NEERAJ BHAGAT & CO.
Chartered Accountants

Valuation of Business

- Different Perspectives and Methodologies

2016 Edition

Knowing what business is worth and what determines its value is prerequisite for intelligent decision making. Corporate valuations form the basis of corporate finance activity including capital raising, M&A and also to meet regulatory / accounting requirements or for voluntary purpose. The rapid globalization of the world economy has created both opportunities and challenges for organizations leading to uncertainty blowing across global markets and raising the importance of independent valuations all over the world. Justifying the value of businesses has grown more complex and challenging as valuation as its been accepted that valuation is not an exact science and depends upon a number of factors like purpose, stage of business, past financials, industry scenario, management and promoters strengths etc.

Valuation is more an art based on professional experience of the valuer rather than a science based on empirical studies and logics.

Business Valuation is the process of determining the "Economic Worth" of a company based on its Business Model under certain assumptions and limiting condition and subject to data available on the valuation date.

It is an important concept in corporate finance and business management. Supposing a business is for sale, how does one know what is the real value that business is worth? More basically, how does a business owner know the net value of his business, or how is valuing a business for sale accomplished?

Income Tax Act, 1961

The Finance Act, 2010 introduced **Section 56(2)(viia)** of Income tax Act, 1961 to extend the coverage of these provisions to closely held companies. As per this section receipt of shares by such company by another closely held company or firm for inadequate consideration; or for nil consideration will be taxable in the hands of the recipient of shares as 'income from other sources' where the FMV or the difference between the FMV and the consideration (as the case may be) of such share exceeds INR 50,000. An exemption is provided for share transfers pursuant to business re-organization such as amalgamation or demerger.

This section effectively ensured that private companies can no longer use gift of shares of an Indian company as a mechanism for corporate restructuring.

The Finance Act, 2012 introduced **Section 56(2)(viib)**, which provides that where a closely held company receives from a resident person any consideration for the issue of shares that exceeds the FMV of such shares, the same shall be chargeable to tax in the hands of the share-issuing company as 'income from other sources'. An exemption is currently provided for shares issued to venture capital companies / funds.

The FMV of the shares have to be determined based on Rules 11U and 11UA of the Income Tax Rules, 1962 with Rule 11U prescribing the various definitions (such as balance sheet, valuation date, etc.) Rule 11UA prescribing the method for computation of FMV. Rule 11UA provides flexibility to use either of the following methods for computation of FMV:

a) Book value of the shares as on the issue date/ latest audited balance sheet date, subject to adjustments as provided in the applicable Rule; or

b) Valuation as undertaken by a Merchant Banker or Fellow Chartered Accountant of Institute of Chartered Accountant of India ('ICAI') as per the Discounted Free Cash Flow method.

It is also pertinent to note that in July 2014, the Reserve Bank of India has done away with the prescription of DCF methodology for valuation under FEMA, providing freedom and flexibility to investors for determining the FMV as per any internationally accepted valuation methodology.

FEMA Regulations

These Regulations deal with Foreign Direct Investment (FDI) into India and the transfer of shares from or to a person resident outside India. These Regulations provide for numerous valuation requirements in case of transfer of shares between resident and non-resident, fresh issue of shares to non-resident investor, share swap, conversion of preference shares/ debentures.

It requires a certificate from a Chartered Accountant on the value of such securities according to the guidelines issued by Securities & Exchange Board of India or as per any internationally accepted pricing methodology on arm's length basis for listed companies and unlisted companies, respectively.

Areas where valuation is used

Areas	Description
Mergers & Acquisitions	Valuation is an important aspect in M& A. It not only assists business owners in determining the value of their business, but also help them maximize value when considering a sale, merger, acquisition, joint venture, or strategic partnership.
Succession Planning	Succession to family members: In planning for the transfer of family business to the next generation. Succession to employees: for many closely held businesses, the sale of the business to one or more key employees is often a viable succession strategy. Succession to outside parties: It comprises of mergers, acquisitions, purchase and sale of businesses.
Going Public	In general, when a new company goes for an Initial Public Offering (IPO), it is doing that in order to generate capital for growing its business. In such a circumstance, a question arises as to how to evaluate the fair value of such a stock. The Indian Capital Market follows a free pricing regime and thus the accurate pricing of an IPO is of immense importance.
Dispute Resolution	Valuations are an increasingly important aspect of many commercial disputes. Before deciding how to manage a dispute, it is necessary to determine the likelihood of a successful outcome and the potential stake involved. Judicial precedents are also available that affect the selection of Valuation methodologies and applicability of discounts/ premiums.
Voluntary Assessment	At times, the management wants to know the true value and fair value of the business for which they undertake the exercise of voluntary assessment for internal management purpose and future decision making.

Valuation Perspectives

Entrepreneur's Perspective:

How much is my company worth?
What are the unique, tangible and intangible assets (value components) we have to offer?

Investor's Perspective:

How much should I pay for this investment opportunity?
Can I earn an appropriate return on investment (ROI) to justify the risk being taken?

The art of valuation lies in identifying the key value drivers and the key risk areas after analyzing the following:

- Nature of Business, its history, future prospects, and growth potential
- Promoter and management background
- Core Team strength
- Profitability strategies
- Competitive landscape and differentiation
- Economic outlook and industry trend
- Purpose of valuation and size of transaction

Generally acceptable methodologies of valuation

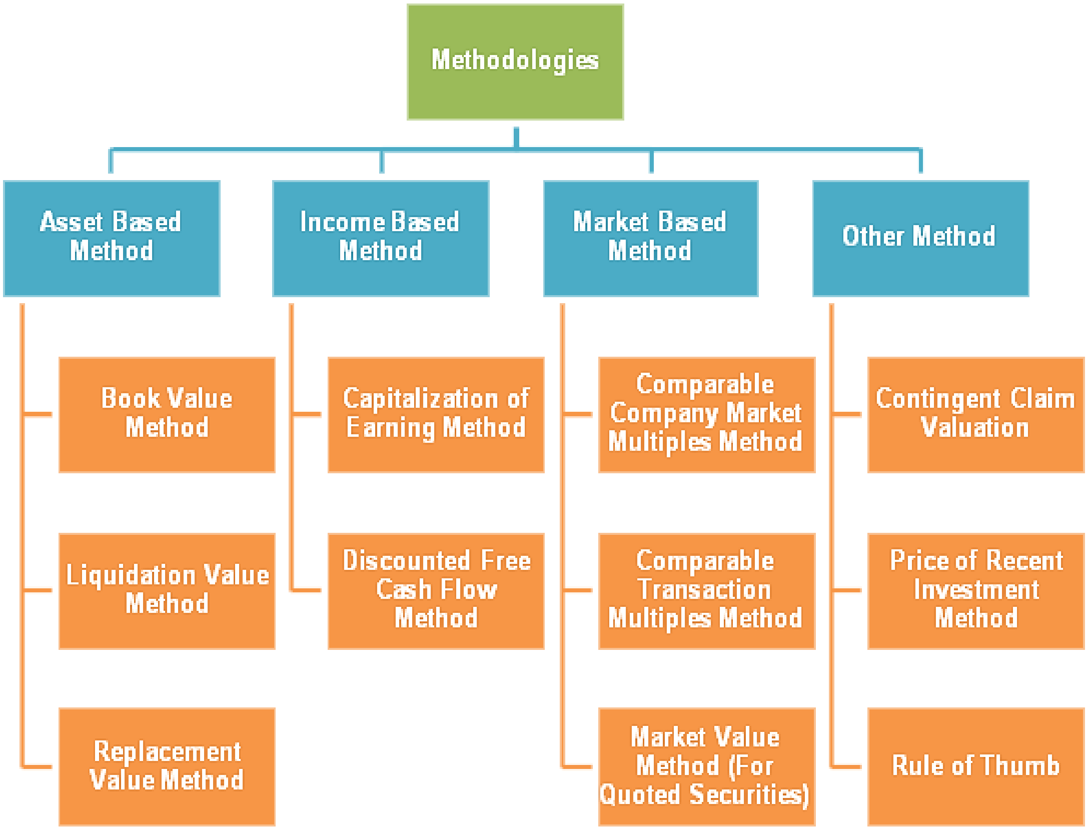
A number of business valuation models can be constructed that utilize various methods under the broad business valuation approaches. Most treatises and court decisions encourage the valuer to consider more than one method, which must be reconciled with each other to arrive at a value conclusion. Understanding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

The choice of the appropriate valuation approach (or approaches) to be used in a given valuation project is based on the judgment of the valuer. The valuer's choice of methods is determined by the characteristics of the business to be valued, the purpose and use of the valuation and its report, the pattern of historical performance and earnings of the subject company, the company's competitive market position, experience and quality of management, the availability of reliable information requisite to the various valuation methods, the marketability of equity ownership interest to be valued, and others. These factors are summarized below:

- History and nature of the business
- Industry and general economic outlook
- Book value and financial condition
- Earning capacity
- Dividend-paying capacity
- Prior sales and size of the block of stock; and
- Comparisons to similar publicly traded guideline companies.

There are broadly three approaches of valuation:

- Asset Approach
- Income Approach
- Market Approach


Methodologies
Asset Based Method
Income Based Method
Market Based Method
Other Method
Book Value Method
Liquidation Value Method
Replacement Value Method
Capitalization of Earning Method
Discounted Free Cash Flow Method
Comparable Company Market Multiples Method
Comparable Transaction Multiples Method
Market Value Method (For Quoted Securities)
Contingent Claim Valuation
Price of Recent Investment Method
Rule of Thumb

Asset Approach

In this cost based approach, the primary emphasis is placed upon the fair market value of the assets and liabilities of a business. As a result, this approach uses various methods that consider the value of individual assets and liabilities including intangible assets. The most well-known method in this approach relies upon reported balance sheet assets and liabilities generally termed as book value. It should be recognized, however as per book value concept assets are reported in accordance with various accounting conventions that may or may not accurately reflect fair market value.

Thus, 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.

There are three methods to this valuation approach:

- ***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.

The Net Asset Value (NAV) Method presumes that the subject company's value will be realized by the hypothetical sale of its assets as part of a going concern. The NAV method should generally be considered if the subject company holds significant tangible assets.

This method was used by Wealth Tax Authorities, and one of the methods adopted by Controller of Capital Issues (CCI) as recommended in the "Guidelines for valuation of equity shares of companies and business (Valuation Guidelines). RBI has advised that for the valuation of unlisted companies the "Valuation Guidelines" issued by the erstwhile CCI be used.

The Income based method of valuations is 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. In other words, the value of the business must be related to the profits it will earn and the cash it will generate in the future.

o ***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. This method is more appropriate when future returns are expected to be substantially different from current operations.

This method usually has two stages, the first stage involves a discreet forecast of future earnings or cash flow to be discounted to the present using a discount rate and the second stage involves the construction and discounting of a terminal value. The terminal value is determined when the entity's future return stream is expected to achieve stable long-term growth.

o ***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. This method is more appropriate when it appears that a company's current operations are indicative of its future operations, assuming of course, a normal growth rate. Under this method a stable level of earnings is divided by a capitalization rate in order to arrive at an operating value for the entity. Where net earnings are being capitalized, the capitalization rate is the net earnings discount rate less the average sustainable growth rate.

Market approach

Market Approach refers to the notion of arriving at the value of a company by comparing it to the market value of similar publicly listed companies. The comparison is based on certain financial ratios or multiples, such as the price to book value, price to earnings, EV/EBITDA, etc., of the equity in question to those of its peers. This type of approach, which is popular as a strategic tool in the financial industry, is mainly statistical, based on historical data, and current market sentiments. This is also known as relative valuation method.

o ***Comparable companies multiples method*** - Market multiples of comparable listed companies are computed and applied to the company being valued to arrive at a multiple based valuation.

o ***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.

o ***Market value method*** - 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.

Valuation: Indian considerations

Valuation is more of an art based on the professional experience of the valuer rather than a science based on empirical studies and logics. 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 complex financial markets, emerging global economy, and changing framework of accounting and financial reporting.

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 developed and recommended Business Valuation Practice Standards (BVPS) aiming to establish uniform principles, practices and procedures for valuers performing valuation services in India.

Who We Are:

We are a team of distinguished chartered accountant, corporate financial advisors and tax consultants in India. Our firm of chartered accountants represents a coalition of specialized skills that is geared to offer sound financial solutions and advices. The organization is a congregation of professionally qualified and experienced persons who are committed to add value and optimize the benefits accruing to clients.

Our Focus:

To provide high quality services to our clients and believe in upholding high standards of honesty and integrity in what we do.

We advise & also hand-hold foreign companies set-up operations in India & cater to their compliance requirements right from inception to regular day-to-day operations.

Our Services:

Accounting / Book-keeping

Book-keeping, Preparation and Compilation of financial statements, Accounting reconciliations and Consolidations, Accounting system implementation, Development of Accounting policies and Procedures Manual, Forecasting and Projections, Financial analysis of reports, Cash flow management.

Audit / Assurance

Audit, Review of financial statements, Internal control reviews, Reporting requirements, Drafting of Management

Regulatory

Advice on Regulatory matters, Assistance in obtaining Clarifications and Approvals from Reserve Bank of India (RBI) and other Statutory Authorities, Company Law Compliance, Compliance with Exchange Control Regulations and Import-Export Code norms.

Taxation

Corporate, Individual & International Taxation, Direct & Indirect tax compliance, Return Filing, Tax Advisory, Tax Audit, Dispute Resolution, Transfer Pricing,

secretarial records, Filing of necessary forms.

Transaction advisory

Business structuring, Valuations, Corporate Finance, Due diligence, Tax planning.

Compliances

Income tax, Service tax, VAT/ CST, Excise/ Customs, RBI and ROC compliances in respect of all types of regulatory filing of documents and their follow up.

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