

# **Valuation of Shares / Business – An Overview**

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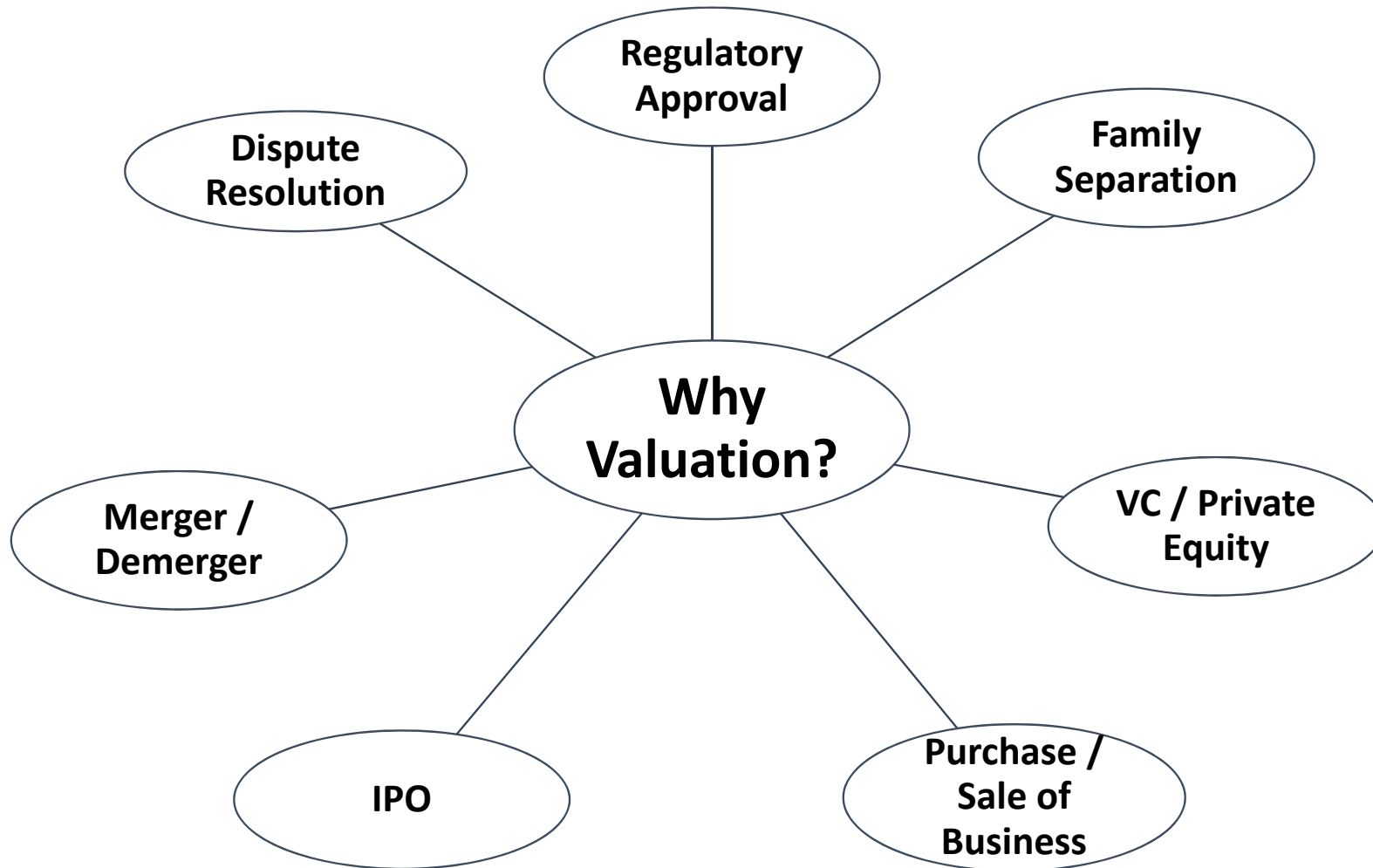
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# Why Valuation?



# **Key Factors Influencing Valuation**

# Key Factors Influencing Valuation

- Cash Flows / Earnings
- Operating Assets
- Non-Operating Assets
- Nature of the business
- Capital Structure
- Growth Prospects
- Competition
- Government Policy
- Political Stability

# Sources of Information

# Sources of Information

- Historical Financials – Income Statement, Balance Sheet and Cash Flow Statement)
- Annual report of the company
- Discussion with Management and Industry Overview
- Future projections
- Stock market quotations
- Representation by the management
- Data on comparable companies
- Market surveys, news paper reports, industry report of consulting houses



# **Valuation for Regulatory Purposes**

# RBI Requirement

	Transactions	Method Prescribed	By Whom?
<b>Reserve Bank of India</b>	Inbound Investment (Equity Shares, CCPS, CCD)	Fair valuation as per any internationally accepted pricing methodology on arm's length basis	SEBI registered Category I Merchant Banker / Chartered Accountant
	Outbound Investment	No method prescribed	Investment > \$5 million - Merchant Banker; Other cases - Chartered Accountant / CPA

- RBI vide RBI/201415/129 A. P. (DIR Series) Circular No. 4 dated 15<sup>th</sup> July, 2014 has replaced DCF methodology with internationally accepted pricing methodology.

# Requirement under the Income Tax Act

Particulars	56 (2) (Vii)	56 (2) (Viia)	56 (2) (Viib)
Allotment of Shares	Yes	Yes	Yes
Transfer of Shares	Yes	Yes	No
Recipient	Individual / HUF	Firm / Closely Held Company	Person Resident Outside India
Issuer	Any Person	Any Person	Closely Held Company
Basis Of Valuation	NAV Method based on Audited Balance Sheet by Chartered Accountant		DCF / NAV Method based on Audited Balance Sheet by FCA or Merchant Banker
Exemption	No	Not applicable to any property received by way of transaction not regared as transfer u/s 47 (via) / (vic) /(vicb) / (vid)	Venture Capital Company, Venture Caital Fund, Ventur Capital Undertaking

# Requirement under the Companies Act, 2013

The rules on Registered Valuers have not yet become effective, following cases require report of registered valuer:

- Sec. 62 – Further Issue of Shares\*
- Sec. 192 (2) – Assets involved in Arrangement of Non-Cash transactions involving directors
- Sec. 230 (2) (c) (v) - Shares, Property and Assets of the company under a scheme of CDR
- Sec. 230 (3) and 232 (2) (d) – Share swap ratio under a scheme of compromise / arrangement

# Requirement under the Companies Act, 2013

- Sec. 236 (2) – Equity Shares held by Minority Shareholders
- Sec. 260 (2) (c) – Preparing valuation report in respect of shares and assets to arrive at reserve price or lease rent or share exchange ratio for the company administrator
- Sec. 281 (1) (a) – Valuing assets for submission of report by company liquidator

# Registered Valuer under the Companies Act, 2013

- Sec. 247 – Registered Valuer (Not yet operative)
- As per Draft Rules, a CA / CS / CWA with 5 years post qualification experience, SEBI registered merchant bankers can be registered as valuers.
- The valuer appointed under sub-section (1) shall,—
  - (a) make an **impartial, true and fair valuation** of any assets which may be required to be valued;
  - (b) exercise **due diligence** while performing the functions as valuer;
  - (c) make the valuation in accordance with such rules as may be prescribed; and
  - (d) **not undertake valuation** of any assets in which he has a **direct or indirect interest** or becomes so interested at any time during or after the valuation of assets

# Registered Valuer under the Companies Act, 2013

- If a valuer contravenes the provisions of this section or the rules, he shall be punishable with fine from **Rs. 25,000 to Rs. 1 lakh**.
- However, if the intention to defraud the company or its members, he shall be punishable with imprisonment for a term which may extend to one year and with fine from **Rs. 1 lakh to Rs. 5 lakh**.
- Also, the valuer will have to
  - **refund the remuneration** received by him to the company; and
  - **pay for damages** to the company or to any other person for loss arising out of incorrect or misleading statements of particulars made in his report.



**“Price is what you pay, Value is what you get”  
– Warren Buffet**

# **Approaches and Methods of Valuation**



Methods of Valuation	Valuation Approaches		
	Asset Based Approach	Market Based Approach	Income Based Approach
	Net Assets Method	Comparable Companies Multiples Method	Discounted Cash Flow (DCF)
	Net Replacement Value	Comparable Transactions Multiples Method	
Net Realizable Value			

- Normally, Income Approach is preferred
- Asset Approach is preferred in case of liquidation
- Market Approach is preferred in case of listed entity and to evaluate the value of unlisted company by comparing it with its listed peers

# Net Assets Method - Formula

Total Assets (excluding Misc. Expenditure and Debit Balance in P&L Account)

Less: Total Liabilities

**Net Asset value**

OR

Share Capital

Add: Reserves

Less: Miscellaneous Expenditure

Less: Debit Balance in P&L Account

**Net Asset Value**

# Net Assets Method - Issue

- Book value may not reflect the true value of assets
- Earnings potential ignored
- Profit generating intangible assets could be understated
- Value of human resource not captured

# Net Replacement Value

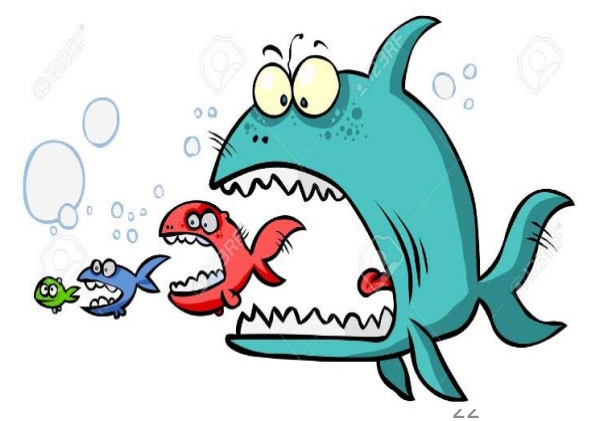
- Current cost of similar asset (-) Depreciation
- The approach tries to determine what it would cost to set up the business if it were being started now.
- Estimating the replacement cost of a variety of assets of different ages can be difficult.

# Net Realizable Value

- Net realisable values of the assets (-) liabilities.
- This amount represents what should be left for shareholders if the assets were sold off and the liabilities settled.
- If the business being sold is successful, then shareholders would expect to receive more than the net realisable value of the net assets because successful businesses are more than the sum of their net tangible assets: they have intangible assets such as goodwill, knowhow, brands and customer lists, none of which is likely to be reflected in the net realisable value.
- Suitable for valuing a company being liquidated



# Market Based Approach



# Comparable Companies Multiples Method

Step1: Identifying the listed peer companies

Step 2: Determining the multiples to measure

Step 3: Collecting the data

Step 4: Spreading the comps.

## Identifying Listed Peer Companies

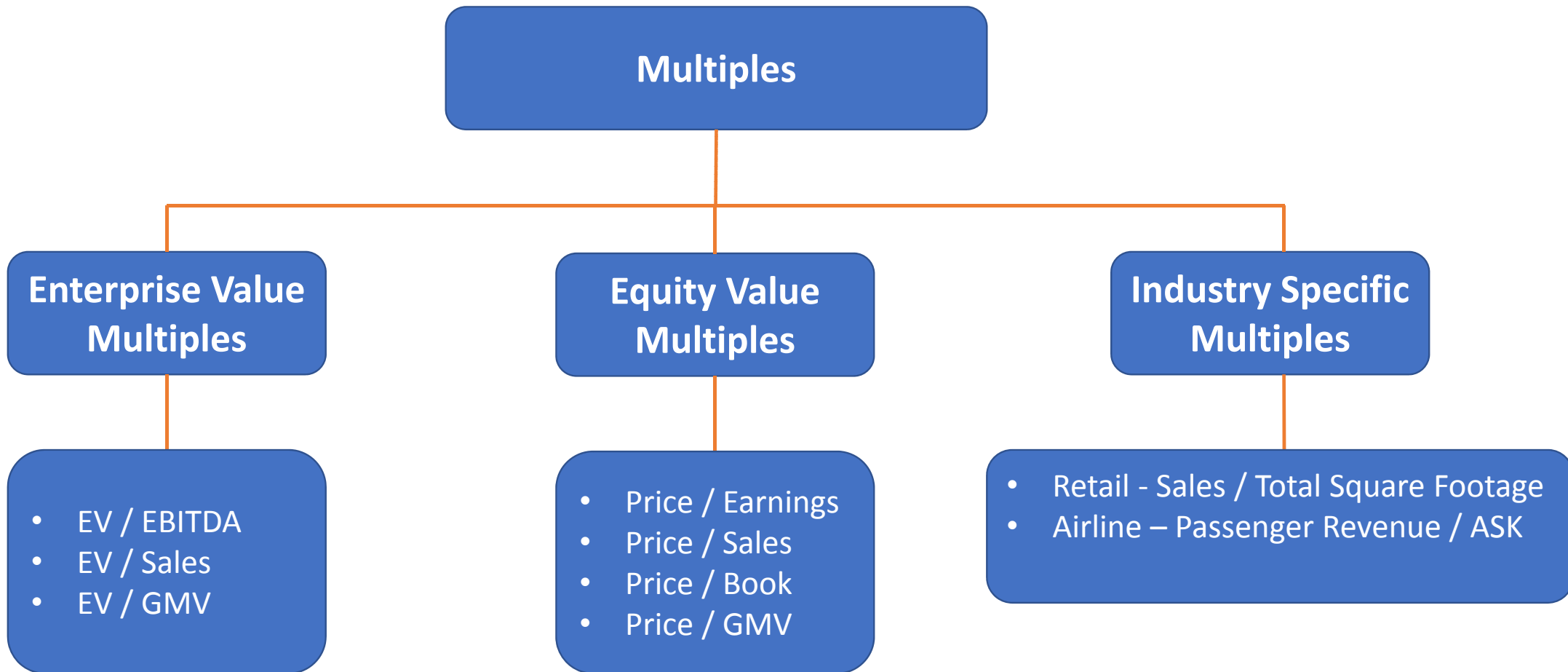
### Qualitative Factors

- Business Model
- Products / Services
- Customers
- Suppliers
- Geography

### Quantitative Factors

- Size
- Performance
- Growth





# Collecting the data

Historical

Current

Forward Looking

- Use multiples computed with latest available data
- Sources of data:
  - Capitaline, Prowess, Bloomberg, Screener, Moneycontrol.com, BSE, NSE websites
  - Annual, Quarterly reports, Investor Presentations of listed Companies
  - Transcripts of analyst conference calls
  - Research reports of large consulting houses

# Spreading the Comps.

- Enterprise Value = Equity + Debt – Cash and Cash Equivalents
- Illustration: Valuing an apparel retail company with expected turnover of Rs. 252 cr and EBITDA of around Rs. 39 cr in FY2020.

# Comparable Transactions Multiples Method

- Select transactions with companies in similar sector  
(similar product / service mix)
- Commonly used multiples (Examples):
  - Cement Industry – EV / Tonne; EV/EBITDA
  - Power Industry – EV / MW
  - Banking – Price/Book Value

# Comparable Transactions Multiples Method

<b>Acquisition / Announcement Date</b>	<b>Acquirer</b>	<b>Target</b>	<b>EV/Tonne (Rs.)</b>
Feb 2016	Ultratech	Jaypee Cement	7,700
Sep 2014	Sagar Cement	BMM Cements	5,655
Mar 2014	Dalmia Cement	Bokaro Cement	5,472

# **Income Based Approach**

# Discounted Cash Flow Method – Overview

- Discounted cash flow analysis is based on the theory that the value of a business is the sum of its expected future free cash flows, discounted at an appropriate rate
- DCF Method is one of the most fundamental and commonly used valuation methods
- DCF analysis is a forward looking valuation approach, based on key projections and assumptions
- Depending on availability of data and practical requirements, it can be simple or elaborate

# DCF Method– Parameters

- **Cash Flows:**
  - Projections
  - Explicit Period
  - Growth Rate
- **Discounting**
  - Cost of Equity
  - Cost of Debt
  - Weighted Average Cost of Capital



# DCF Projections

- **Factors to be considered for reviewing projections:**
  - Industry/Company Analysis
  - Dependence on single customer/ supplier
  - Installed capacity
  - Existing policy/ legal framework
  - Capital expenditure – increasing capacities
  - Working capital requirements
  - Quality of earnings / cashflow

# DCF Method– Approaches

- **Free Cash Flows to Firm:**
  - Cash flows attributable to the long term capital providers
  - Includes Long Term Debt and Preference Share Capital (PSC) as ‘Sources of Capital’
  - LT Debt and PSC servicing cost NOT considered as cost/ outflow
  - LT Debt and PSC considered for WACC computation
  - DCF Value for equity shareholders computed by reducing LT Debt and PSC
  - Part repayment of long term capital does not impact cash flows

# DCF Method– Approaches

- **Free Cash Flows to Equity Shareholders:**
  - Cash flows attributable to Equity Shareholders alone considered
  - Long Term Debt and PSC NOT considered as ‘Sources of Capital’
  - LT Debt and PSC servicing cost considered as cost/ outflow –affects yearly cash flows
  - LT Debt and PSC NOT considered for WACC computation
  - DCF Value for equity shareholders is aggregate of cash flows (PV)

# Ascertainment of Cash Flows

- Similar to Indirect Method under AS-3:
  - **Profit Before Tax**
    - Add: Depreciation
    - Add: Interest on Long Term Debt
    - Add: Increase in Short Term Debt
  - **Total Inflows**
  - **Less: Outflows**
    - Incremental Working Capital
    - Short Term Debt Repayment
    - Capital Expenditure
    - Tax Provision
  - **Net Cash Inflows**
- Non-cash and non-operating items suitably adjusted/ eliminated
- Net Cash Flows are to be discounted on the basis of an appropriate discount rate

# Computation of WACC

- Cost of Equity (Ke) using Capital Asset Pricing Model (CAPM)
- **CAPM:**
  - Return on equity =  $R_f + \beta (R_m - R_f)$
- **Rf = Risk free rate of return**
  - Return on government securities with long-term time horizon generally considered
  - RBI 10 year G-Sec yield can be considered
- **Rm = Market rate of return**
  - Returns delivered by markets over long period for equity investments
  - Returns of BSE Sensex, Nifty, over 15 to 20 years can be considered
- **Risk Premium (Rm-Rf)**
  - Signifies extra return expected by investors for investing in risky investments
  - Risk premium is always positive

# Computation of WACC

- $WACC = \text{Cost of Equity (Ke)} + \text{Cost of Debt (Kd)} \cdot (1-t) + \text{Cost of Preference Shares (Kp)}$
- **Liquidity Premium:** Added to WACC to provide for limited liquidity on unlisted shares
- **Control Premium:** Reduced from WACC

# Beta ( $\beta$ )

- **Beta** is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole.
- Beta =  $\frac{\text{Covariance of the Asset with Market Portfolio}}{\text{Variance of Market Portfolio}}$
- **Beta for Unlisted Companies:**
  - Identify comparable listed companies
  - Obtain beta of comparable listed companies
  - Average Beta, considered as Beta for valuation purpose

# Beta ( $\beta$ ) - Interpretation

Value of Beta	Interpretation
Beta < 0	Inverse relation to the market - possible but unlikely
Beta = 0	Regardless of which way the market moves, the value remains unchanged. Eg: Cash and Government Securities
Beta between 0 and 1	Companies have volatility lower than the market Eg: Pharma Stocks
Beta = 1	Stock or portfolio tracks the market closely Eg: Index funds
Beta > 1	Denotes a volatility that is greater than the market Eg: Real estate stocks



# Terminal Value

- Terminal Value refers to value of the company at the end of the explicit period
- Terminal Value is discounted applying explicit period's last year's discount rate
- ***Terminal Value =  $\frac{\text{Terminal Cash flow}}{WACC-g}$***
- Where, WACC = Weighted Average Cost of Capital  
g = Growth Rate for perpetuity
- Growth rate for Terminal Value – 2% to 4%
- Justification of higher growth rate challenging – Converges with long term GDP growth rate

# Value per Share

## Enterprise Value including Long Term Debt

Sum of:

- NPV of Explicit Period
- Present Value of Perpetuity

## Add/(Less): Adjustments

- Add: Current cash balance
  - Add: Fair Value of Surplus Assets including Land, etc –net of tax
  - Add: Fair Value of Investments and Deposits
  - Less: Contingent Liabilities
  - Less: Share application money
  - Less: Long Term Debt and Preference Shares (current value)
- 
- **Total Value attributable to the Current Equity Shareholders**
  
  - **Value per Equity Share**

# DCF - Illustration

		(Rs. In Mn)					
Particulars		2013-14	2014-15	2015-16	2016-17	2017-18	Perpetuity
<b>Operating PBT</b>		<b>170</b>	<b>187</b>	<b>205</b>	<b>226</b>	<b>248</b>	
<b>Add: Inflows</b>							
Interest		69	70	72	73	75	
Depreciation		81	85	90	94	99	
<b>Total Inflows</b>		<b>320</b>	<b>342</b>	<b>367</b>	<b>393</b>	<b>422</b>	
<b>Less: Outflows</b>							
Capital Expenditure		25	25	50	25	25	
Incremental Working Capital		39	49	61	54	62	
Tax		77	83	90	97	105	
<b>Total Outflows</b>		<b>141</b>	<b>157</b>	<b>201</b>	<b>176</b>	<b>192</b>	
<b>Free Cash Flows (FCF)</b>		<b>179</b>	<b>185</b>	<b>166</b>	<b>217</b>	<b>230</b>	
<b>Free Cash Flow for 2016-17</b>							<b>230</b>
<b>Growth Rate</b>							<b>3%</b>
<b>Capitalised Value for Perpetuity</b>							<b>2,257</b>
Discounting Factor	13.50%	0.88	0.78	0.68	0.60	0.53	0.53
<b>Net Present Value of Cash Flows</b>		<b>158</b>	<b>144</b>	<b>113</b>	<b>131</b>	<b>122</b>	<b>1,198</b>
<b>Enterprise Value</b>							<b>1,866</b>
Less: Loan Funds							(350)
Less: Contingent Liabilities							(50)
Less: Preference Share Capital							(800)
Add: Surplus Funds							120
Add: Value of Investments							1,000
<b>Adjusted Value for Equity Shareholders</b>							<b>1,786</b>
<b>No. of Equity Shares</b>							<b>7,969,000</b>
<b>Value per share (FV Rs. 10)</b>							<b>224</b>

# Weighted Average Method

(In Rs.)

Method	Value per Share (In Rs.)	Weight	Product (In Rs.)
Net Assets Method	107	1	107
EV/ EBIDTA Method	226	1	226
DCF Method	224	1	224
Market Price Method	196	2	392
<b>Total</b>		<b>5</b>	<b>949</b>
<b>Fair Value per share (in Rs.)</b>			<b>190</b>

# Sanity Check

- Value of unlisted companies should closely correspond to related companies
- DCF value should not be too divergent from multiples based values

## **Adjustments for Increase in Value:**

- Reduction of Liquidity Premium
- Increase in Growth Rate for Terminal Value
- Modification of projections – Increase in profitability
- Reworking of working capital numbers
- Elimination of certain comparables in Beta

## **Adjustments for Decrease in Value:**

- Increase of Liquidity Premium
- Decrease in Growth Rate for Terminal Value
- Modification of projections – Reduction in profitability
- Reworking of working capital numbers
- Elimination of certain comparables in Beta

# DCF Method – Summary



- Project the operating results and free cash flows of the business over the forecast period (typically 5 year projections required)

- Estimate the growth rate in perpetuity of the business at the end of the forecast period

- Estimate the company's WACC to determine the appropriate discount rate.

- Discount the projected free cash flows and terminal value to the present

- Compute Enterprise Value and Value Per Share

# THANK YOU

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