ICAI

Corporate Valuation – Overview

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Recent Development

RBI withdraws DCF pricing norms

- RBI issued it's first Bi-monthly Monetary Policy Statement for 2014-15 on April 1st
- Apart from the monetary and liquidity measures for the economy, Part B of the monetary policy in the context of development and regulatory policies stated as follows:

  "As regards foreign direct investment (FDI), it has been decided to withdraw all the existing guidelines relating to valuation in case of any acquisition/sale of shares and accordingly, such transactions will henceforth be based on acceptable market practices. Operating guidelines will be notified separately"

- RBI has recently issued a circular, replacing the DCF valuation norms with Internationally Accepted Methodologies on an arm's length basis
- In spite of DCF being made non-mandatory, DCF method will continue to remain the mainstay in all valuations
- Highly unlikely to come across an independent valuation not adopting DCF method

Section 1

Considerations in Valuation of Shares/ Business

Factors influencing Valuation of Shares/ Business

4 Basic Factors

Four basic factors affecting Valuation	
Earnings/ Cash Flows	Dividends
Underlying Asset Value	Price of share in an arm's length transaction

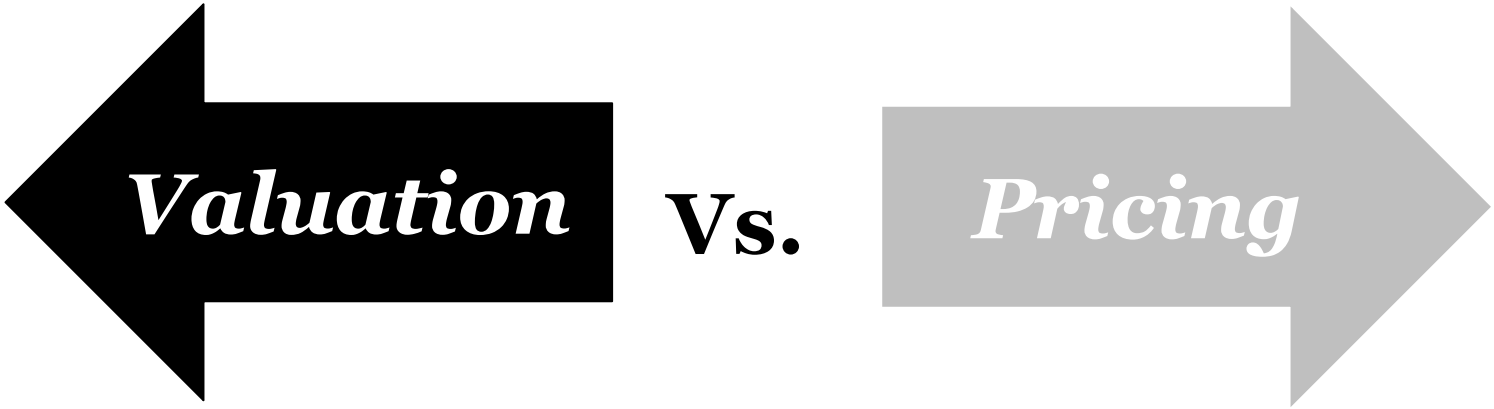
Other Factors

Other factors affecting Valuation		
Nature of business	Calibre of management	Expansion prospects
Financial structure	Cash flow	Patents, franchises & other IPs
Restrictions on transfer	Incidence of taxation	Extent of competition
Size of the holding	Government policy	Prevailing political climate
Risk of obsolescence of items manufactured	Existence of convertible rights	Other external factors

Section 2

Methods of Valuation of Shares/ Business

Valuation Vs. Pricing



Methods of Valuation/ Pricing of Shares & Business

- More than one right way to value
- Approaches are not exclusive – but complement each other

Asset based	***Market based***	***Dividends based***	***Others***
Book Value	Market comparable method	Single-period valuation model	Discounted cash flow (DCF) technique
Net Replacement value	Market transaction method	Multi-period valuation model	Liquidation Value
Net realisable value/ Appraised value	Price earnings (PE)/ Book value (BV) multiple Method		PECV
Value in use	Trading multiples		

Valuation Vs. Pricing ?

The Valuation Method is dependent on the purpose of the valuation and also combination of methods can be used

Section 3

Asset Based Methods

Asset Based Methods

- Three major steps in valuing shares on assets basis are:

Valuation of Assets

Ascertainment of Liabilities (including contingent liabilities)

Fixation of the Value of Equity Shares

Key steps:

- Assessment of residual life of the assets
- Enquiry on cost of similar assets
- Assessment of market value of the assets, especially land
- Goodwill and other intangibles needs to be separately valued
- Ascertainment of liabilities:
  - Consideration of contingent liabilities, short provisions for expenses, etc.
  - In case of shutdown, retrenchment expenses need to be assessed
  - Legal opinion regarding sustainability of claims

Asset Based Methods – Alternatives

Book Value	• Book value reflects historical costs • May be much lower/ higher than their economic value • Investments are generally recognised at their market values • Does not depict a true picture
Net Replacement Value	• Net Replacement Value = Current cost of similar asset *less* Depreciation • Inflation adjustment can also be given • Best suites valuation on a 'Going concern' basis • Suitable for large manufacturing plants – cement, steel, etc. • *ACC – Harshad Mehta* • Gives a fair measure of the current values of the assets
Net Realisable Value/ Liquidation Value	• NRV = Sale proceeds *less* selling cost *less* Tax (direct & indirect) • Best suites valuation of a concern being wound up • Typically adopted in JV exits for a non-profitable ventures

Section 4

Market Linked Methods

Market Linked Methods

- ***Market Comparable Method:***

  Analyze the market multiples of comparable publicly traded companies

  Apply suitable adjustments to the multiples based on the relevant operating characteristics

  Apply the adjusted multiples to the relevant parameters of the company to arrive at the fair value

  Often used parameters are:
  - P/E
  - EV/ EBITDA
  - EV/ Sales
  - EV/ Book Value

- ***Comparable Transaction Method:***

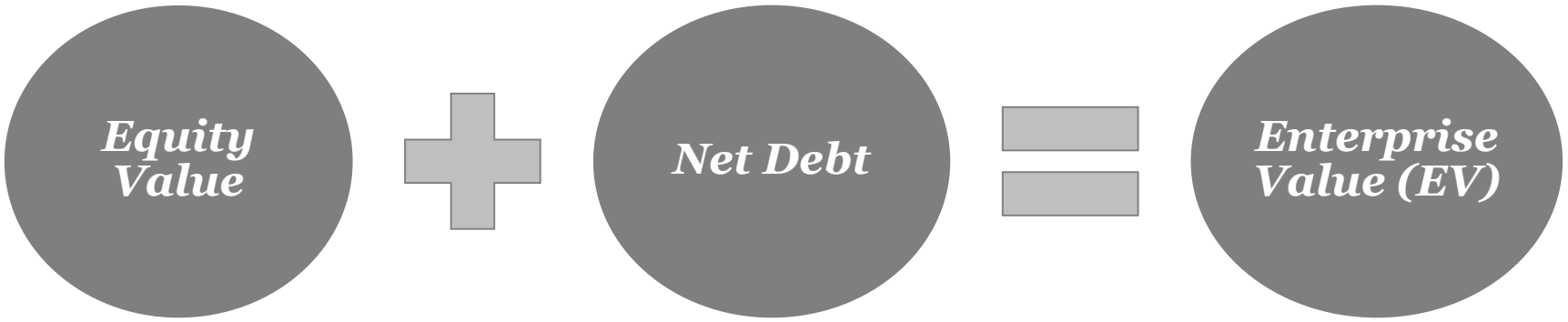
  Analyze market transactions involving companies with comparable business lines

  Arrive at the relevant multiples which can be used to determine the equity value of the Company



Market Linked Methods

Method of Valuation	*Formula*	*Value*
EV/ EBITDA	EBITDA * Avg. EBITDA Multiple	Enterprise Value
EV/ Sales	Sales * Avg. Sales Multiple	Enterprise Value
EV/ Book Value	Total Assets * Avg. Book Value Multiple	Enterprise Value
Mcap/ Book Value	Net-worth * Avg. Book Value Multiple	Equity Value
P/E	PAT *Avg. PE Ratio	Equity Value



Market Linked Methods

Key Aspects:

- Single point valuation
- Inherent strengths are not always reflected
- Ignores future growth potential – favours established companies vs. promising ones
- Divergent values emerge under different multiples
- Normalisation of metrics – Extraordinary items need to be excluded
- Combination of multiples are used

Comparable Transactions – Illustrations

Telecom Towers

Date	Acquirer Company	Target Company	Towers of Target Company	Tenancy of Target Company	Tenancy Ratio	EV (In INR Crs.)	EV/Tenancy (In INR Lakhs)	EV/Tower (In INR Lakhs)
Aug' 2010	MSIF & SBI	VIOM Networks	4,121	8,510	2.06	2,076.43	24.46	50.39
Mar' 2010	VIOM Networks	21st Century Infrastructure Tele Ltd.	2,535	5,450	2.15	1,318.00	24.18	51.99
Feb' 2010	American Tower Co.	Essar Telecom Infrastructure Ltd.	4,450	8,010	1.8	2,000.00	24.97	44.94
July' 2010	GTL Infrastructure	Aircel	17,500	21,000	1.2	8,026.00	38.22	45.86
Nov' 2009	American Tower Co.	Transcend Infrastructure	325	423	1.3	95	22.49	29.23
May' 2009	American Tower Co.	XCEL Telecom Private Ltd.	1,660	2,324	1.4	973.75	41.90	58.66
	Average						**29.37**	**46.85**

Comparable Transactions – Illustrations

Cement Industry

Date	Acquirer Company	Target Company	EV/ Tonne (in Rs,)
In-process	Ultratech	Jaypee Cement	7,917
In-process	Ambuja Cement	ACC	6,900
Mar' 2014	Dalmia Cement	Bokaro Jaypee Cement	5,476
Aug' 2013	Dalmia Cement	Adhunik Cement	7,233
	Average		**6,881.55**

Comparable Transactions – Illustrations

Power Industry

Date	Acquirer Company	Target Company	Nature	EV/ MW (Rs. in Crs.)
Called-off	Targa	Jaypee	Hydro	6.97
In-process	Adani	Lanco	Thermal	5.00
		Average		**5.98**

Market Price while valuing Listed Cos

- Pricing guidelines as per SEBI ICDR Regulations for preferential allotment can be adopted
- ***Average or Higher of the following values:***

Average of weekly high & low closing prices during the last 6 months

Average of weekly high & low closing prices during the last 2 weeks

Section 5

Overview of DCF Method

Why Discounted Free Cash Flow Valuation ?

- DCF closest approximation to intrinsic stock value
- Relative valuation metrics such as P/E, EV/EBITDA, etc. are fairly simple
  - Aren't very useful if an entire sector or market is over or undervalued
- DCF relies on Free Cash Flows, a trustworthy measure
  - No distinction between capital and revenue expenditure
  - Free cash flow tracks the residual funds available for investors
  - Cash flows not easily subject to accounting 'window-dressing'
  - Non-cash items are eliminated
  - Most often used and reliable measure
- DCF valuation is perceived to be better measure in ascertainment of true value

DCF Method

"DCF Method is a complicated method under which the free cash flows attributable to the company or its equity shareholders for a predetermined number of future years and perpetuity are considered and discounted to their present value"

- Attempts to compute present value of expected cash flows
- Forces an in-depth understanding of the business
- Can derive values qua product lines, businesses, transactions
- Permits sensitivity analysis

Cash Flow Projections

- Three components to forecasting cash flows:
  - Determination of the length of the high-growth period (Explicit Period)
  - Estimating cash flows during the Explicit Period
  - Terminal Value calculation
- Factors to be considered for determining length of high-growth period:
  - Size of the firm
  - Existing growth rate and excess returns
  - Magnitude and sustainability of competitive advantages
  - Business should stabilize and start generating profits towards the end of Explicit Period
  - Normally, 5 year period is considered as Explicit Period
- Historical growth rate as an indicator of expected future growth rate

Key Steps in Valuation

- Identification of Peer Set – Beta & Comparison (TP Study)
- Ascertainment of Cost of Capital/ WACC
- Determine the duration of the 'Explicit Period'
- Estimate the profit-after tax for a company/ business over the Explicit Period
- Estimate post-tax cash flows from the profit-after tax
- Cash flows to be ascertained after taking into consideration the non-cash expenses, working capital movement and reinvestment needs
- Estimate Terminal Cash Flow and compute Perpetuity Value
- Discount total cash flows and Perpetuity Value at WACC
- Computation of DCF Value
- Sanity check
- Management discussion

DCF Method – Approaches

- ***Free Cash Flows to Firm***
  - Cash flows attributable to the long term capital providers ascertained
  - 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
- ***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)

Free Cash Flows to Firm approach considered in this presentation

Broad Overview of DCF

$$\frac{\text{Cash Flow Year 1}}{(1+\text{WACC})^{1}} + \frac{\text{Cash Flow Year 2}}{(1+\text{WACC})^{2}} + \frac{\text{Cash Flow Year 3}}{(1+\text{WACC})^{3}} + \frac{\text{Cash Flow Year 4}}{(1+\text{WACC})^{4}} + \frac{\text{Cash Flow Year 5}}{(1+\text{WACC})^{5}}$$

$$+ \frac{\text{Terminal Value Year 6 onwards}}{(1+\text{WACC})^{5}}$$

Cash Flow = PBT

Less: Tax

Add: Depreciation

Add/ Less: Working Cap

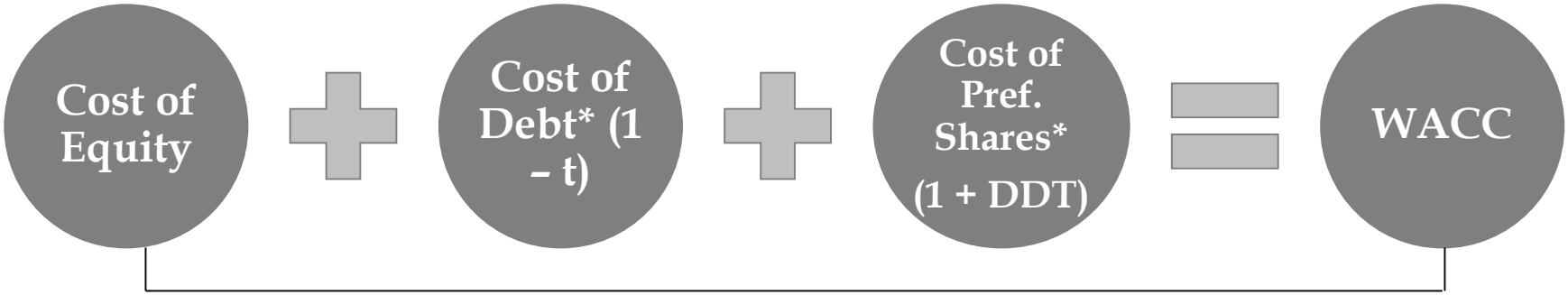
Less: Capex

Add/ Less: Non Cash

Add/ Less: Other Adjustments

Computation of WACC

- Weighted Average Cost of Capital (WACC):



Proportion of equity, debt and preference capital in the total capital

- Proportion of capital components can be based on latest financials or Target Capital Structure
- Different weightages can be considered for Explicit and Terminal Cash Flows
- DDT on Equity Shares shall not be considered; however, shall be considered on Preference Shares
- Liquidity premium
  - Added to WACC to provide for limited liquidity on unlisted shares
- Control premium
  - Reduced from WACC

Computation of WACC

- Cost of Equity (K_e):
  - Dividend growth model – Not generally used
  - Capital Asset Pricing Model (CAPM)
- Capital Asset Pricing Model (CAPM):
  - Return on equity = Rf + β (Rm – Rf)
  - Rf = Risk free rate of return
  - Rm = Market rate of return
  - β = Beta of the stock
- Risk free rate of return (R_f):
  - Return on government securities with long-term time horizon generally considered
- Market rate of return (R_m):
  - Returns delivered by markets over long period for equity investments
  - Returns of BSE Sensex, S&P CNX 500, over 10 to 20 years generally considered
- (R_m - R_f) is referred to as the risk premium
  - Signifies extra return expected by investors for investing in risky investments
  - Risk premium is always positive

Beta

- Beta (β):
  - Diversifiable (firm-specific) and Non-diversifiable (market-wide) risks
  - Non-diversifiable / Market risk is captured by Beta

$$\text{Beta} = \frac{\text{Covariance of the Asset with Market Portfolio}}{\text{Variance of Market Portfolio}}$$

- Obtaining Beta for Unlisted Companies
  - Identify list of comparable listed companies
  - Comparable listed company in TP Study to be of assistance
  - Obtain Betas for comparable listed companies
    - Betas can be obtained from databases, newspapers and websites
  - Average Beta as above, considered as Beta for valuation purposes
- ***Adjustment for financial leverage***
  - Asset Beta to be computed based on Debt/ Equity ratios for each of the companies
  - Average Asset Beta to be geared back taking Debt/ Equity ratio of the company concerned

Beta

- Interpretation of various Beta values

Value of Beta	Interpretation
Beta < 0 (Negative Beta)	Inverse relation to the market - is possible but highly unlikely
Beta = 0	Regardless of which way the market moves, the value remains unchanged. Eg: Cash and Government Securities
0<Beta<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

WACC for Foreign Companies

Approach I

- Assess Rm and Rf for the foreign market
- Identify similar companies in the target market for Beta
- Currency used for projections is critical
- Adjustment required for USD projections in non-USD markets
- Growth rates need to be moderated for the USD projections
- Local factors like financial turmoil, inflation, long term growth rate, etc. to be considered

Approach II

- Rely on parameters laid down by Damodaran
- Start point – Rm for developed markets (USA)
- Add country specific risk premium
- Identify industry Beta
- Compute geared Beta, considering the company specific capital structure

Yearly Cash Flow Ascertainment

- Determination of Yearly Cash Flows – Similar to Indirect Method under AS 3
  - ***PBT***
    - Add: Depreciation
    - Add: Interest on **Long Term Debt**
    - Add: Increase in Short Term Debt
  - ***Total Inflows***
  - ***Less: Outflows***
    - Incremental Working Capital, **excluding Cash**
    - Short Term Debt repayment
    - Capital Expenditure
    - Tax Provision **on PBIT** *(interest on long term debt to be added back)*
  - **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

Perpetuity/ Terminal Value

- Perpetuity/ Terminal Value refers to value of the firm at the end of the Explicit Period
- Terminal Value is discounted applying Explicit Period's last year's discount rate
- ***Terminal Cash Flow (Annual)***

  PBDIT for Perpetuity

  - Less: Tax on PBDIT, as above
  - Less: Incremental Working Capital
  - Less: Annual Gross Capex in Perpetuity, net of tax benefit on account of Depreciation
- PBDIT for Perpetuity = PBDIT for last year in Explicit Period * (1 + g)
  - g = Y-o-Y growth rate for cash flow in Perpetuity
  - Growth rate for Terminal Value can be in the range of 1% to 5%
  - Typically used range – 2% to 4%
  - Justification of higher growth rate challenging – Converges with long term GDP growth rate
- Incremental Working Capital
  - Working capital excluding Cash in last year of Explicit Period * g
  - To be taken as Nil, if closing working capital is 'Negative'

Perpetuity/ Terminal Value

- Gross Capex in Perpetuity (Annual)
  - Linked to assumption of going concern of the business in perpetuity
  - Mirrors replacement rate of the assets
  - Should approximate average rate of depreciation (excluding land)
- Tax Savings on Depreciation on Gross Capex
  - PBDIT is considered as the base for Terminal Cash Flow
  - Tax savings on depreciation on Gross Capex in Perpetuity should be considered
  - PV of tax savings to be ascertained based on WDV method, in the Indian context

$$\textit{Terminal Value}_n = \frac{\textit{Terminal Cash flow}}{\textit{WACC} - g}$$

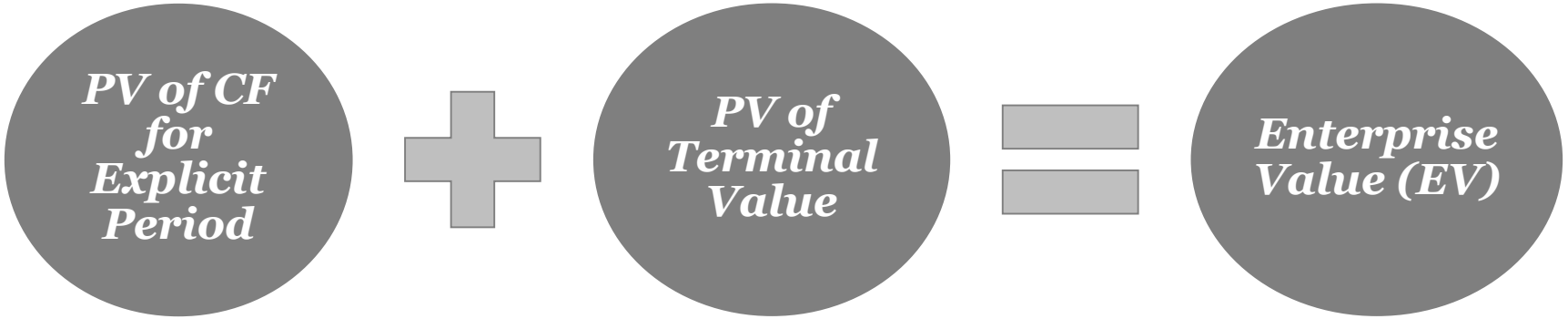
- Where,

  WACC = Weighted Average Cost of Capital

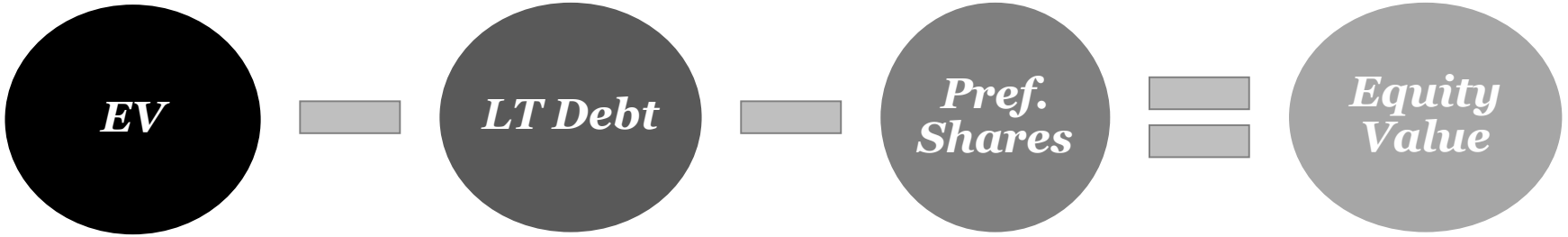
  g = Growth Rate for perpetuity

Enterprise Value & DCF Value of Equity Shares

Enterprise Value



DCF Value of Equity Shares



DCF Value per Share

- **Enterprise Value including Long Term Debt**

  Sum of:

  - NPV of Explicit Period – 3 or 5 years
  - 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
  - Add: PV of MAT Credit
  - Add: PV of tax holiday benefits, beyond Explicit Period
  - Add: PV of benefit of interest free loans
  - 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**

Section 5.2

DCF Method – Specific Aspects

Specific Aspects – Valuation Period

- **Base period consideration**
  - Difference between valuation date and date of base financials
  - Need for audited numbers in interim financials
- **Projection period**
  - Only future periods should be considered
  - Ideally at-least 5 years to be considered for projections (minimum of 3 years)
  - Company needs to turn profitable on a sustainable basis during the projection period – may need to consider longer period
  - No DCF valuation for perpetually loss making companies – NAV may be more suitable

Specific Aspects – Debt & Interest Cost

- **Long Term Debt**
  - Interest NOT considered as cost/ outflow
  - Interest Rate considered for WACC computation, net of tax
  - Part repayment not considered for cash flows
  - LT debt outstanding at the beginning reduced from EV
  - No adjustment for incremental long term debt raised during Explicit Period
- **Short Term Debt and Bank O/D**
  - Interest considered as cost/ outflow
  - Interest Rate NOT considered for WACC computation
  - Part repayments of short term debt considered for cash flows
  - Movement in Bank O/D considered as part of Working Capital movement
  - ST debt outstanding at the end of Explicit Period not to be reduced from EV – EBITDA for Perpetuity will be after interest on ST debt

Specific Aspects – Allotment of Shares

- **Share Application Money**
  - Outstanding share application money to be considered as debt
  - To be reduced from EV
  - Above treatment suggested, since number of shares that would be allotted is not known
  - Assumption in relation to number of shares – Not suggested
- **Allotment of Shares during Explicit Period**
  - Funds received on allotment of shares not considered as inflow
  - Above treatment suggested, since number of shares that would be allotted is not known
  - Assumption in relation to number of shares – Not suggested
  - Similar treatment for Long Term debt raised during Explicit Period

Specific Aspects – Convertible Instruments

Allotment of Convertible Instruments

- FEMA requires conversion price or conversion formula to be fixed upfront
- Conversion price under conversion formula should be in compliance
- Conversion price > Current DCF value
- Variable conversion ratio:
  - Conversion price at the lower end (maximum shares allotted) > Current DCF value
  - Illustration:
    - FV per equity share as per DCF – Rs. 100
    - Variable conversion ratio of CCPS – Between 1: 2 or 2.5, depending on the performance
    - Minimum issue price of CCPS – Rs. 250
    - No further valuation required at the time of allotment

Specific Aspects – Convertible Instruments

Impact of Outstanding Convertible Instruments on Valuation

- ***Compulsorily Convertible Instruments***
  - Should not be reduced as debt while carrying out valuation
  - Deemed conversion can be considered
  - Underlying equity shares on conversion to be added to existing number of equity shares
  - Similar to computation of 'Diluted EPS'
  - Treatment similar additional allotment of equity shares during the explicit period
- ***Optionally Convertible Instruments***
  - Probability of conversion to be assessed
  - Low probability of conversion
    - Regard such instruments as debt
    - Treatment as LT or ST debt to be assessed
  - High probability of conversion
    - Similar treatment as compulsorily convertible instruments

Specific Aspects – ESOPs

- Probability of exercise of ESOPs to be assessed
- Low probability of exercise
  - Exercise price is significantly higher than DCF value
  - No adjustments to be carried out in valuation
- High probability of exercise
  - Exercise price is lower than DCF value
  - PV of cash to be collected on exercise to be included in valuation
  - Number of shares to be ascertained on a diluted basis (post exercise)

Specific Aspects – Pre & Post Money, Preference Shares

Pre & Post Money

- DCF Valuation to be based on Pre Money terms
- However, Post Money cash flows to be considered
- Amount obtained on allotment of shares to be considered as Debt
    - Similar treatment as Allotment of Shares during Explicit Period
- Pre allotment number of shares to be considered

Preference Shares

- Considered on par with Long Term Debt
- Preference dividend rate with DDT to be considered for WACC purposes
- To be reduced from Enterprise Value along with Debt for Equity Shareholders Value

Specific Aspects – Business Assets & Surplus Assets

- **Business Assets**
  - DCF method is based on Cash Flows
  - Income from Business Assets included in Cash Flows
  - Value of Business Assets implicitly captured in Cash Flows
  - Fair Value of Assets used for the purpose of business not relevant
  - Disposals and acquisitions to be reflected in Cash Flows
- **Surplus Assets**
  - Refers to assets not actively used for the purpose of business
  - Income from such assets NOT to be considered for Cash Flows
  - Disposals and acquisitions NOT to be reflected in Cash Flows
  - Fair value of such assets to be added to EV
  - Fair value may be determined through appropriate method
  - ***Tax incidence on disposal of Surplus Assets needs to be reduced***

Value of Land and Other Assets

Business Assets – Not Relevant

Surplus Assets – To be considered

Specific Aspects – Cash & Cash Equivalents & Dividend

- **Cash & Cash Equivalents**
  - Current cash and bank balance to be considered as Surplus Assets
  - Valuation of cash and cash equivalents required ??
- **Dividend – Equity & Preference**
  - Proposed dividends should not impact cash flows
  - Low growth rates of companies with high dividend payout rates
    - Infosys vs. Apple

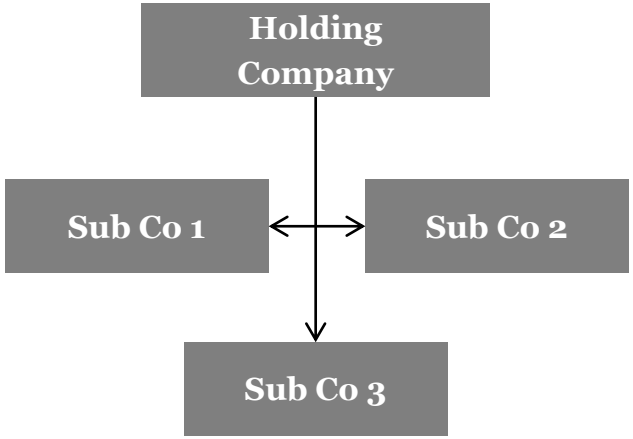
Specific Aspects – Investments

- **Trade Investments**
  - Income from such investments to be considered for Cash Flows
  - Disposals and acquisitions to be reflected in Cash Flows
  - Generally, consolidated Cash Flows can be considered in case of subsidiary companies
  - Alternatively, DCF value of subsidiary companies can be added to DCF value of parent company
    - Cash flows of subsidiary companies not be considered in parent company
- **Non Trade Investments**
  - Income from such investments NOT to be considered for Cash Flows
  - Disposals and acquisitions NOT to be reflected in Cash Flows
  - Fair value of investments to be added to EV
  - Fair value may be determined through appropriate method
- **Bank Deposits**
  - More appropriate to treat them as Non Trade Investments
  - Not appropriate to discount risk-free interest flows at WACC

Specific Aspects – Tax, Tax Holiday & MAT

- Benefit of carry-forward of losses to be considered
- Reduced tax on account of tax holiday considered during explicit period
- Full tax rate to be considered for Terminal Value
- Tax outflow to consider MAT implications
- PV of MAT credit at the end of the Explicit Period can be added to EV
  - Can be discounted for Explicit Period + One year or higher period
- Separate tax computation required for Tax Holiday and Non Tax Holiday units
- Typically no deferred tax adjustment, since actual cash flows are considered (rather than accounting profits)
- PV of tax holiday benefits, post the Explicit Period, to be included in Terminal Value computation
  - Full tax rate would be considered for Terminal Value computation
  - Hence, benefit needs to be added

Specific Aspects – Holding Companies



- Not appropriate to consider dividend flows from subsidiary companies as Cash Flows for DCF
  - Similar position in case of Operating-cum-Holding Companies
- DCF can be based on Consolidated Cash Flows
  - Yearly Cash Flows of all subsidiary companies can be aggregated with Holding Company
  - Proportionate consolidation to be adopted where necessary
- Alternatively, DCF value of all subsidiary companies to be computed on separately
- DCF Value of holding company to be the aggregate of such values

Specific Aspects – New Companies & Cash Flows Not Ascertainable

- Challenges in estimating cash flows for new companies
- Companies whose operations are contingent on obtaining license/ permits – determination of cash flows challenging
- RBI not accepting the contention that DCF valve cannot be ascertained
  - Notices are being issued to companies who have not submitted DCF valuation
- New Amendment for initial investment in New Companies
  - Allotment of shares pertaining to the Subscribed Capital as per MoA can be carried out at face value
  - DCF valuation not applicable in such cases
  - Allotment of shares at premium – Boon or Bane ??

Specific Aspects – Interest Free Loans

- **Interest Free Loans from Promoters**
  - Arms' length interest cost can be considered, in cases leading to change in ownership
  - Likely that interest free loans would be discontinued, once the promoters cease to hold shares
  - Typically, DCF valuation is done from an Acquirer's perspective
- **Interest Free Loans from Government**
  - Sales Tax deferral schemes, capital grant with nil/ low interest, etc.
  - Typically, not considered as long term source of funds
  - Hence, not considered for WACC computation
  - No add back of interest during the Explicit Period
  - PV of loan outstanding at the end of Explicit Period to be reduced from EV
  - PV of Interest saved, net of tax, needs to be added to the EV

Specific Aspects – Promoter Compensation

- Promoters generally may not be drawing adequate compensation from the company
- In case of PE investments, promoter compensation needs to be considered at more meaningful level

Specific Aspects – Liquidity Premium & Control Premium

- **Liquidity Premium**
  - Shares in unlisted companies lack liquidity, with respect to disposal
  - Majority of comparables used in the valuation would be of listed companies
  - Lack of liquidity results in reduction of value, in comparison to listed shares
  - Options for Adjustment:
    - Adhoc Discount while computing DCF Value – 20% to 30%
    - Increase in WACC – 1% to 3%
- **Control Premium**
  - Acquirer of unlisted company would have complete control over the company
  - Issues associated with listed companies – Takeover code, lack of 100% control
  - Higher control leads to increased value
  - Options for Adjustment:
    - Adhoc Increase while computing DCF Value – 20% to 30%
    - Decrease in WACC – 1% to 3%

Not compulsory to have both Liquidity Premium & Control Premium at the same time

Section 5.3

DCF Method – Sanity Check

Sanity Check

- Value of unlisted companies should closely correspond to related companies
- P/E Ratio and Book Value multiples can be considered as appropriate measures
- Indicative values
  - EPS x P/E Ratio of comparable companies
  - Book Value per share x B/V Ratio of comparable companies
- P/E Ratio and Book Value multiples can be obtained from BSE website Index wise

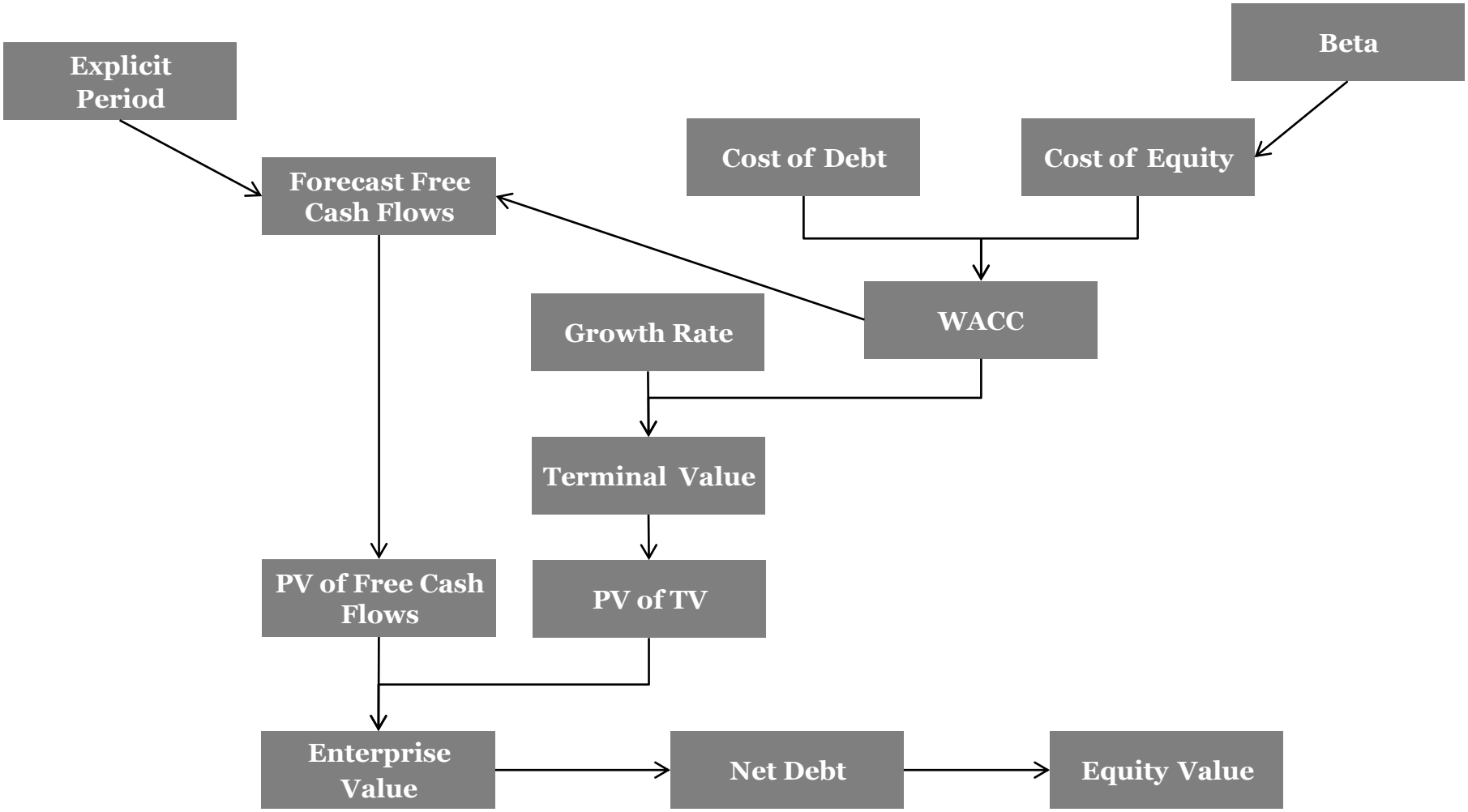
Sanity Check

- Not appropriate to have DCF value 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

Section 5.4

Recap/ Summary

Recap/ Summary

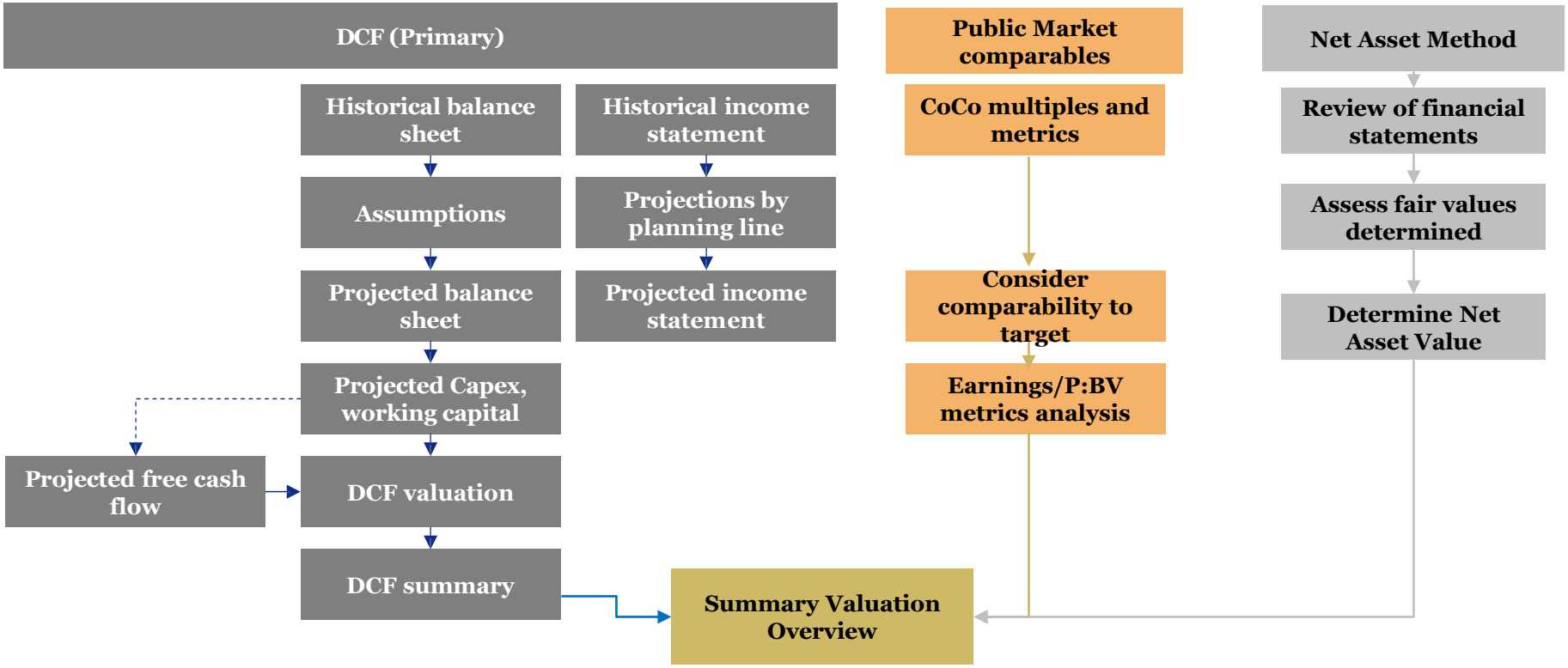


Section 6

Fair Value based on Weighted Average

Fair Value – Illustration

The methodology typically applied in the valuation is summarized below:



- DCF method is primarily relied upon for the valuation
- Comparable Companies method has been used as a market linked method for the valuation
- Net Asset Method (fair values) can also been considered

Fair Value based on Weighted Average

- Combination of methods is generally used for valuation of shares
- Weightages depend on nature of operations and purpose of valuation
  - Asset intensive industries
  - Growth companies
  - Stable/ aging companies
  - IP driven companies
  - Young companies
- DCF and earnings based methods may be given higher weightages
- If shares of listed companies are being valued, market price may be given higher weightage
- Rule of thumb – DCF Value and CMP should not be significantly diverge
  - Market is one of the best judges
  - Role of equity analysts ?
  - Buy vs. Sell Ratings

Fair Value based on Weighted Average

- Illustration:

Method of Valuation	***Value per share***	***Weights***	***Product***
Net Assets	82.79	1	82.79
Multiples based method	132.6	2	265.2
Discounted Cash Flow	208.4	3	625.2
	Total	***6***	***973.19***
Fair Value Per Share (Weighted Average)			**162.20**

Section 7

Valuation in M&A Scene

Valuation in Mergers

- Mergers require determination of swap ratio
  - Absolute values need not be indicated; swap ratio is an indicator of relative values
- High Court's role:
  - Limited scope for review of valuations / valuation reports
    - Hindustan Lever Employees' Union vs HLL (83 Comp Cases 30)
    - Hindustan Ciba Giegy (14 SCL 115)
  - Not to disturb ratio unless proved to be grossly wrong / unfair
- Due diligence & multiple independent valuations is advisable
- Fairness opinion from a merchant banker mandatory for listed companies
- ***Swap Ratio = $\frac{\text{FV per share of Transferor Co}}{\text{FV per share of Transferee Co}}$***
- Typically, in case of mergers involving listed companies only share swap ratio is disclosed
  - Specific value could be seen as forward looking statements



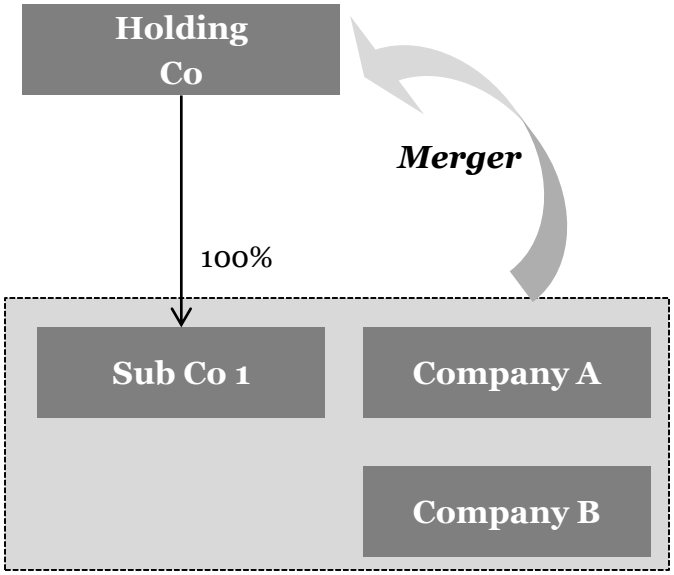
Valuation in Demergers

- ***Mirror Demergers***
  - Valuation technically not applicable
  - Swap ratio does not impact shareholders' value
  - Target capital approach/ arbit share exchange ratio can be adopted
  - Key point – New Co should have nominal capital
- ***Demerger into existing Operating Co***
  - Fair value of unit being demerged and Transferee Co to be ascertained
  - Value attributable per share of demerged co to be found out
  - Valuation akin to a mergers
  - ***Swap Ratio = $\frac{\text{FV of demerged unit attributable to per share of Transferor Co}}{\text{FV per share of Transferee Co}}$***

Section 8

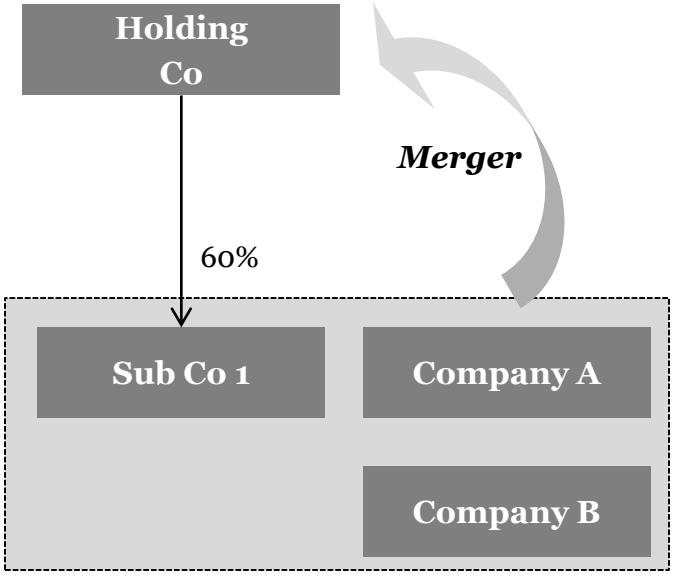
Case Studies

Merger of WOS & Other Companies



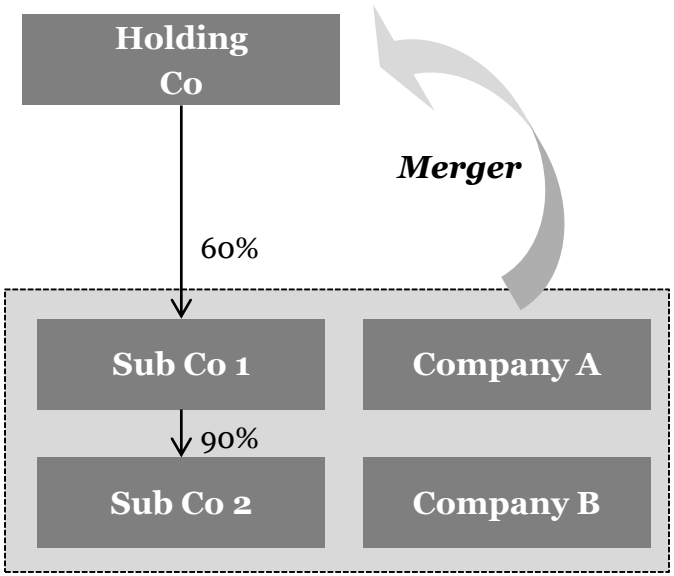
Particulars	Holding Co	Sub Co 1	Company A	Company B
Share Capital (Rs. 10 each)	500	200	100	250
No. of shares	50	20	10	25
EV (excl. investments)	3,500	1,500	2,500	3,000
Fair Value for Merger	***5,000***		2,500	3,000
Fair Value per share	100		250	120
Share Exchange Ratio	**-**		***2.50***	***1.20***

Merger of Sub & Other Companies



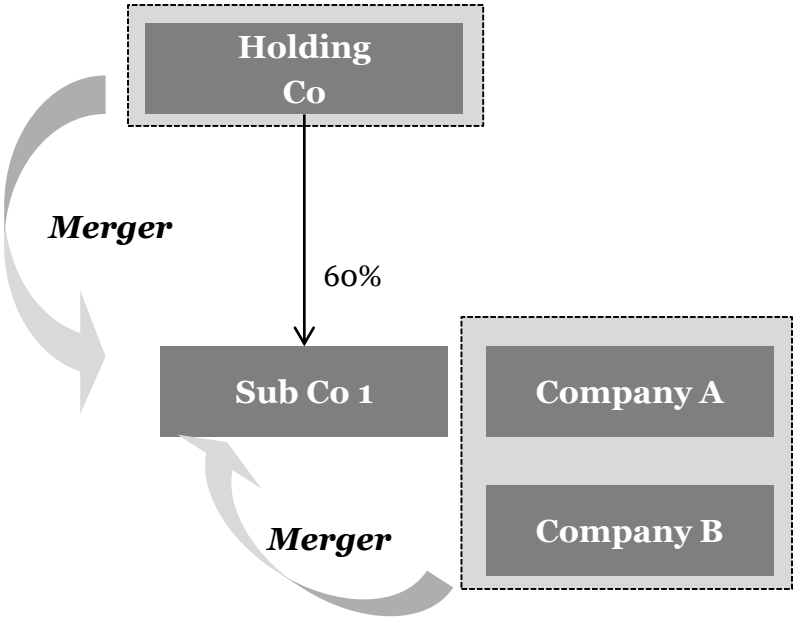
Particulars	Holding Co	Sub Co 1 60%	Company A	Company B
Share Capital (Rs. 10 each)	500	200	100	250
No. of shares	50	20	10	25
EV (excl. investments)	3,500	1,500	2,500	3,000
Fair Value for Merger	***4,400***	1,500	2,500	3,000
Fair Value per share	88	75	250	120
Share Exchange Ratio	**-**	***0.85***	***2.84***	***1.36***

Merger of Two Level Subs & Other Companies



Particulars	Holding Co	Sub Co 1 60%	Sub Co 2 90%	Company A	Company B
Share Capital (Rs. 10 each)	500	200	100	100	250
No. of shares	50	20	10	10	25
EV (excl. investments)	3,500	1,500	1,250	2,500	3,000
Fair Value for Merger	***5,075***	***2,625***	1,250	2,500	3,000
Fair Value per share	102	131	125	250	120
Share Exchange Ratio	**-**	***1.29***	***1.23***	***2.46***	***1.18***

Reverse Merger



Particulars	Holding Co	Sub Co 1 60%	Company A	Company B
Share Capital (Rs. 10 each)	500	200	100	250
No. of shares	50	20	10	25
EV (excl. investments)	3,500	1,500	2,500	3,000
Fair Value for Merger	4,400	1,500	2,500	3,000
Fair Value per share	88	75.0	250	120
Share Exchange Ratio	***1.17***	-	***3.33***	***1.60***

Thank You

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Views expressed in the presentation are personal