Overview of Business Valuations

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Last few years have not been encouraging for the global economy due to crisis and slow recovery in several large and developed countries. India experienced slowdown in reforms, rising interest rates, depreciating rupee and slow GDP growth. The Indian economy has also been affected due to slowdown in US and economic crisis in Euro Zone. All these have severely impacted India. There is decline in the outbound deal activities by Indian Companies. Inbound investments also declined due to, decline in Country's GDP growth, Regulatory changes and high expectations in valuations.

But as is rightly said, there is always a demand for the right product at right price. The valuation of companies play a critical role in the market.

<u>Valuation Concept:</u>

When business or shares are transferred from one entity to another, it becomes very important for both buyer as well as seller wants to know what is the worth of that particular asset which is being transferred.

The process which is undertaken to know the worth is commonly known as "Valuation". It is popularly said that "Price" is what you pay and "Value" is what you get. "Value" refers to the worth of an asset, whereas "Price" is the result of a negotiation process between a willing but not an overeager buyer and a willing but not an overeager seller. In simple terms, *valuation is a process of determining value of a company or an asset*. Valuation is an art and not an exact science. Depending on the structure of the transaction, there may be a need to value Shares of the Company or a particular business or an intangible asset. 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.

<u>Why Valuation is done?</u>

Valuation is called for in various situations, some of them are listed below:

a) **<u>Purchase/ Sale of business / Shares:</u>** Valuation plays an important role in case of takeover/acquisition of business/shares of a company. A valuer needs to apply appropriate valuation methodologies depending upon the nature of business being transferred and the industry to which it belongs.
b) **<u>Merger:</u>** In case of merger, one needs to determine the share exchange/ swap ratio i.e. number of shares of Transferee Company to be allotted to the shareholders of Transferor Company. The attempt is to arrive at the relative value of the shares of the transferor and transferee company.
c) **<u>Demerger:</u>** It involves transfer of undertaking from one entity to other. The resulting company issues shares to the shareholders of the demerged company, which is based on the share entitlement ratio to be recommended by the valuer.
d) **<u>Regulatory requirements:</u>** Recently there has been many regulatory changes governing valuations under FEMA as well as Income-tax Act like transfer of shares of an Indian company between residents and non- resident, valuation needs to be done using DCF method.
e) **<u>Impairment testing</u>**: As per AS-13 "Accounting for Investments", long-term investments are usually carried at cost. However, when there is a permanent diminution in the value of such

investment, the carrying amount needs to be reduced to recognise the diminution. To ascertain this diminution, valuation of such investment needs to be carried out.

Thus, the purpose of valuation and the structure of transaction needs to be understood before commencement of the valuation exercise.

Valuation techniques:

The valuation exercise of same asset attempted by two valuers could be different as the valuation is influenced by valuer's judgment on various parameters. Valuer may use different valuation methodologies for valuing the shares of a company/ business. Following are the generally accepted methodologies:

1. Net Assets Method
2. Discounted Cash Flow Method
3. Earnings Capitalisation Method
4. Comparable Companies Multiple Method
5. Market Price Method

1. Net Asset Method: This method is used when valuation under this method is expected to be higher compared to other valuation methods. Net Asset Value is the book value of the assets of a business less its liabilities. This method arrives at valuation in terms of stated net worth of the company using depreciated replacement cost of fixed assets or net realisable value. Valuation may be higher in case of companies making low profits or losses or when business is about to be closed down and cannot be considered as going concern.

But there are certain limitations of this method that it does not take intangibles into account, ignores future growth potential of the business and is impacted by accounting policies.

2. Discounted Cash Flow Method: DCF method proceeds on the assumption that "Cash is King". 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 represents the cash available for distribution to both the owners and the creditors of the business.

***Approaches to DCF*:** There are two broad approaches for valuation under DCF approach:

- ***FCFE*:** Under this approach, the value for equity holders is obtained by discounting expected cash flows available for the equity holders. Cash flows to equity holders is arrived by reducing from gross operational cash flows, tax payments, amount required for incremental working capital, capital expenditure, interest payment, principal repayment for loans, etc. The net cash flows so arrived are discounted by the cost of equity.
- ***FCFF:*** Under this approach the value of firm is obtained and from this value amount of loan as on the valuation date is reduced to arrive at the value of equity shareholders. Cash flows to firm are arrived by reducing from gross operational cash flows, tax payments, amount required for incremental working capital, capital expenditure, non-cash expenditure (depreciation), etc. The free cash flows is discounted by Weighted Average Cost of Capital.

Under the DCF approach it is very important to consider the reasonable projections which the enterprise can achieve. Each activity of the company needs to be identified and revenue assumptions need to be made for each stream of income. An appropriate growth rate has to be applied to this considering the past trend of the enterprise, present and expected capacity utilisation of the enterprise, expected trend in the industry, etc. Various cost and expenditures need to be bifurcated into variable cost and fixed cost. The variable cost should be related to the revenue assumptions / activity of the company whereas fixed costs will be mainly time cost.

WACC*:* The Weighted Average Cost of Capital is the weighted average of the costs of the different components of financing used by an enterprise. Arithmetically, WACC is calculated as follows:

$$\text{WACC} = \frac{[(\text{Cost of Equity*Weight}) + (\text{Cost of Debt*Weight}) + (\text{Cost of Preference Shares*Weight})]}{[\text{Weight of Equity} + \text{Weight of Debt} + \text{Weight of Preference Shares}]}$$

Where,

Cost of Equity: Risk Free Return + [Beta*Equity Risk Premium]

Cost of Debt: is the long term cost of debt of an enterprise where interest on debt is a tax-deductible item.

Cost of Preference Shares: is the dividend rate of the preference shares along with the applicable dividend distribution tax.

To arrive at the weights of the different components of financing used by the enterprise, one has to consider the sustainable financing pattern of the enterprise and also of the industry in which it operates.

Terminal Value

To arrive at the value for equity holders under firm approach of valuation following adjustments needs to be made:

Value for equity holders = Present Value of Cash Flows for explicit period + Present value of Terminal Value – Opening balance of loan as on valuation date + Opening Surplus cash not considered for working capital requirement + Realisable value of surplus assets, etc.

Where,

Present value of terminal value= Gross terminal value*Discount factor for last year of explicit period.

$$\text{Gross Terminal Value} = \frac{\text{Net cash flow for terminal value}}{(\text{WACC- Growth Rate for Terminal Value})}$$

DCF method is gaining importance in the recent past and is a universal method. It takes into account cash requirement for working capital and capital expenditure, financial gearing of the enterprise, etc. which are not given much importance under the traditional methods of valuations like PECV, EV/ EBITDA, Net Assets, etc. But the valuer has to keep in mind the fact that the projections provided by the management will generally be growth oriented. Thus it is important to understand the risk involved in achievement of particular projections and accordingly discount rate and growth rate for perpetuity needs to be chosen.

3. Earnings Capitalisation Method: determines the business value using a single measure of the expected business economic benefit as the numerator. This is divided by the *capitalization rate* that represents the risk associated with receiving this benefit in the future. In using this valuation method, care must be given to the proper selection of the economic benefit being capitalized and the appropriate capitalization rate. The earnings figure reflects the true nature of the business based on the expected normalized profits, excluding the impact any extraordinary items not expected to accrue in future.

This methodology is appropriate where a company or business has demonstrated a stable record of earnings that is expected to continue indefinitely. It is the most frequently applied methodology in valuing industrial companies.

4. **Comparable Companies Multiple Method:** this method uses multiples derived from valuations of listed comparable companies operating in similar space (known as comparable companies' quoted multiples) or valuations based on transactions / M&A deals involving comparable companies (known as transaction multiples). After the selection of comparable companies, a comparison of the valuation subject with comparable companies is carried out on various financial parameters (sales/ profit growth, profit margins, return on capital employed) and industry specific factors (e.g. growth in subscribers for telecom companies).
It helps in objective value assessment based on publicly available benchmarks. The difficulty here is in the selection of a comparable company, since it is rare to find two or more companies with the same product portfolio, size, capital structure, business strategy, profitability and accounting policies.

5. **Market Price Method:** If the valuation subject's equity shares are traded on the stock exchanges, the valuation of the company based on the market price provides a very objective benchmark.

Value of business= Market capitalisation of the Company (No. of shares outstanding multiplied by the market price) + Gross debt- Cash and cash equivalents

The valuer needs to analyse the following factors:

a) Whether the shares are frequently traded.
b) Reasons for sudden changes in the market price of the equity shares company.

Market price method reflects value of equity shares based on transactions between investors holding minority equity stakes in the company.

Thus, Valuation Analysis as ephemeral it may sound at times is both science as well as an art. Though quantitative in nature, the valuation methods require inputs that require quite a lot of subjective judgement and hence the quality of the information / data provided and an analysis and review of the same is of prime importance for arriving at a valuation conclusion.

The valuer's role of review constitutes the following pieces:

- Evaluation of data provided through discussion and analysis.
- Broad review of management estimates in terms of public domain information.
- Discussions on the data provided with management.

Hence, review / analysis is very necessary and a pre-requisite for any valuation analysis.

Role of professionals: Management of companies always sought help of professionals like Chartered Accountants or Investment Bankers to value intrinsic worth of business / shares using various techniques of valuation. Some of the important aspects that needs to be taken care of are listed below:

- Understanding the nature of transaction.
- Proper understanding of the business and the industry scenario.
- Back up of data used for valuation
- Representation letter on various information received from the management.
- Filing of working papers.
- Format of valuation report giving details on data considered, information received, methods used, factors considered for valuation, the final recommendation and also the scope limitations.

Conclusion

The Indian courts have acknowledged that valuation is a technical and challenging discipline. The judiciary is conscious of the fact that the word value means different things to different people and the result will not be the same. Valuation involves high degree of professional judgement, knowledge of business, analysis of facts, interpretation, developing financial models, methods and procedures, which may result into different conclusions in each given situation. Therefore, the objective of every valuer should be "to build confidence and trust in valuation process by creating a framework for delivery of credible valuation opinions by suitably trained valuation professionals acting in an ethical manner".

The Institute of Chartered Accountants has made it mandatory for all valuers in India to abide by the Business Valuation Practise Standard that was brought into effect on 1st April, 2010. Further, the valuer should maintain an impartial attitude and should never develop or report biased analyses, opinions and conclusions.