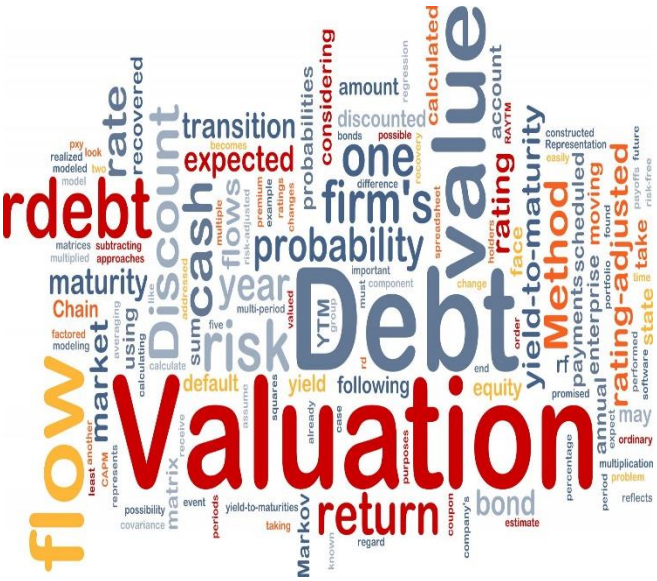
VALUATION METHODOLIGIES FOR FINANCIAL ASSETS

Introduction



Companies Act 2013 has introduced the whole new concept of the registered valuer under a separate chapter covering all kinds of valuation requirements. Ministry of corporate affairs vide notifications dated 18th of October 2017 has notified section 247 of the Companies Act, 2013and Companies (Registered Valuers and Valuation Rules, 2017). As per section 247 of the Act and above-mentioned Rules, it has been stated that where a valuation is required to be made in respect of any property, stocks, Shares, debentures, securities or goodwill or any other assets or net worth of a company or its liabilities under the provisions of this act, it must be valued by a registered valuer.

The rationale behind introducing this is to set certain valuation standards and regulate the practice which will bring transparency and better governance during a valuation exercise.

VALUATION APPROACHES

As per the notified rules, the registered valuer shall, while conducting a valuation, comply with the valuation standards as notified or modified under Rule 18 of the Companies (Registered Valuers and Valuation Rules, 2017 by the Central Government on the recommendations of the committee to advice on valuation matters which is yet to be constituted.

Whereas until the valuation standards are notified or modified by the Central Government, a valuer shall make valuations as per-

(a) internationally accepted valuation standards;

(b) valuation standards adopted by any registered valuers organisation.

The registered valuer may obtain inputs for his valuation report or get a separate valuation for an asset class conducted from another registered valuer, in which case he shall fully disclose the details of the inputs and the particulars etc. of the other registered valuer in his report and the liabilities against the resultant valuation, irrespective of the nature of inputs or valuation by the other registered valuer, shall remain of the first mentioned registered valuer.

A valuer should keep the following considerations in mind while carrying out valuation assignments: -

• Nature of the business and the history of the enterprise from its inception

• Economic outlook in general and outlook of the specific industry in particular

• Book value of the stock and the financial condition of the business

• Earning capacity of the company

• Dividend paying capacity of the company

• Goodwill or other intangible value

• Sales of the stock and the size of the block of stock to be valued

• Market prices of stock of corporations engaged in the same or a similar line of business

• Contingent liabilities or substantial legal issues, within India or abroad, impacting the business

• Nature of instrument proposed to be issued, and nature of transaction contemplated by the parties

A registered valuer shall decide the approach to valuation based upon the purpose of the valuation in accordance with applicable standards, if any and can choose from Asset, Income and Market Approach. A valuer can use one or more of the following prescribed methods or any other method accepted or notified by the Reserve Bank of India, Securities and Exchange Board of India or Income Tax Authorities or the method he may deem fit to adopt; which should be justified in the report:

- **Net Asset Value Method**

  An asset-based approach is a type of business valuation that focuses on a company's net asset value (NAV), or the fair-market value of its total assets minus its total liabilities, to determine what it would cost to recreate the business. There is some room for interpretation in the asset approach in terms of deciding which of the company's assets

and liabilities to include in the valuation, and how to measure the worth of each. The asset-based approach is best used when a business is nonoperating or has been generating losses, and the company's focus is on holding investments or real estate. The adjusted net asset method is commonly used for estimating the value of the business. The difference between the fair market value of the company's total assets and the fair market value of its total liabilities determines the fair market value of the business. The asset-based approach begins by creating a financial picture of the company through information on the balance sheet. Current asset values may differ dramatically from the assets' acquisition costs. Although the balance sheet lists assets and liabilities at historical cost, accurately using this method depends on recasting those costs and capturing the current value. Assets are reviewed and the fair market value of each is obtained.In contrast, liabilities are typically already stated at fair market value. In most cases, no additional calculations are needed. The fair market values of the assets are added up and the total liabilities are subtracted fromthat to arrive at the value of the business.

- **Market Price Method**

  A market approach is a method of determining the appraisal value of an asset, based on the selling price of similar items. The market approach is a business valuation method that can be used to calculate the value of property or as part of the valuation process for a closely held business. Additionally, the market approach can be used to determine the value of a business ownership interest, security, or intangible asset. Regardless of which asset is being valued, the market approach studies recent sales of similar assets, making adjustments for differences in size, quantity or quality.

- **Profit Earning Capacity Value (PECV)**

  This method is used while valuing a going concern business with a good profitability history. It involves determining the future maintainable earning level of the entity from its normal operations. It is essential for the valuer to understand the business of the entity and take into account the normal business profits after adjusting the non-recurring/extraordinary items of income and expense. E.g. a one-time Voluntary Retirement Scheme (VRS) expense borne by the entity or an award won in monetary terms. It is important to remove non-recurring expenses and income as the valuer is calculating the future maintainable profits of the entity with normal operations. The valuer must give optimal weights to each financial year considering the profit trend and cyclical nature of business. This maintainable profit, considered on a post tax basis, is then capitalised at a rate, which in the opinion of the valuer, combines an adequate expectation of reward from enterprise and risk, to arrive at the business value. While arriving at such factor, valuer may also consider the market data available for comparable companies, which reflects the fair expectation of the price by the market for the given earnings of those companies. The selection of the Capitalisation Rate, inverse of the Price Earning ('PE') Multiple, is a judgment of the valuer taking into account strengths and weaknesses of the company as well as market situations prevailing at the time of valuation. It would be essential for the valuer to know the PE

Multiple of other companies in the same business and market advantages of the company subject to valuation to give it a fair multiple. Value of assets viz. Investments, Surplus Assets, etc. which do not contribute to the operating profits of the business, after considering the impact of notional tax, if any needs to be added to the earnings capitalisation value.

- **Discounted Cash Flow Method (DCF)**

  In today's scenario, it is essential for valuers to not only take into consideration the past profits of the company, but also look at its future profitability. With the increase of the knowledge sector, where the asset base of the company is much smaller than its future profitability, this method has become very popular. The DCF method values the business by discounting its free cash flows for the explicit forecast period and the perpetuity value thereafter. The free cash flows to firm (FCFF) represent the cash available for distribution to both the owners and the lendors of the business. The perpetuity value of the entity is calculated to fully capture the growth capacity of the entity to infinity, after the explicit period. It is important for the valuer to take into consideration the past growth rate of the concern as well as the future projections for the explicit period, while determining the perpetuity growth rate. The free cash flows and perpetuity are discounted by a Weighted Average Cost of Capital (WACC). WACC is an appropriate rate of discount to calculate the present value of the cash flows as it considers equity-business risk and the debt-equity ratio of the company. The Cost of Equity is worked out by taking into consideration the risk-free rate of return and adjusting the same for the equity risk premium and the Beta factor. The risk-free rate of return is taken based on the current return on Government Treasury Bills. Beta is the sensitivity of a particular stock vis-a-vis Market or Index. Equity Risk Premium is the expectation of the investor over and above the risk-free return. On the other hand, net of tax long-term cost of debt is taken after considering the existing cost for the debt raised by the entity. The Debt-Equity ratio is applied and a WACC can be calculated in a manner shown by the formula below:

$$WACC = \frac{(\text{Cost of Equity} \times \text{Equity Weight}) + (\text{After Tax Cost of Debt} \times \text{Debt weight})}{(\text{Debt weight} + \text{Equity weight})}$$

  After discounting the future cash flows and the perpetuity value, the present value calculated is a fair indicator of the value of the business.

- **Comparable Transaction Multiples Methodology (CTM)**

The Comparable Transaction Method is a relative valuation method, wherein the details of recent transactions of similar business/ companies are considered to estimate the business/ company value. This method is seldom used in practice since, there may not be enough transactions of similar business/ company or the details of relevant transactions may not be available in the public domain. It is more used as a cross check. Adequate care is to be exercised by the valuer when carrying out valuation since, the comparable transaction value may include control premium or liquidity discount which needs to be adjusted.

- **EV/EBIDTA Multiple Method**

  This method is also called the "price-to-EBIDTA multiple" or "Comparable Companies Multiple Method". The EBITDA multiple is the ratio of the value of capital employed (enterprise value) to EBITDA. This method is similar to Earnings Capitalisation Method, only difference being EBITDA of the company needs to be capitalised to arrive at the Enterprise Value. While considering the EV/EBITDA Multiple of comparable companies, the valuer needs to keep in mind that EBITDA multiple does not capture the differences in depreciation methods and also the debt funding that one company may have taken vis-a-vis another. EV/EBIDTA multiple is calculated as:

$$\text{EV/ EBITDA Multiple} = \frac{\text{Enterprise Value}}{\text{EBITDA}}$$

Enterprise Value = Market Value of Equity + Market Value of Debt - Cash

CONCLUSION

The Registered Valuer may consider some of the above methods or may be some additional methods to arrive at a fair value of the business.