shareholders, minority shareholders etc. Enterprise valuation is one of the fundamental metrics used in business valuation, financial modeling, accounting, portfolio analysis, etc.

EV= market value of equity + market value of debt + minority interest at market value + preference capital at market value – cash & cash equivalent + market Value of non Operating Assets.

Enterprise valuation is the present value of the claims of all stake-holders against an enterprise where an enterprise is financed with debt and equity. If the company has no non-operating assets, firm value can be valued by estimating future free cash flows and discounting those cash flows with an appropriate rate of return (which may vary from year to year) that embodies the returns required by creditors and shareholders of the firm.

Since this is essentially the value of operations of the firm, if there is any non-operating assets, the value of such non-operating assets should be added separately to arrive at the firm value or enterprise value.

In short enterprise value is the value shared by all investors, unlike debt value or equity value, which are shared only by creditors or by equity-holders respectively.

Key issues and challenges while calculating EV

- Should only cash or excess cash be deducted?
  Should only cash be deducted or even cash and cash equivalents?
- Should debt be taken at market value?
- Treatment of debt if taken at year end or for setting up a new business?
- Treatment of loans & advances given to subsidiary company?

Issue 1 - Should only cash or excess cash be deducted?

The 1st question is - why cash is deducted? - Think of enterprise valuation as the theoretical takeover price. In the event of a buyout, an acquirer would have to take on the company's debt, but would pocket its cash which could be used to pay off debt or be treated as surplus funds for the acquirer.

What is excess cash & Why should it be deducted instead of total cash
excess cash is defined as 'total cash (in balance sheet) **–** operating cash (i.e. minimum required cash) This is because, operating cash is required to sustain operations (working capital) and manage contingencies. If total cash is used to pay down debt, the company will have nothing left for working capital requirements and contingencies!
Practical problem – It is very difficult to estimate excess cash in a company. 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.

Issue 2 - Should only cash be deducted or even cash equivalents?

Yes, cash equivalents should also be deducted since most companies invest their excess cash in short term money instruments or investments. Therefore it is important to deduct these small term investments considering they are not used for operation of the company.

What are cash equivalents? 'near cash' items that include investments that are actively traded, available for sale and held to maturity are called cash equivalents.

Issue 3 - Should debt be taken at market value or book value?

To arrive at fair valuation, all the values should be taken at the market value. Thus debt should also be taken at market value.

In the present economic conditions the depreciation in rupee has increased the fair value of principal repayment in terms of Rupees. Therefore it is important to take the market value of debts since its market value can be significantly higher from the book value in such cases.

Issue 4 - Treatment of debt taken at the yearend or for setting up a new business?

Practically debt which has not had an impact on the sales should not be included in the enterprise valuation since it has had no contribution in sales. Therefore debt taken near end of year should be added at a weighted rate & debt used for setting a new plant (which is not yet operational) should not be included at all.

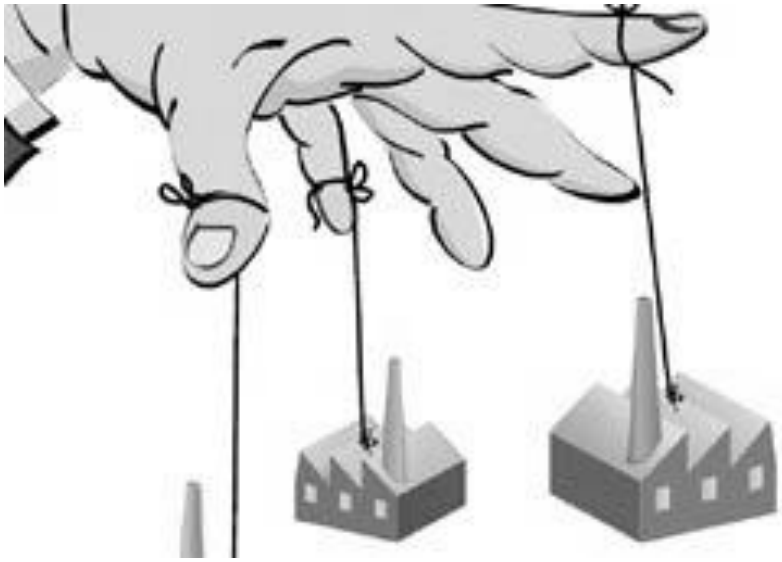
Practical difficulty: -Some portion of debt taken at the yearend may be a part of cash & cash equivalents or other non-operating assets which we subtract from the enterprise valuation

Issue 5 - Treatment of loan & advances given to other companies?

If you are valuing Company on standalone basis & applying Comparable companies Multiples Method, then in that case If the company has given loan and advances to other companies not forming part of its business, then you should add back the loan & advances given to them, because in that case loan & advances are not captured in the company's standalone business value, as it is a form of surplus asset.

Concluding thoughts

Enterprise Valuation (EV) is the total value of any business which represents all stakeholders and often looked at while acquiring/ selling any business or making any strategic decision and is dependent on the standalone value of the company, its subsidiaries and the Value of surplus assets. All the above issues are relevant for working out EV.



Valuation Discount Applicable to Holding Companies

It's been observed that valuers apply holding company discount in the range of 40 to 60% on the value of holding companies. But adjustments should be made to the discount depending on the dividends paid and received by the holding company and also expected future scenario of the company. The type of investments the holding company holds also has an impact on the discount that should be applicable for holding company in question. It may also be stated that reorganization of holding company may also result in reduction of this discount and thereby value creation.

Holding company

Where a company is holding a large chunk of investments in other companies and it's not having any material business operations of its own, is called a "holding company" A holding company typically does not have its own business operations other than the retention and management of assets in anticipation of future sale or trade or may be as a tool of corporate restructuring. The holding company thus derives its income primarily through the return on the assets held for investment purpose. To be particular, Income of holding co. is only the dividends received by it's from the investments made in other companies.

Valuation of holding companies

There are two ways to look at value of a holding company-

- **Value based on income**

As the income of a holding company (dividends) may be negligible when compared to the Value of its underlining Assets i.e. investments, it may not make sense to Value it based on Income alone.

- **Value based on assets**

The value of a holding company should be essentially based on the underlining assets it holds i.e. based on the value of its subsidiary / associate companies. Therefore a valuer should evaluate the company based on the value of its assets than on the value of its operating income.

Valuation discounts applicable to holding companies

When valuing holding companies valuer should consider three types of discounts as the value of a holding company does not follow the sum of parts rule, and generally it's seen that the value of a holding company is significantly less than the sum value of all its subsidiaries / associates. The value of holding company thus suffers from three types of discounts majorly.

- **Liquidation discount**

As such the value of holding company is based on the sum values of its subsidiaries. However liquidation discount is generally provided for built in or embedded capital gains even when no liquidation is planned, more so as far as the value if assets of the subsidiary have to pass to the holding company, it must pay taxes. Holding period, rate of tax etc determine this discount.

- **Discount for lack of control**

The holding company value also gets discounted on account of lack of control, for example a holding company holds 100% stake in a subsidiary and a holding company holds 15% stake in a company both have different values preposition i.e. the one in which 100% stake is held have a controlling value and the one in which 15% is held shall not command that much proportionate value. Often discount for lack of control on associates is applied. The less% of holding, the more the discount & vice versa.

- **Discount for lack of marketability**

Due to separate legal entity often more restrictions exist upon transfer of assets of subsidiary company by holding company which

leads to discount for lack of marketability in the hands of the holding company.

Under any investment, the buyer is concerned with the holding period, the risk exposure and the cash return. The longer the term to liquidity, greater the risk of sale and lower the dividend yield, the higher the marketability discount.

Empirical research for holding company discount

Under few of the research on holding company discount carried in Indian context it is observed that the holding company trades at a value significantly less than its net asset value, sometimes as high as 50%.

- **Can such discounts be mitigated?**

As discussed above, the value of a pure holding company with no operating assets of their own trade at a heavy discount to their NAV. But this discount can in certain cases be mitigated and in some cases trade at a premium depending upon:-

- **Future Expectation from the Company**

In cases where markets expect some M&A- consolidation of the holding company, in such cases the holding company is generally valued near to its NAV or its discounts set on the lower side if it holds controlling stake subsidiary companies. This is because due to the M&A reorganization, there may exist only single entity having direct control on all assets.

Also a holding company that is expected to sell its stake in other companies/ other investments also tend to trade at a lower discount since the value of the holding company's investments are realized and expectation of dividend by the shareholder increases.

- **Dividend paid by subsidiaries**

It is generally seen that holding companies which receive dividends from their subsidiaries trade at a lower discount as compared to other holding companies which do not receive a dividend.

This is because the only income of a pure holding company is dividends received from its subsidiaries. Also holding companies are expected to pay out dividends received from its subsidiaries to its own shareholders since dividend distribution tax is exempt for the holding company if it distributes dividend in the year it receives dividend from its subsidiary.

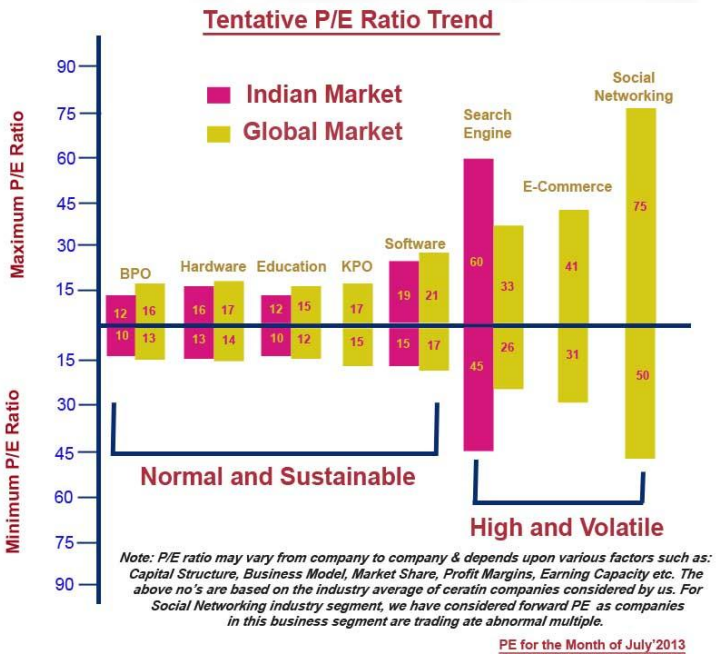
- **Type of investment made:-**

If a holding company's investments include holding a controlling stake in other companies then it generally trades at a lower discount than a company holding a non controlling stake in other companies. This is because of the level of control the holding company has on its subsidiary and also Sales of its subsidiary are reflected in the consolidated financial statements of the holding company.

Concluding thoughts

It's been observed that valuers apply holding company discount in the range of 40 to 60% on the value of holding companies. But adjustments should be made to the discount depending on the dividends paid and received by the holding company and also expected future scenario of the company. The type of investments the holding company holds also has an impact on the discount that should be applicable for holding company in question. It may also be stated that reorganization of holding company may also result in reduction of this discount and thereby value creation.

Valuation in Information Technology Sector



Recently Just Dial has been listed in Indian market at a PE of 55x under search engine category. It has got good response due to first entry in Indian market. It is also worth mentioning that it is trading at double the value of its peers in global markets like Google. However, it has been observed that the valuation trend in the high growth segment of IT industry (Search Engine, E-Commerce & Social Networking) is on an upswing and though there exist limited public listed companies in this segment, majorly all trade at very high valuation multiples with corresponding high volatility owing to their sensitive business models prone to competition with new technology and recent developments. Where would their valuations be stabilized would be decided in times to come.

Valuation in IT (Information Technology) sector

It has been believed in the market that "Technology has the shelf life of a banana." If that happens then what factors drives the value of information technology based companies whose survival is totally dependent on that. The answer of this question is not so easy as it appears to be, As whatever the size of organizations large or small face the same dilemma: scare resources, choosing and deploying the right resources at right time & at right place to maximize the organization performance.

Why sub sector categorization is necessary

There is a difference in valuing a company which invest in IT to increase the efficiency of its business and the Company whose survival is totally dependent on IT because Companies with a view to increase the efficiency might Invest in IT and often viewed as a cost center, and when a department is viewed solely as a cost center, budgets get squeezed year over year, but that would not be in the case of IT co's, as their view of investment might be different.

Therefore, to make the proper judgment on the parameters that derives the value of companies in IT sector. We have divided the IT sector into various sub- sectors.

Overview of IT sector

The IT sector can be broadly classified into following sub-sectors:

ITES (BPO) – Major corporations across the world outsource their back-office operations to some companies. E.g. employee payroll for a US company's global workforce is maintained by an Indian BPO. Slowly the definition is expanding to Human resources, accounting, logistics, legal processes etc.

IT- Hardware - The stuff you can actually see and touch is hardware. This would include laptops, desktops, storage devices, networking devices, LCD, printers etc.

IT- Education - This segment provides training for employment in the other segments. This would include companies providing various certification courses, like Java, Oracle etc. These companies also provide training for employees in corporate sector.

ITES (KPO) - It refers to the outsourcing of knowledge intensive tasks and functions to outside experts.

IT- Software – These companies help in developing and implementation of different software for their clients worldwide, which could be use for documentation, security services, banking software's etc.

IT - Search Engines - Search engines are the programs that search documents for specified keywords and return a list of the documents where the keywords were found.

IT – E-Commerce - Leverage the unique qualities of internet and web uses internet technology to create markets that bring buyers and sellers together.

IT- Social Networking - It is an online service, platform, or site that focuses on facilitating the building of social networks or social relations among people.

Key valuation drivers in IT sector

ITES - BPO

Factors need to be consider

1. **Service Level%:** *The % of calls answered with a certain amount of time.*
2. ***Average Handle Time:*** *(Total talk time + Wrap time)/ Total Calls.*
3. ***Longest Wait Time:*** *The time a caller has to wait before the call is answered.*
4. ***Book Order***

Preferable Valuation Multiples

1. EV/EBIDTA
2. PE Ratio
3. EV/No. of Seats
4. EV/FCF
5. EV/Sales

IT-Hardware

Factors need to be consider

1. % of Market Share covered.
2. Durability of a Product.
3. Customer Retention Ratio.
4. Govt. Regulations
5. After Sales Services.

Preferable Valuation Multiples

1. EV/EBIDTA
2. PE Ratio
3. Price/Book Value
4. EV/FCF
5. EV/Sales

IT-Education

Factors need to be consider

1. Level of Education.
2. Use of Innovative tool for Dissemination of Education.
3. No. of Students/No. of Users.

Preferable Valuation Multiples

1. EV/EBIDTA
2. PE Ratio
3. EV/FCF
4. EV/Sales

ITES - KPO

Factors need to be consider

1. Employee Attrition Rate.
2. Organization recruitment rate.
3. Service Level %.
4. Customer Retention Rate.

Preferable Valuation Multiples

1. EV/EBIDTA
2. PE Ratio
3. EV/Work Force
4. EV/FCF
5. EV/Sales

IT-Software

Factors need to be consider

1. Customer Satisfaction Level.
2. Future Growth %.
3. Customer Retention Ratio.
4. Market Recognition.
5. Employee Attrition Ratio.

Preferable Valuation Multiples

1. EV/EBIDTA
2. PE Ratio
3. EV/Work Force
4. EV/FCF
5. EV/Sales
6. PEG Ratio

IT-Search Engines

Factors need to be consider

1. Document inception.
2. Website Content.
3. Website linking to search engine.
4. Content updation Rate.

Preferable Valuation Multiples

1. EV/EBIDTA
2. PE Ratio
3. EV/No. of hits
4. EV/FCF
5. EV/Sales

IT-E-Commerce

Factors need to be consider

1. **Conversion Rate:** Rate at which viewers get converted into active customers.
2. Average Order Value.
3. Visitors Loyalty and Visitors Recency.
4. Depthness of Search.
5. Product Line.

Preferable Valuation Multiples

1. EV/EBIDTA
2. PE Ratio
3. EV/No. of Subscribers
4. EV/FCF
5. EV/Sales

IT-Social Networking

Factors need to be consider

1. Traffic: Number of users.
2. Profile of social networking site in Niche.
3. Unique features offered.
4. User Retention Rate.
5. Current earning & Potential earning.
6. Dependence upon Number of advertisement Co's. for business.

Preferable Valuation Multiples

1. EV/EBIDTA
2. PE Ratio
3. EV/No. of users
4. EV/FCF
5. EV/Sales

Key valuation parameters used in IT sector

Valuation Parameters	Rationale
Valuation Multiples	
Price to Book value	As IT Software companies do not have significant fixed assets. Therefore, Price to Book value ratio will not provide the clear picture for IT software sector. However this may not be in case of IT hardware company as it involves huge investment in plant and machinery.
Price to Earning	This ratio can be used to evaluate the share price of IT sector co's.
Price to sales	Generally, this ratio is not accepted due to the high gestation period involves in the IT sector projects. As the project which may not be profitable now may generate revenue after some period of time.
EV/Sales	This ratio is commonly used in the valuation of companies whose operating costs exceed revenues, even for startups valuer can also rely on this ratio.
Price/Earnings to Growth Ratio	As the software industry has largely dependent on future potential, therefore this ratio can be use as rule of thumb for valuation purpose.
EV/EBITDA	If the company has cash-generating power, then EV/EBITDA can be used as valuation tool. But this tool does not take into account whether that EBITDA has been financed from equity or debt source.
EV/Free Cash Flows	Companies which have strong cash flows, for them EV/FCF can depict the clear picture.
Rule of Thumb	
EV/ No. of seats	This ratio can be used as validation ratio for Co's involved in BPO sector as for them human intellectual factor is not that much important in comparison for other IT sector co's. But concern is required to be put on the area upon which the respective BPO is operating, as we cannot say that the value of two BPO's are same on the basis of No. of seats ignoring the fact that one BPO is operating at small area in comparison to other.
EV/No. of subscribers	This parameter is most widely used in valuing the Co's in E-commerce sector.
EV/No. of Users	This parameter work as rule of thumb mainly for valuing social networking sites.
EV/No. of Hits	More the number of visitors, more the number of page views helps in gauge the traffic and popularity trends of search engines.
EV/Work Force	As the main assets in IT sector co's are their employees or technical staffs which can be evaluated by considering the hiring cost and training cost that co's bear for their employees. But this methodology does not consider intangibles values associated with specific employees such as personal reputation, relationship and know-how.

RBI Valuation

RBI has prescribed DFCF as the only valuation method in case of FDI for unlisted companies but has not provided any guidance on its technical aspects. Since valuation is essentially a forward looking exercise, it is generally believed that DFCF is one of the most acceptable valuation method used by business valuers worldwide; however DFCF for all FDI transactions (like minority stake/start up valuation etc) may not yield fair value in line with the commercial understanding. However law being such, suitable logical adjustments may be necessary on a case to case basis. The price to be computed using the DFCF method would normally be much higher than that computed under the erstwhile CCI guidelines which followed a fixed formulae approach. Therefore it is needed to be used with great care as it's a very sensitive model where the values get affected significantly with a small change in assumption like beta value, terminal growth rate, risk free rate of return and market return. As such, the valuation approaches / methods being applied must take into account the standard of value and premise of value and also suitable adjustments to make valuation discounts and premium based on the facts of each case.

RBI guidelines for valuation of equity shares

For Foreign Direct Investment (FDI) transactions, notification no. FEMA 20/2000-RB dated May 3, 2000, as amended from time to time deals with Foreign Exchange Management (transfer or issue of security by a person resident outside India) Regulations, 2000.

In terms of schedule 1 of the notification, an Indian company may issue equity shares/compulsorily convertible preference shares and compulsorily convertible debentures (equity instruments) to a person resident outside India under the FDI policy, subject to inter alia, compliance with the pricing guidelines. The price/ conversion formula of convertible capital instruments is also require to be determined upfront at the time of issue of the instruments.

In order to make the valuation of shares in line with global business valuation practices and maximize forex earnings for Indian residents, Reserve Bank of India (RBI) had recently introduced revised valuation guidelines in case of allotment or transfer of equity shares / compulsory convertible instruments by Indian resident to nonresident and vice versa.

Now for all unlisted companies having Foreign Direct Investment (FDI), RBI has prescribed mandatory valuation of shares strictly through Discounted Free Cash Flow (DFCF) method only, a prominent method based on income approach of valuation which is entirely based on the "future cash earning capacity" of any business and thus often lead to optimum value scenario (from exchange control perspective). Before DFCF method was prescribed, the basis of valuation for RBI transactions was Controller of Capital Issues (CCI) guidelines which determined a conservative valuation by considering the average of Net Asset Value ('NAV') the company's Profit Earning Capacity Value ('PECV'), which was arrived at based on its past financial performance.

This valuation article is covering different situations envisaged under RBI Law for both FDI as well as Overseas Direct Investment (ODI) transactions and some valuation methodologies are also suggested based on our practical experience and global valuation principles.

FDI valuation guidelines

In case Indian resident is unlisted company

Under the revised guidelines, the approach taken in the CCI guidelines are abandoned, and the applicable allotment / transfer price for FDI in unlisted shares is required to be not less than the price determined based upon the DFCF method as determined by a SEBI registered category - I merchant banker or a chartered accountant.

In case Indian resident is listed company

Under the revised pricing guidelines, allotment / transfer of listed company shares in India by Indian Resident to non-resident shall not be made at less than the price at which the preferential allotment of shares can be made under the SEBI (ICDR) Regulations 2009, which provides that If the equity shares of the issuer have been listed on a recognized stock exchange, then the equity shares shall be allotted at a price not less than the higher of the following:

"Average weekly high and low closing price over a trailing six month period, or a trailing two week period, from the "relevant date of transaction."

In case of transfer of shares from non - resident to Indian resident, the same DFCF price would govern to be the maximum price for transaction.

ODI valuation guidelines

Mandatory valuation by merchant banker where the investment is being made outside India for more than USD 5 million, valuation of the shares of the foreign company shall be made by a category I merchant banker registered with SEBI or an investment banker / merchant banker outside India registered with the appropriate regulatory authority in the host country.

In case investment is by way of swap of shares where foreign company is involved irrespective of the amount, valuation of the shares will have to be made by a category I merchant banker registered with SEBI or an investment banker outside India registered with the appropriate regulatory authority in the host country.

In all other cases, valuation of shares can be made by a chartered accountant or a certified public accountant.

it is clarified herein that no method for valuation of shares has been prescribed by RBI in case of ODI valuation. From a exchange control perspective the price of shares issued by foreign entity shall not be more than the price determined by SEBI registered category- I merchant banker / CA as the case may be.

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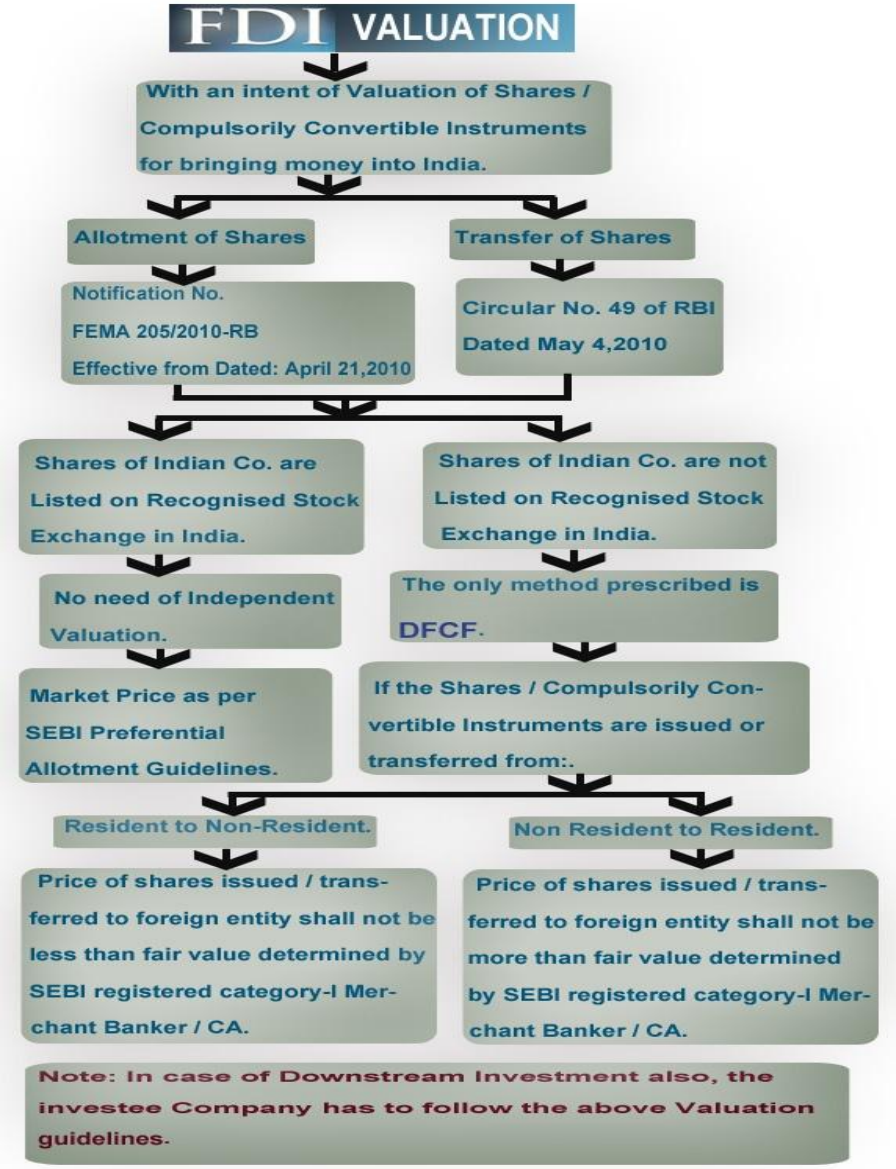
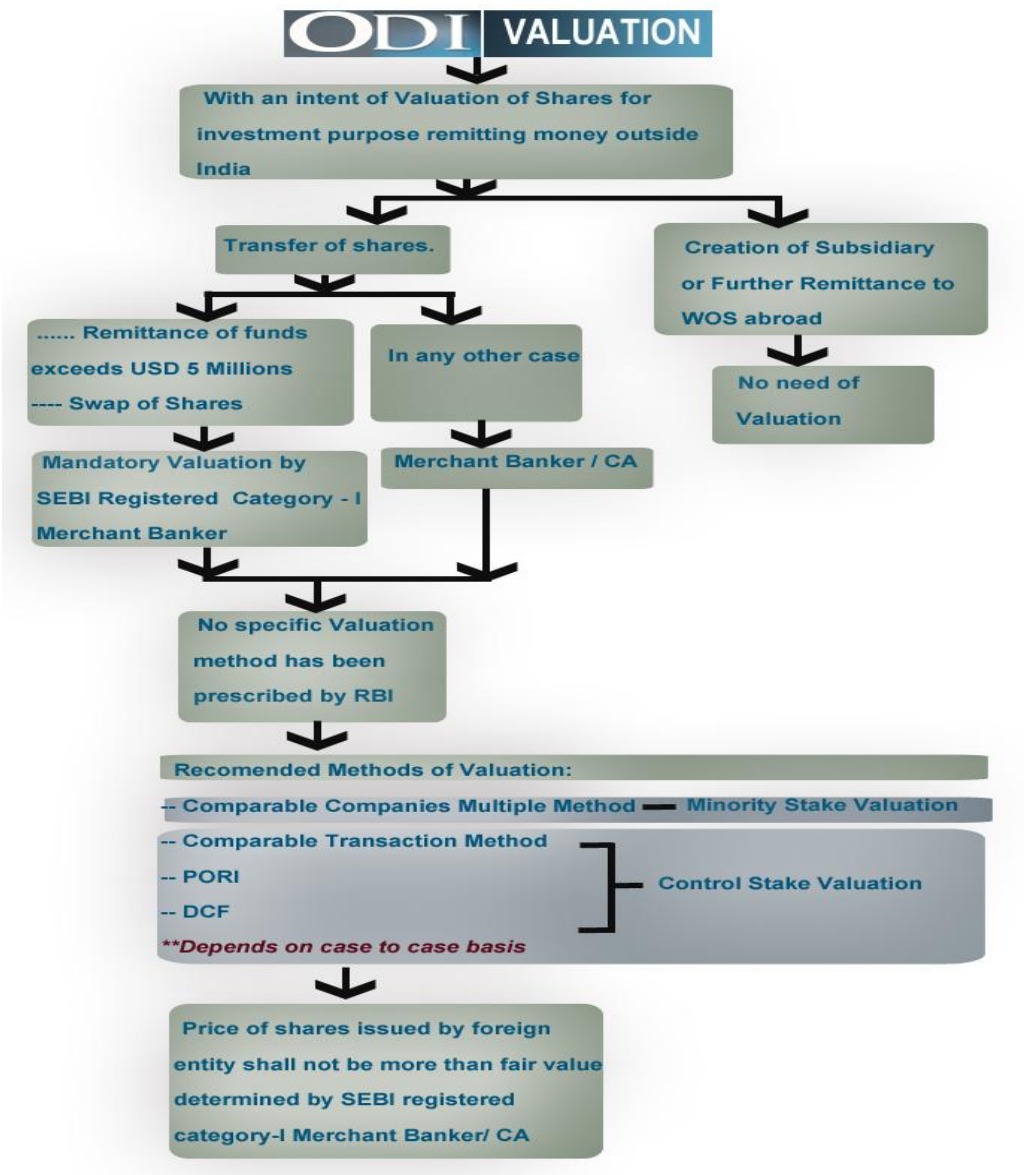
Face to Face comparison of CCI guidelines and RBI guidelines

Particulars	Valuation before April 21, 2010	Valuation after April 21, 2010
Guidelines in force	**CCI** guidelines	**<u>In case of FDI transactions:</u>** • **Listed company: Market value as per SEBI preferential allotment guidelines** • **Unlisted company: DFCF** **<u>In case of ODI transactions:</u>** **No method has been prescribed**
Methods prescribed	• **Net Assets Value** (NAV) • **Profit Earning Capacity Value**(PECV) • **Market value** (in case of Listed Company)	
Discount	**15%** Discount has been prescribed on account of **lack of marketability**	**No such discount has been prescribed**
Historical / Futuristic	It is based on **historical values**	It is based on **future projections**
Possibility of variation in value conclusion	**As valuation is more formulae based, final values came standardized**	**As valuation is more dependent on assumptions and choice of factors like growth rate, cost of capital etc, value conclusion may vary significantly.**

Glimpse of RBI guidelines for FDI and ODI valuation and our suggested approach





Regulatory Valuations

The key role of the valuer is to remove the bias and subjectivity in the valuation process and find the fair value of the business based on science, logic, empirical studies, case law and last but not the least the professional experience of the valuer on an objective basis. As such, the valuation approaches / methods being applied must take into account the standard of value and premise of value and also suitable adjustments to make Valuation discounts and premium based on the facts of each case. The ongoing concept of "registered valuer" is also expected to bring clarity on the methods of Valuation and would lead Valuation practice as a discipline in India.

Introduction

It has rightly been said that “What has never been doubted, has never been proven”. Valuation is a specialized field which has evolved in response to developments in law, taxation, finance, accounting, and economics and has graved impact on financial health of the valued company. Connected to this aspect, there has been increasing interest seen in valuation by all stakeholders.

Navigation to valuation approaches

The rapid globalization of the world economy has created both opportunities and challenges for organizations leads to uncertainty blowing across global markets which raise the importance of independent valuations all over the world. There is no simple recipe to determine the economic worth of the company, However Globally there are only three broad approaches to valuation:

- **Asset approach**: The asset based approach views the business as a set of assets and liabilities that are used as building blocks to construct the picture of business value. Since every operating business has assets and liabilities, a natural way to address this question is to determine the value of these assets and liabilities. The difference is the business value. However, it is used to evaluate the entry barrier that exists in a business and is considered viable for companies having reached the mature or declining growth cycle and also for property and investment companies having strong asset base.

- **Income approach:** The Income based approach of valuations are based on the premise that the current value of any business is a function of the future value that an investor can expect to receive from purchasing all or part of the business. It is generally used for valuing businesses that are expected to continue operating for the foreseeable future.

- **Market Approach:** In this approach, value is determined by comparing the subject, company or assets with its peers in the same industry of the same size and region. Most Valuations in stock markets are market based. This is also known as relative valuation approach

Valuation – Indian perspective

At present there are not much prescribed standards and codes on valuation in India and in many cases the valuation lacks the uniformity and generally accepted global valuation practices. A number of business valuation models can be constructed that utilize various methods under the broad business valuation approaches.

In determining approaches and methods to use, the valuation professional must exercise discretion. Each technique has advantages and drawbacks, which must be considered when applying those techniques to a particular business. Most treatises and court decisions encourage the valuer to consider more than one method, which must be reconciled with each other to arrive at a Value conclusion. Understanding of the internal resources and intellectual capital of the business being valued is as important as the economic, industrial and social environment

Regulatory valuations

To keep pace with ever evolving economic and business environment, various regulatory bodies in India (RBI, Income Tax, SEBI, etc) have prescribed different and in some cases even conflicting valuation methodologies creating practical difficulties. In some cases, absolute discretion is given to valuers on one hand and in other cases strict adherence to practical method like NAV, DFCF, Market price etc is sought. However, in most cases, there is not much guidance on how to apply a particular method like DFCF; comparable companies market multiples method. A diagrammatic view for all regulatory valuations in India is provided on next page:

Comprehensive comparison of regulatory valuations in India

	Transactions	Prescribed Methodologies	Mandate to be done by
Reserve Bank of India	Inbound Investment	DFCF	CA / MB
	Outbound Investment	Valuer Discretion	>5Mn$ - MB, otherwise CA/MB
Income Tax	Gift of Unquoted Equity Shares (Min)	NAV	-
	Gift of Unquoted Equity Shares from Resident (Max)	DCF (Valuation Based on Assets, Business & Intangibles is also acceptable)	FCA / MB
	Gift of Unquoted Shares other than Equity Shares	Price it would fetch if sold in open market	MB
	ESOP Tax	Valuer Discretion	MB
SEBI	ESOP Accounting	Option – Pricing Model	-
	Takeover Code/ Delisting - Infrequently Traded	Only Parameters Prescribed – Return on Net Worth, EPS, NAV vis-a vis Industry Average	CA/MB
	Takeover Code/ Delisting - Frequently Traded	Based on Market Price	-
Stock Exchanges	Preferential Allotment to promoters / their relatives for consideration other than cash	Valuer Discretion	CA / MB
Companies Act	Sweat Equity	Valuer Discretion	-

Corporate Professionals
WHERE EXCELLENCE IS LAW

About Corporate Professionals

Offering varied legal & financial services, 'Corporate Professionals' has emerged as an innovative leader in delivering corporate advisory & solutions. Aiming to become a one-stop-shop offering integrated legal and financial solutions, the Group has successfully completed a high number of corporate transactions in the last couple of years. We have successfully engaged in and executed over 3000 assignments of more than 1200 corporate houses, domestic as well as international, across several Industries.

The Group has distinctively positioned itself as Merchant Banker (SEBI Cat-I license) with Boutique Investment Banking & Transaction Advisory services and as Legal Advisors with high quality comprehensive Corporate Laws, Tax & Regulatory services. With an endeavor to satisfy our clients' stated as well as unstated needs, we adopt the most feasible and legally viable approach to execute assignments in a seamless, cost effective and time bound manner. High Integrity and Confidentiality in dealing with clients and assignments undertaken is deeply inculcated in our team.

The Group prestigiously owns a strong skill set that comes from its research oriented, multi-disciplinary, young and dynamic team. With right blend of legal and financial skills, continuous focus on research and effective use of Information Technology, Corporate Professionals is creating customized products, for different class of clients. Innovative flair of executing assignments with problem solving zeal and use of Technology has enabled us to offer path breaking solutions. Not just for executing Clients' Assignments but also in internal management, the Group adheres to a system driven approach.

The Group dedicates around 30% working time of its professional team on continuous research in the dynamic legal and financial fields, with an object of creating a knowledge hub, extensive knowledge dissemination and to develop skills of its team to deliver high quality services.

“Corporate Professionals” refers to one or more of group companies and its network of firms and other entities, each of which is a separate legal, independent entity. For more details, please visit www.corporateprofessionals.com.

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Corporate Professionals
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AS CLOSE AS YOU NEED

AS FAR AS YOU GO.....

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Our Associates

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Overseas

Bulgaria, Belgium, British Virgin Islands, Canada, China, Costa Rica, Cyprus, European Union, Germany, Hongkong, Ireland, Japan, Kenya, Malaysia, Mauritius, Singapore, Sri Lanka, Switzerland, The Netherlands, Turkey, United Arab Emirates, United Kingdom, United States.