Valuation of Business and Assets for Corporate Restructuring

Lesson 13

KEY CONCEPTS

■ Business Valuation ■ Method of Valuation ■ Takeover ■ Slump Sale ■ Valuation Report

Learning Objectives

To understand:

- Business Valuation and its types
- Circumstances when valuation becomes essential
- Method of Valuation
- Amalgamation
- Valuation for Slump Sale
- Demerger
- Principles and techniques of Reporting
- Swap Ratio

Lesson Outline

- Introduction
- Need of valuation
- Business valuation methods
- Valuation principles and techniques
- Valuation under SEBI (SAST) Regulations, 2011
- Valuation of Slump Sale
- Valuation of demergers
- Principles and techniques of reporting
- Relative valuation
- Swap ratio
- Lesson Round-Up
- Glossary
- Test Yourself
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- References

BUSINESS VALUATION

Valuation is the process of determining the economic worth of a company/business based on its business model and external environment and supported with reasons and empirical evidence. During valuation, a valuer looks at the company's management, composition of its capital structure, the prospect of future earnings and market value of assets, etc. Proper valuation helps an entity or business make an intelligent decision. In a merger or amalgamation or demerger or acquisition, valuation is essential to fix the value of the shares to be exchanged in a merger or the consideration payable for an acquisition. The valuation plays a very important role during the resolution of existing debts, unlocking of hidden value and assets, introduction of risk capital and in some cases a turnaround of the underlying business can lead to substantial profits on exit from the investments.

The use of different valuation techniques and principles has made valuation a subjective process. Conflict in valuation could result from the choices with respect to any of these namely valuation base or approach or method or technique. In the case of merger, for instance, the asset value can be determined both at the market price and the cost price. A great deal depends upon the rationale of the parties to a transaction and therefore, it is important that the merging parties should first discuss and agree upon the valuation bases, approaches, methods and techniques.

When it comes to merger / amalgamation, calculating the swap ratio is at the core of the valuation process. It is the ratio at which the shares of the acquiring company will be exchanged with the shares of the acquired company. For instance, a swap ratio of 1:2 means that the acquiring company will provide its one share for every two shares of the other company.

Valuation models are used to determine the true value of a business mostly by financial market participants. Business valuation can be for the entire company or a part of the operations of a company. There are tools and methods used for valuation. Usually the valuation is done by analysing the financial statements, the cash flows and other market factors.

Valuation involves financial modelling. This financial model can be different for different entities, as because one financial model for an industry may not be suitable for another industry and the choice of model to use for the industry is subjective.

Valuation Motives

An important aspect in the merger/amalgamation/takeover activity is the valuation aspect. The method of valuation of business, however, depends to a great extent on the acquisition motives. The acquisition activity is usually guided by strategic behavioural motives. The reasons could be

(a) either purely financial (taxation, asset-stripping/correcting valuation errors, financial restructuring involving an attempt to augment the resources base and portfolio-investment) or

(b) business related (expansion/ diversification, addressing poor performance) or

(c) behavioural reasons have more to do with the personal ambitions or objectives (desire to grow big) of the top management.

The expansion and diversification objectives are achievable either by building capacities on one's own or by buying the existing capacities or a combination of both. The decision criteria in such a situation would be the present value of the differential cash flows. These differential cash flows would, therefore, be the limit on the premium which the acquirer would be willing to pay. On the other hand, if the acquisition is motivated by financial considerations (specifically taxation and asset-stripping), the expected financial gains would form the limit on the premium, over and above the price of physical assets in the company. The cash flow from operations may not be the main consideration in such situations. Similarly, a merger with financial restructuring as its objective will have to be valued mainly in terms of financial gains. It would, however, not be easy to determine the level of financial gains because the financial gains would be a function of the use to which these resources are put.

NEED FOR BUSINESS VALUATION

Business valuation refers to the process of determining the economic worth or value of a business or company. It involves assessing the various factors that contribute to the financial value of the business, such as its assets, liabilities, financial performance, market position, and growth potential.

The need for business valuation arises in several situations:

1. Mergers and Acquisitions: Valuation is crucial when companies are considering buying or selling businesses. It helps determine a fair price for the acquisition or sale and enables negotiation between the parties involved.

2. Investment Analysis: Investors, both individual and institutional, require business valuations to assess the potential return on investment and determine if a business is a viable investment opportunity.

3. Financial Reporting: In some cases, businesses need to estimate the value of their assets for financial reporting purposes, such as for accounting standards or compliance requirements.

4. Shareholder Disputes: During shareholder disputes, business valuation can help determine the fair value of shares or ownership interests.

5. Estate Planning: Valuing a business is essential for estate planning and determining the value of business assets to distribute among beneficiaries or for tax purposes.

6. Litigation and Legal Proceedings: Business valuations may be necessary in legal situations, such as divorce settlements, partnership dissolutions, or damage claims.

7. Strategic Planning: Valuations are useful in strategic planning to assess the overall financial health of the business, identify areas for improvement, and make informed decisions about growth strategies or restructuring.

By conducting a business valuation, stakeholders gain insights into the financial worth of the business, which helps them make informed decisions. It provides a foundation for negotiation, investment decisions, and overall strategic planning. Furthermore, business valuation helps ensure fair transactions, protects the interests of stakeholders, and provides a benchmark for future growth and performance evaluations.

Situations requiring Valuation

The following are some of the usual circumstances when valuation of shares or enterprise becomes essential:

1. When issuing shares to public either through an initial public offer or by offer for sale of shares of promoters or for further issue of shares to public.

2. When promoters want to invite strategic investors or for pricing a first issue or a further issue, whether by way of a preferential allotment or rights issue.

3. In making investment in a joint venture by subscription or acquisition of shares or other securities convertible into shares.

4. For making an 'open offer' for acquisition of shares.

5. When company intends to introduce a 'buy back' or 'delisting of shares'.

6. In schemes involving mergers/demergers, share valuation is resorted to determine the consideration for the purpose of issue of shares or any other consideration to shareholders or transferor of demerged companies.

7. On directions of Tribunal or or other statutory Authority.

8. For determining fair price for effecting sale or transfer of shares as per Articles of Association of the company.

9. As required by the agreements between two parties.

10. To determine purchase price of a 'block of shares', which may or may not give the holder thereof a controlling interest in the company.

11. To value the interest of dissenting shareholders under a scheme of amalgamation, merger or reconstruction.

12. Conversion of debt instruments into shares.

13. Advancing a loan against the security of shares of the company by the Bank/Financial Institution.

14. As required by provisions of law such as the Companies Act, 2013 or Foreign Exchange Management Act, 1999 or Income Tax Act, 1961 or the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 [the Takeover Code] or SEBI (Buy Back of Securities) Regulations, 2018 or Delisting Guidelines.

Factors Influencing Valuation

Determining the value of a business is a complicated and intricate process. Valuing a business requires the determination of its future earnings potential and the risks inherent to those future earnings. The process of arriving at this value includes a detailed analysis of its mix of physical and intangible assets, and the general economic and industry conditions. Major factors influencing the valuation of a business include:

- debt equity ratio
- nature of business and its growth history
- customer base
- areas of operations
- audited financial statements
- management team and its competency
- litigation and disputes
- related party transactions, etc.

The other salient factors include:

1. The stock exchange price of the shares of the two companies before the commencement of negotiations or the announcement of the bid.

2. Dividends paid on the shares.

3. Relative growth prospects of the two companies.

4. In case of equity shares, the relative gearing of the shares of the two companies. ('gearing' means ratio of the amount of issued preference share capital and debenture stock to the amount of issued ordinary share capital.)

5. Net assets of the two companies.

6. Voting strength in the merged (amalgamated) enterprise of the shareholders of the two companies.

7. Past history of the prices of shares of the two companies.

8. Merger and amalgamation deals can take a number of months to complete during which time valuations can fluctuate substantially. Hence provisions must be made to protect against such swings.

Preliminary Steps in Valuation

A business valuation involves analytical and logical application/analysis of historical/future tangible and intangible attributes of business. The preliminary study to valuation involves the following aspects:

1. Purpose of valuation.
2. Goodwill/Brand name in the market.
3. Business environment of the entity to be valued.
4. Estimation/forecast of future cash flows as accurately as possible.
5. Is company listed on any stock exchange?
6. If listed, whether shares of the company are traded frequently?
7. The industry in which the entity is part of.
8. The industry P/E ratio, past and future growth rate.
9. Who are the competitors locally, internationally?
10. Whether any similar valuation has been done recently
11. The technology concerning the enterprise and its probability of obsolescence.
12. The accepted discounting rate.
13. Study of market capitalization aspects.
14. Identification of hidden liabilities through analysis of material contracts.

BUSINESS VALUATION METHODS

Valuing a business typically involves assessing its assets, liabilities, financial performance, market position, growth potential, and other relevant factors. Several different methods and approaches are used to determine the value of a business, and the choice of method depends on the nature of the business, industry, purpose of the valuation, and available data.

Followings are some commonly used business valuation methods:

1. *Market Approach:* This method determines the value of a business by comparing it to similar businesses that have recently been sold or are publicly traded. It relies on market data and transactions to estimate the value.
2. *Income Approach:* This method values a business based on its expected future income or cash flow. It involves discounting projected future cash flows to their present value using an appropriate discount rate.
3. *Asset Approach:* This method focuses on the value of the assets and liabilities of a business. It assesses the net asset value by subtracting liabilities from the fair market value of the assets.
4. *Multiple-based Approach:* This method uses financial ratios or multiples (such as price-to-earnings ratio or price-to-sales ratio) derived from comparable companies or industry averages to estimate the value of a business.

The choice of valuation method depends on factors such as the purpose of the valuation, the industry in which the business operates, the availability and reliability of data, and the specific circumstances surrounding the valuation.

It's worth noting that business valuation is not an exact science, and different methods may yield different results. Professional valuation experts or appraisers are often hired to conduct thorough and objective business valuations, taking into account all relevant factors and applying their expertise to ensure an accurate and reasonable valuation.

It's important to consult with professionals or conduct in-depth research when conducting a business valuation, as it can have significant implications for decision-making, negotiations, and financial transactions related to the business.

VALUATION PRINCIPLES AND TECHNIQUES FOR MERGER

When conducting a valuation for a merger, there are several principles and techniques that can be applied. Here are some key principles and techniques used in merger valuation:

1. *Comparable Company Analysis:* This technique involves identifying comparable companies in the same industry or sector and analyzing their financial metrics, such as price-to-earnings ratio (P/E), price-to-sales ratio (P/S), or enterprise value-to-EBITDA ratio (EV/EBITDA). The valuation multiples derived from these comparable companies can then be applied to the target company to estimate its value.

2. *Discounted Cash Flow (DCF) Analysis:* DCF analysis is a widely used valuation technique that estimates the present value of a company's future cash flows. It involves projecting the expected cash flows of the merged entity and discounting them back to their present value using an appropriate discount rate, such as the weighted average cost of capital (WACC). The sum of these discounted cash flows represents the estimated value of the merged entity.

3. *Synergy Analysis:* Synergy refers to the potential benefits and cost savings that can be achieved through the merger. It is important to assess and quantify the synergistic effects of the merger, such as increased revenue, cost reductions, economies of scale, or market expansion. These synergies can then be incorporated into the valuation analysis to determine the enhanced value of the merged entity.

4. *Asset-Based Valuation:* This approach involves assessing the value of the tangible and intangible assets of the companies involved in the merger. It includes analyzing the fair market value of assets, such as property, plant, and equipment (PP&E), inventory, intellectual property, and brand value. Liabilities are subtracted from the asset value to derive the net asset value, which forms the basis of the valuation.

5. *Market Capitalization:* Market capitalization is a straightforward valuation technique that calculates the value of a company based on its market price per share multiplied by the number of outstanding shares. In the context of a merger, this technique can be used to determine the relative value of the merging entities and the resulting ownership structure.

6. *Transaction Multiples:* Transaction multiples involve analyzing historical merger and acquisition transactions in the same industry to determine valuation benchmarks. This includes assessing multiples such as the purchase price-to-sales ratio (PP/S), purchase price-to-earnings ratio (PP/E), or enterprise value-to-revenue ratio (EV/Revenue) observed in past transactions. These multiples can then be applied to the financial metrics of the merging entities to estimate their value.

It's important to note that valuing a merger is a complex task, and a combination of multiple valuation techniques is often used to arrive at a reasonable valuation. Professional expertise, careful analysis of financial data, and consideration of industry-specific factors are crucial in accurately valuing the merging entities and assessing the potential value creation resulting from the merger.

ASSET-BASED APPROACH

The Asset-Based Approach is a valuation method that assesses the value of a business based on its net asset value. It involves calculating the fair market value of the company's assets and subtracting its liabilities to arrive at the net asset value.

Illustration:

Let's consider a company called ABC Manufacturing. ABC Manufacturing has the following assets and liabilities:

- Cash and Cash Equivalents: Rs. 100,000
- Accounts Receivable: Rs. 200,000
- Inventory: Rs. 300,000
- Property, Plant, and Equipment: Rs.1,000,000
- Total Assets: Rs. 1,600,000
- Accounts Payable: Rs. 150,000
- Long-Term Debt: Rs. 500,000
- Total Liabilities: Rs. 650,000

To calculate the net asset value using the Asset-Based Approach, we subtract the total liabilities from the total assets:

Net Asset Value = Total Assets - Total Liabilities

Net Asset Value = Rs. 1,600,000 - Rs. 650,000 = Rs.950,000

In this example, the net asset value of ABC Manufacturing is Rs.950,000. This represents the estimated value of the company's assets after deducting its liabilities.

It's important to note that the Asset-Based Approach may not capture intangible assets such as intellectual property, brand value, or customer relationships, which could significantly impact the overall value of a business. Therefore, this approach is most suitable for asset-intensive industries or situations where the company's tangible assets represent a significant portion of its value.

The Asset-Based Approach is one of several valuation methods, and it's advisable to consider other approaches and factors when conducting a comprehensive business valuation.

Illustration:

Let's assume we're valuing a company called XYZ Services. XYZ Services has the following assets and liabilities:

- Cash and Cash Equivalents: Rs.150,000
- Accounts Receivable: Rs.200,000
- Inventory: Rs. 100,000
- Property, Plant, and Equipment: Rs. 500,000
- Intangible Assets (e.g., patents, trademarks): Rs. 300,000
- Total Assets: Rs.1,250,000
- Accounts Payable: Rs. 100,000
- Long-Term Debt: Rs. 400,000
- Total Liabilities: Rs.500,000

To calculate the net asset value using the Asset-Based Approach, we subtract the total liabilities from the total assets:

Net Asset Value = Total Assets - Total Liabilities Net Asset Value = Rs.1,250,000 - Rs.500,000

Net Asset Value = Rs. 750,000

In this example, the net asset value of XYZ Services is Rs.750,000. This represents the estimated value of the company's assets after deducting its liabilities.

It's important to note that the Asset-Based Approach focuses primarily on tangible assets and may not fully capture the value of intangible assets, such as brand reputation, customer relationships, or intellectual property. Therefore, when using this approach, it's crucial to consider the specific industry, market conditions, and the relevance of intangible assets to get a comprehensive understanding of the business's value.

Please note that business valuation involves various factors and considerations, and the Asset-Based Approach is just one method among several others. It's always advisable to consult with valuation professionals and consider multiple approaches to arrive at a well-rounded assessment of a company's value.

Illustration:

ABC Ltd. has the following values in its books:

Particulars	(₹ in thousand)
Land and building	300
Plant and machinery	200
Inventory	200
Investment	100
Receivables	300
Cash	100
Current liabilities	300
Term loans	200

Land and buildings will fetch 500 more. Plant and machinery will fetch 100 less. Inventory will fetch 50 less. Receivables will fetch 50 less. Current liabilities of 50 will not be payable.

Calculate the net realizable value of this business.

	Book Value	Impairment/Appreciation	Realizable Value
Assets			
Land & Buildings	300	+500	800
Plant & Machinery	200	-100	100
Investments	100		100
Inventory	200	-50	150
Receivables	300	-50	250
Cash	100		100
TOTAL	1200	300	1500
Liabilities			
Bank Borrowings	200		200
Current Liabilities	300	-50	250
		Net Realisable Value	1050

INCOME-BASED APPROACH

In the income-based approach, as the name suggests, value of the business is calculated based on future income flows of the entity. In this approach the most important factor is determination of future cash flows of the business. The more accurate the forecast of cash flows, more correct will be the valuation. The future cash flows of the business are discounted at a predetermined rate to arrive at the present value of the business.

Another way of income approach is based on market capitalisation. In this approach the net earnings are capitalised. For this the earnings before interest and tax depreciation and amortization is considered. Another method used is to look at the price earnings of similar businesses. By comparing similar businesses, model is built and the share price of the company under consideration is estimated.

For example, company-A is in FMCG business, and we want to find out the value of the business. The earnings per share of company-A is Rs. 5.5. Now let us look at businesses in the FMCG industry which are listed on the stock exchange. Company-B has price earnings ratio of 39. Company-C has a price earnings ratio of 45. Another FMCG company-D has a price earnings ratio of 33. The average price earnings ratio of companies B, C and D is 39. Now let us apply this average ratio to company-A's earnings per share. 5.5 × 39 = 214.5. So, the value of the company A per share is Rs. 214.5.

Suppose the earnings of the company is Rs. 2 crore then the value of the company is 2 × 39 equal to Rs. 68 crores. This method of calculation can be tricky because in a volatile market the prices of stocks may fluctuate widely. Moreover, listed companies always have a better valuation because of the liquidity. Normally unlisted companies' evaluation is reduced by 30 to 50%. That is if a listed company's value is Rs. 100 crore then a similar but unlisted company will have a value of only Rs.50 crore with other things remaining same. The price earnings approach is useful in takeovers and mergers.

MARKET BASED APPROACH

Under the market-based approach, we look for a similar business which has changed hands in the recent past and value the target entity on the same basis. If exactly similar business transaction is not available, a closely similar transaction can be taken, and adjustments can be made for any variations in any parameter to arrive at the correct valuation. The adjustments can be for difference in size, quantity, or quality. It is easy to value a company which is publicly traded. However, when a similar company is not available then it becomes necessary to adjust as mentioned above.

There are two popular types of market approach methods, one is based on guideline transaction method and the other based on guideline public method, i.e., publicly traded entity. Market approach method is useful in case of Real Estate Company because we can easily estimate by looking at similar sale transactions. Also, we can look at recent merger and acquisition transactions in the same industry and make adjustments for any size, product or other relevant factor to arrive at the target company valuation. There is also another method called back solve method. This involves analysis of equity transactions of the target entity in the past 12 months with unrelated investors.

Importance of Market-Based Approach

1. **Relies on Real Market Data:** The Market-Based Approach utilizes actual transaction data from the market, providing a real-world benchmark for valuation.
2. **Consideration of Market Perception:** This approach considers how the market perceives the value of similar assets or businesses, reflecting investor sentiment and market dynamics.
3. **Simplicity and Transparency:** Market comparables are relatively easy to understand and transparent, making this approach accessible to a wide range of users.
4. **Validation of Other Methods:** Market-based valuations can serve as a validation or sanity check for other valuation methods, providing additional insight into the value of the subject entity.

Calculation Technique:

The Market-Based Approach involves comparing the subject entity to similar entities or transactions in the market and applying relevant valuation multiples. Common multiples used in the Market-Based Approach include Price-to-Earnings (P/E) ratio, Price-to-Book (P/B) ratio, Price-to-Sales (P/S) ratio, and Price-to-EBITDA (P/EBITDA) ratio.

Illustration:

Let's consider an example of using the Market-Based Approach to value a manufacturing company, AMBA Manufacturing Inc.:

Company Description: AMBA Manufacturing Inc. is a medium-sized manufacturing company producing automotive components.

Valuation Date: December 31, 2023

Comparable Company Transactions:

1. Company A: Similar size and business model as AMBA Manufacturing Inc. Recently sold for $50 million.
2. Company B: Larger than AMBA Manufacturing Inc. with a broader product portfolio. Recently sold for $75 million.
3. Company C: Smaller than AMBA Manufacturing Inc. with a niche market focus. Recently sold for $30 million.

Financial Metrics for AMBA Manufacturing Inc.:

- Net Income for the year ending December 31, 2023: $10 million
- Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) for the year ending December 31, 2023: $15 million
- Revenue for the year ending December 31, 2023: $100 million

Calculation:

1. Market-Based Approach (P/E Ratio):

   Calculate the Price-to-Earnings (P/E) ratio for each comparable transaction:

   - P/E Ratio for Company A: $50 million / $10 million = 5x
   - P/E Ratio for Company B: $75 million / $X million = Yx
   - P/E Ratio for Company C: $30 million / $X million = Yx

   Apply the average P/E ratio to AMBA Manufacturing Inc.:

   - Average P/E Ratio = (5x + Yx + Yx) / 3

2. Market-Based Approach (P/EBITDA Ratio):

   Calculate the Price-to-EBITDA (P/EBITDA) ratio for each comparable transaction:

   - P/EBITDA Ratio for Company A: $50 million / $15 million = 3.33x
   - P/EBITDA Ratio for Company B: $75 million / $X million = Yx
   - P/EBITDA Ratio for Company C: $30 million / $X million = Yx

   Apply the average P/EBITDA ratio to AMBA Manufacturing Inc.:

   - Average P/EBITDA Ratio = (3.33x + Yx + Yx) / 3

Conclusion:

The Market-Based Approach to valuation provides a comparative analysis of the subject entity to similar entities or transactions in the market. By applying relevant valuation multiples derived from comparable transactions, this approach helps estimate the value of the subject entity based on real market data. However, it's essential to select appropriate comparables and consider qualitative factors to ensure the accuracy and reliability of the valuation.

DISCOUNTED CASH FLOW (DCF) APPROACH

The Discounted Cash Flow (DCF) technique is a widely used method for business valuation. It estimates the present value of a company's projected future cash flows, taking into account the time value of money. The DCF technique involves the following steps:

1. Project Future Cash Flows: Forecast the future cash flows of the business over a specific period. Cash flows typically include operating cash flows, capital expenditures, working capital changes, and any other significant cash flow components.

2. Determine the Discount Rate: Select an appropriate discount rate, often the company's weighted average cost of capital (WACC). The discount rate represents the required rate of return expected by an investor considering the risk associated with the investment. It reflects the opportunity cost of investing in the company rather than alternative investments.

3. Discount Cash Flows: Apply the discount rate to each projected period's cash flow to calculate the present value of the cash flows. This involves dividing each projected cash flow by (1 + discount rate) raised to the power of the respective period.

4. Calculate Terminal Value: Estimate the value of the company beyond the projected period, usually based on a perpetuity or exit multiple. The terminal value represents the value of the business's cash flows beyond the projection period.

5. Sum the Present Values: Sum up the present values of the projected cash flows and the terminal value to obtain the total present value of the future cash flows. This represents the estimated value of the business.

6. Sensitivity Analysis: Perform sensitivity analysis by varying key assumptions such as cash flow projections, discount rate, and terminal value to assess the impact on the estimated value.

7. Compare to Market and Comparable Companies: Consider market conditions, industry trends, and comparable company valuations to evaluate the reasonableness of the estimated value.

It's important to note that the accuracy of the valuation heavily depends on the quality of cash flow projections, appropriate selection of the discount rate, and other assumptions made during the process. The DCF technique requires careful consideration and professional expertise in financial analysis to ensure a comprehensive and accurate valuation of the business.

Illustration:

Assume ABC Manufacturing Company is projected to generate the following cash flows over the next five years:

Year 1: 500,000

Year 2: 600,000

Year 3: 700,000

Year 4: 800,000

Year 5: 900,000

The discount rate for ABC Manufacturing Company is determined to be 10%.

Step 1: Calculate the Present Value (PV) of Cash Flows

PV Year 1 = 500,000 / (1 + 0.10)^1 = 454,545 PV Year 2 = 600,000 / (1 + 0.10)^2 = 495,868 PV Year 3 = 700,000 / (1 + 0.10)^3 = 513,310 PV Year 4 = 800,000 / (1 + 0.10)^4 = 526,446 PV Year 5 = 900,000 / (1 + 0.10)^5 = 535,714

Step 2: Calculate the Sum of PV Cash Flows

Sum of PV Cash Flows = PV Year 1 + PV Year 2 + PV Year 3 + PV Year 4 + PV Year 5 Sum of PV Cash Flows = 454,545 + 495,868 + 513,310 + 526,446 + 535,714

Sum of PV Cash Flows = 2,525,883

Step 3: Determine the Terminal Value

Assume the terminal value is estimated to be 10 million. To calculate the present value of the terminal value, we need to select an appropriate exit year and discount it back to the present value using the discount rate.

Assuming the exit year is Year 5: PV Terminal Value = 10,000,000 / (1 + 0.10)^5 = 6,209,677

Step 4: Calculate the Total Present Value

Total Present Value = Sum of PV Cash Flows + PV Terminal Value Total Present Value = 2,525,883 + 6,209,677 Total Present Value = 8,735,560

In this example, the estimated valuation of ABC Manufacturing Company using the DCF technique is approximately 8,735,560. This represents the present value of the projected cash flows and the terminal value discounted at the appropriate rate. Remember that this is a simplified example, and additional factors, such as growth rates, risk factors, and sensitivity analysis, should be considered for a comprehensive valuation.

VALUATION UNDER SEBI (SAST) REGULATIONS, 2011

The Securities and Exchange Board of India (SEBI) Substantial Acquisition of Shares and Takeovers (SAST) Regulations, 2011, govern the acquisition of shares and control of companies in India. The regulations aim to ensure fair practices and protect the interests of shareholders during the acquisition process. While the SEBI (SAST) Regulations primarily focus on the acquisition of shares, they also include provisions related to valuation. Here are some key aspects of valuation under the SEBI (SAST) Regulations, 2011:

1. Valuation of Shares:
   - Regulation 8 of the SEBI (SAST) Regulations mandates that the acquirer must disclose the highest price paid for the shares of the target company in the 26 weeks preceding the public announcement of the acquisition.
   - If the acquisition involves a preferential issue of shares, the price at which the preferential issue is made must be disclosed.
   - The valuation of shares is important in determining the price to be paid by the acquirer and for assessing the fairness of the transaction.
2. Open Offer Price:
   - Regulation 20 of the SEBI (SAST) Regulations specifies that the open offer price should be determined by the acquirer based on the valuation of the shares of the target company.
   - The open offer price is the price at which the acquirer intends to acquire shares from the public shareholders of the target company.
   - The acquirer must ensure that the open offer price is fair and in compliance with the SEBI (SAST) Regulations.
3. Registered Valuers:
   - The SEBI (SAST) Regulations require the appointment of a registered valuer for determining the valuation of shares.

- Regulation 22 mandates that the valuer must be a merchant banker, registered with SEBI, and should have expertise in valuation.
- The valuer plays a crucial role in assessing the fair value of shares and providing an independent opinion on the valuation.

4. Valuation Report:
   - Regulation 35 of the SEBI (SAST) Regulations requires the acquirer to submit a valuation report to SEBI.
   - The valuation report provides details of the valuation methodology, assumptions, and factors considered in determining the valuation of shares.
   - The report is a crucial document that helps establish the fairness of the acquisition and provides transparency to the regulators and shareholders.

CASE STUDIES

One notable case study in the Indian context is the valuation of Flipkart, a leading e-commerce company in India. Flipkart was founded in 2007 by Sachin Bansal and Binny Bansal and grew rapidly to become one of India's largest online marketplaces. Over the years, the company attracted significant investments from various investors, resulting in multiple valuation rounds. Here is a summary of Flipkart's valuation journey:

Case Study 1:

1. Initial Valuation: In its early stages, Flipkart secured its initial funding from small investors and angel investors. In 2009, the company raised approximately $1 million in its first round of funding at a valuation of around $5 million.

2. Early Growth and Investor Interest: Flipkart experienced significant growth and gained traction in the Indian e-commerce market. As a result, it attracted investments from prominent venture capital firms. In 2010, the company raised $10 million from Accel Partners and Tiger Global Management at a valuation of around $50 million.

3. Continued Expansion and Funding: Flipkart continued to expand its operations and gained market share. The company received multiple rounds of funding in subsequent years. In 2011, Flipkart raised $20 million in a funding round led by Tiger Global Management, valuing the company at around $1 billion.

4. Steady Growth and Billion-Dollar Valuation: Flipkart's growth trajectory remained strong, and it secured significant investments from both existing and new investors. In 2014, the company raised $1 billion in a funding round led by Tiger Global Management, DST Global, and others, valuing Flipkart at approximately $7 billion. This marked the first Indian e-commerce company to achieve a billion-dollar valuation.

5. Valuation Ups and Downs: Flipkart faced intense competition from international players and witnessed increased competition in the Indian e-commerce market. In subsequent years, the company faced some downward adjustments in valuation due to changes in market dynamics and increased competition. For instance, in 2017, SoftBank Vision Fund invested $2.5 billion in Flipkart, valuing the company at around $11.6 billion.

6. Walmart Acquisition: In 2018, US retail giant Walmart acquired a majority stake in Flipkart for $16 billion, valuing the company at approximately $20 billion. This acquisition provided an exit for several early investors and represented one of the largest acquisitions in the Indian startup ecosystem.

The Flipkart case study showcases the valuation journey of an Indian e-commerce company, highlighting the different stages of funding, investor interest, market dynamics, and the impact of competition on the company's valuation. It demonstrates how a startup's valuation can evolve over time based on its growth, performance, and external factors influencing the market.

Case Study 2:

XYZ Tech Solutions is a fast-growing technology company specializing in software development and IT services. The company was founded five years ago and has experienced rapid revenue growth and a strong customer base. The management team is exploring options for fundraising and needs to determine the valuation of the business.

Key Information:

1. Financial Performance:
   - Year 1: Revenue - $2 million, Net Income - $500,000
   - Year 2: Revenue - $3 million, Net Income - $800,000
   - Year 3: Revenue - $5 million, Net Income - $1.2 million
   - Year 4: Revenue - $7 million, Net Income - $1.8 million
   - Year 5: Revenue - $10 million, Net Income - $2.5 million
2. Industry Analysis:
   - Comparable companies in the same industry are trading at an average Price-to-Earnings (P/E) ratio of 15x.
   - The average Enterprise Value-to-Revenue (EV/Revenue) multiple is 2.5x.
3. Discount Rate: 10% The discount rate represents the required rate of return considering the risk associated with the investment.

Solution:

1. Calculate Average Net Income: Average Net Income = (Net Income Year 1 + Net Income Year 2 + Net Income Year 3 + Net Income Year 4 + Net Income Year 5) / 5 Average Net Income = ($500,000 + $800,000 + $1,200,000 + $1,800,000 + $2,500,000) / 5 Average Net Income = $1,360,000
2. Estimate the Earnings Value: Earnings Value = Average Net Income * P/E Ratio Earnings Value = $1,360,000 * 15 Earnings Value = $20,400,000
3. Estimate the Revenue Value: Revenue Value = Revenue Year 5 * EV/Revenue Multiple Revenue Value = $10,000,000 * 2.5 Revenue Value = $25,000,000
4. Calculate Present Value (PV) of Earnings Value: PV of Earnings Value = Earnings Value / (1 + Discount Rate) ^ Number of Years Assuming a projection period of 5 years, PV of Earnings Value = $20,400,000 / (1 + 0.10) ^ 5 PV of Earnings Value = $12,187,365
5. Calculate Present Value (PV) of Revenue Value: PV of Revenue Value = Revenue Value / (1 + Discount Rate) ^ Number of Years Assuming a projection period of 5 years, PV of Revenue Value = $25,000,000 / (1 + 0.10) ^ 5 PV of Revenue Value = $14,911,242
6. Calculate Valuation: Valuation = PV of Earnings Value + PV of Revenue Value Valuation = $12,187,365 + $14,911,242 Valuation = $27,098,607

In this case, the estimated valuation of XYZ Tech Solutions is approximately $27,098,607 based on the average net income, industry multiples, and discount rate applied to both earnings and revenue values. It's important to note that this is a simplified valuation approach, and additional factors, such as the company's growth prospects, market conditions, and competitive landscape, should be considered for a comprehensive valuation analysis.

AMALGAMATION AND VALUATION

Amalgamation refers to the combination of two or more companies into a single entity. It involves the merging of assets, liabilities, and operations of the companies to form a new entity or for one company to absorb another. Valuation plays a crucial role in determining the terms of the amalgamation, including the exchange ratio for the shares of the companies involved.

Valuation in the context of amalgamation involves assessing the value of each company participating in the amalgamation to determine the exchange ratio or share swap ratio. The exchange ratio determines the number of shares of the acquiring company that will be issued in exchange for the shares of the target company. Valuation methods such as the market value approach, asset-based approach, income-based approach, or a combination of these approaches can be used to determine the fair value of the companies involved.

The valuation process typically involves the following steps:

1. *Gather Financial Information:* Collect the financial statements and relevant information of the companies involved, including their assets, liabilities, revenues, and expenses.

2. *Select Valuation Method:* Determine the appropriate valuation method or combination of methods based on the nature of the business, industry standards, and regulatory requirements. Common methods include the market approach, income approach, and asset-based approach.

3. *Perform Valuation Analysis:* Apply the chosen valuation method(s) to assess the value of the companies. This may involve analysing financial statements, forecasting future cash flows, considering market comparable, and applying appropriate valuation multiples or discount rates.

4. *Determine Exchange Ratio:* Once the values of the companies are determined, the exchange ratio or share swap ratio is calculated. The ratio determines how many shares of the acquiring company will be issued for each share of the target company.

5. *Consider Other Factors:* Apart from valuation, other factors such as strategic fit, synergies, and management considerations are also considered during the amalgamation process.

6. *Obtain Approvals:* The valuation results and exchange ratio are presented to the board of directors and shareholders of the companies involved. They must approve the terms of the amalgamation, including the valuation methodology and the exchange ratio.

It's important to note that the specific details and requirements of amalgamation and valuation can vary depending on the jurisdiction, industry, and individual circumstances of the companies involved. Consulting with financial advisors, valuation experts, and legal professionals is recommended to ensure compliance with applicable laws and regulations and to obtain a fair and accurate valuation in the context of an amalgamation.

Case Study:

Assume Company A and Company B are merging through an amalgamation. The financial information of both companies is as follows:

Company A:

- Shareholders' Equity: 10 million
- Total Assets: 20 million
- Total Liabilities: 5 million

Company B:

- Shareholders' Equity: 15 million
- Total Assets: 25 million

- Total Liabilities: 8 million

To determine the exchange ratio for the amalgamation, we will use the book value method, which considers the net asset value of each company.

Step 1: Calculate the Net Asset Value (NAV) of each company:

Company A NAV = Shareholders' Equity of Company A = 10 million

Company B NAV = Shareholders' Equity of Company B = 15 million

Step 2: Determine the Exchange Ratio:

Exchange Ratio = NAV of Company A / NAV of Company B

Exchange Ratio = $10 million / $15 million Exchange Ratio = 0.67

This means that for every share of Company B, 0.67 shares of Company A will be issued in the amalgamation.

Step 3: Assess the Value of Amalgamated Company:

To assess the value of the amalgamated company, we need to consider the post-amalgamation financials.

Assuming the combined assets of the amalgamated company after the merger are 45 million and the total liabilities are 13 million:

Amalgamated Company Shareholders' Equity = Combined Assets - Total Liabilities Amalgamated Company Shareholders' Equity = 45 million - 13 million

Amalgamated Company Shareholders' Equity = 32 million

The value of the amalgamated company will be 32 million.

Step 4: Allocate Shares to Shareholders: Based on the exchange ratio, shareholders of Company B will receive 0.67 shares of Company A for each share of Company B held.

For example, if a shareholder of Company B holds 1,000 shares, they will receive 0.67 * 1,000 = 670 shares of Company A.

Note: This numerical example is simplified and does not consider other factors such as market conditions, synergies, or strategic considerations that could impact the valuation and exchange ratio in a real-world amalgamation. Additionally, professional advice from financial advisors and legal experts should be sought to ensure compliance with applicable regulations and to consider all relevant factors in an actual amalgamation scenario.

SLUMP SALE

A slump sale refers to the transfer of an undertaking, business, or division of a company as a going concern, where all assets and liabilities are transferred as a package to another entity. In a slump sale, the business is sold as a whole, and individual assets and liabilities are not separately identified or valued. The consideration for the slump sale is usually a lump sum amount.

Here's an example to illustrate the concept of a slump sale:

Company A owns and operates a manufacturing division that manufactures and sells electronic devices. Company B is interested in acquiring the entire manufacturing division through a slump sale.

In the slump sale agreement, Company A transfers the entire manufacturing division, including all its assets and liabilities, to Company B. This includes manufacturing equipment, inventory, intellectual property rights, customer contracts, employees, and any other assets and liabilities associated with the division.

The consideration for the slump sale is agreed upon between Company A and Company B. It could be a fixed amount, a combination of cash and shares, or any other form of consideration. The exact terms of the sale, including payment timelines and any warranties or representations, are negotiated and documented in the agreement.

After the slump sale is completed, Company A no longer operates the manufacturing division, and Company B becomes the new owner of the division. Company B assumes all the assets, liabilities, and ongoing operations of the division, including customer relationships, supplier contracts, and any legal or financial obligations.

It's important to note that the tax and legal implications of a slump sale can vary across jurisdictions. It is advisable to consult with tax and legal professionals to ensure compliance with applicable laws and regulations and to understand the specific implications of a slump sale in a particular context.

Slump sale is a strategic transaction used by companies to divest or acquire business divisions as a going concern. It offers advantages such as simplicity, continuity of operations, and tax efficiency. However, careful consideration of accounting and tax implications is essential for both the seller and the buyer to optimize the outcome of the transaction.

Features of Slump Sale

Transfer of Business as a Going Concern: The buyer acquires the business in its entirety, including all assets and liabilities necessary for its operation.

Single Transaction: Slump sale is typically executed as a single transaction, where the entire business is transferred for a lump sum consideration.

No Break in Continuity: The business continues to operate seamlessly after the transfer, ensuring continuity of operations and customer relationships.

Process of Slump Sale

Negotiation and Agreement: The buyer and seller negotiate the terms of the slump sale, including the consideration, assets and liabilities to be transferred, and any conditions precedent.

Due Diligence: The buyer conducts due diligence to assess the assets, liabilities, and potential risks associated with the business being acquired.

Documentation: Legal documents such as the slump sale agreement, transfer deeds, and relevant contracts are drafted and executed to affect the transfer.

Approval and Registration: The slump sale transaction may require approval from regulatory authorities and compliance with statutory requirements. The transfer documents are registered with the appropriate authorities.

Accounting Treatment of Slump Sale:

Purchase Price Allocation: The purchase price is allocated to the assets and liabilities acquired based on their fair values at the date of transfer.

Recognition of Gain or Loss: Any difference between the purchase price and the net assets acquired is recognized as a gain or loss in the financial statements of the seller.

Tax Implications of Slump Sale:

Capital Gains Tax: The seller may be liable to pay capital gains tax on the difference between the sale consideration and the cost of acquisition of the business.

Tax Treatment of Assets and Liabilities: The tax treatment of assets and liabilities transferred in a slump sale may vary based on applicable tax laws and regulations.

Illustration:

Company A sells its manufacturing division to Company B as a slump sale for a lump sum consideration of Rs. 10 million. The fair value of the assets transferred is Rs. 8 million, and the net liabilities assumed by Company B amount to Rs. 2 million.

Solution:

Purchase Price Allocation:

- The purchase price of Rs. 10 million is allocated to the assets and liabilities acquired based on their fair values.
- Assets acquired: Rs. 8 million
- Liabilities assumed: Rs. 2 million

Recognition of Gain or Loss:

- The difference between the purchase price and the net assets acquired represents the gain or loss on the slump sale.
- Gain on Slump Sale = Purchase Price - Net Assets Acquired
- Gain on Slump Sale = Rs. 10 million - (Rs. 8 million – Rs. 2 million) = Rs. 4 million

Tax Implications:

- Company A may be liable to pay capital gains tax on the gain realized from the slump sale transaction.
- The tax treatment of the transaction may vary based on applicable tax laws and regulations in the jurisdiction.

Case Study:

1. Introduction: This case study examines the slump sale of ABC Manufacturing Company, a leading player in the automotive components industry. The slump sale was executed to streamline operations, divest non-core assets, and consolidate resources for the company's core business activities.
2. Background: ABC Manufacturing Company had diversified its operations over the years, expanding into multiple sectors and product lines. However, this diversification had resulted in operational complexities and resource allocation challenges. To refocus on its core competencies and improve profitability, the company decided to undertake a slump sale of non-core business segments.
3. Rationale for Slump Sale: The key reasons for pursuing a slump sale were as follows:
   a. Strategic Focus: The slump sale aimed to enable ABC Manufacturing Company to concentrate its resources and efforts on its core business activities. By divesting non-core assets, the company could redirect its attention to areas where it held a competitive advantage and maximize growth opportunities.
   b. Cost Rationalization: The non-core business segments were associated with additional costs, such as separate management teams, infrastructure, and overhead expenses. Through the slump sale, the company could eliminate these costs and achieve operational efficiencies.
   c. Debt Reduction: In some cases, non-core business segments might have been burdened with significant debt. The proceeds from the slump sale could be utilized to repay debt, thereby strengthening the company's financial position and reducing interest obligations.
4. Slump Sale Process: The slump sale process involved the following steps:
   a. Identification of Non-Core Assets: The management conducted a thorough evaluation of the company's businesses and identified the non-core assets that would be divested. This assessment involved analyzing financial performance, growth prospects, and strategic alignment with the company's long-term objectives.
   b. Valuation and Pricing: The non-core assets were valued based on their fair market value, taking into account factors such as asset condition, market demand, and future cash flows.

The pricing of the slump sale was determined through negotiations with potential buyers or investors.

c. Due Diligence: The potential buyers or investors performed due diligence on the non-core assets to assess their financial, operational, and legal aspects. This step ensured transparency and minimized risks associated with the slump sale.

d. Agreement and Execution: Once the negotiations and due diligence were completed, a formal agreement was drafted, outlining the terms and conditions of the slump sale. The execution of the agreement involved the transfer of ownership and assets, including tangible and intangible assets, contracts, and employees.

e. Post-Sale Transition: Following the slump sale, ABC Manufacturing Company focused on smoothly transitioning the divested business segments to the new owners. This involved ensuring a seamless handover of operations, customer relationships, and support functions.

5. Outcomes and Results: The slump sale of non-core assets yielded several positive outcomes for ABC Manufacturing Company:

   a. Enhanced Focus and Efficiency: By divesting non-core assets, the company could concentrate its resources and expertise on its core business activities. This led to improved operational focus, increased efficiency, and better utilization of available resources.

   b. Improved Financial Performance: The slump sale resulted in a reduction of costs associated with non-core assets, leading to improved financial performance. The company could reallocate capital and reinvest in core business activities, thereby enhancing profitability and shareholder value.

   c. Debt Reduction: If the non-core assets carried significant debt, the proceeds from the slump sale could be utilized to repay debt obligations. This reduced interest expenses and improved the company's overall financial health.

   d. Strategic Alignment: The slump sale allowed ABC Manufacturing Company to align its business portfolio with its long-term strategic objectives. By divesting non-core assets, the company could focus on its core core competencies and capitalize on growth opportunities in its primary market.

6. Conclusion: The slump sale of non-core assets enabled ABC Manufacturing Company to streamline operations, consolidate resources, and improve profitability. By focusing on its core business activities, the company achieved strategic alignment, cost rationalization, and enhanced financial performance, ultimately leading to increased shareholder value.

DEMERGER

Demerger is a corporate restructuring process in which a company transfers one or more of its divisions, subsidiaries, or business units into separate independent entities. In a demerger, the assets, liabilities, and operations of the division or subsidiary are divided and distributed among the newly formed entities or existing companies.

Here's an example to illustrate the concept of a demerger:

Company XYZ is a conglomerate with diverse business operations, including a pharmaceutical division and a real estate division. The company decides to demerge its real estate division into a separate entity called Company R, which will be a standalone real estate company.

The demerger process involves the following steps:

1. *Planning and Announcement:* Company XYZ's management identifies the real estate division as a separate entity with its own growth potential. The decision to demerge the division is made, and the company announces its plans to shareholders and stakeholders.
2. *Valuation and Asset Allocation:* The real estate division's assets, liabilities, and operations are evaluated and valued. The valuation determines the distribution of assets and liabilities between the parent company (Company XYZ) and the new entity (Company R). This may involve conducting a separate business valuation for the real estate division.
3. *Legal and Regulatory Requirements:* Company XYZ complies with legal and regulatory requirements specific to the jurisdiction where the demerger is taking place. This may involve obtaining approvals from shareholders, regulatory authorities, and other relevant parties.
4. *Implementation:* The demerger is executed by transferring the identified assets, liabilities, and operations of the real estate division from Company XYZ to Company R. This could involve transferring property titles, contracts, employees, and other necessary arrangements to ensure the smooth functioning of the new entity.
5. *Shareholder Allocation:* Company XYZ determines how the shares of the newly formed entity (Company R) will be allocated among its existing shareholders. This can be done through a share swap ratio, where shareholders receive shares of the new entity in proportion to their holdings in the parent company.
6. *Independent Operations:* After the demerger, Company R operates as an independent real estate company, having its own management, board of directors, financials, and strategic direction. Company R can raise funds, make investments, and pursue growth opportunities specific to its real estate business.

A demerger allows the parent company to focus on its core operations, while the demerged entity can operate autonomously and pursue its own growth strategies. It can unlock value by creating separate entities with specialized expertise and clearer market positioning.

It's important to note that the specific details and processes of a demerger can vary based on legal requirements, regulatory frameworks, and company-specific considerations. Professional advice from legal, financial, and tax experts should be sought to ensure compliance with applicable laws and to handle the complexities involved in a demerger.

Reasons for Demergers

Focus on Core Business: Companies may opt for demergers to focus on their core competencies and streamline operations.

Unlocking Value: Demergers can unlock the hidden value of distinct business units by allowing them to operate independently and pursue their strategies.

Financial Flexibility: Separate entities can access capital markets and financing opportunities that may not have been available as part of a larger conglomerate.

Types of Demergers

Partial Demerger: Only a portion of the business is spun off into a separate entity.

Complete Demerger: The entire business is divided into separate entities.

Split-up Demerger: The parent company splits into multiple independent entities.

Equity Carve-out: The parent company sells a portion of its subsidiary's shares to the public while retaining control.

Legal and Regulatory Framework

Demergers are subject to various legal and regulatory requirements, including approval from shareholders, creditors, and regulatory authorities. Companies must comply with company law provisions, securities regulations, and taxation laws governing demergers.

Accounting Treatment

Accounting for demergers involves allocating the assets, liabilities, and equity of the parent company among the demerged entities based on their fair values. The process may include adjustments for goodwill, intangible assets, and contingent liabilities.

Taxation Implications

Demergers can have significant tax implications for both the parent company and the spun-off entities. Tax considerations include capital gains tax, stamp duty, transfer pricing, and tax consolidation rules. Companies must carefully plan the demerger structure to optimize tax outcomes.

Illustration 1: Partial Demerger

Company XYZ decides to spin off its software division into a separate entity. The fair value of the software division is Rs.50 million, and its net assets are Rs.40 million. The parent company's shareholders will receive one share in the new entity for every two shares they hold in XYZ.

Calculation:

- Fair value of the software division: Rs.50 million
- Net assets of the software division: Rs.40 million
- Shareholders' entitlement: 1 share in the new entity for every 2 shares in XYZ

Based on the above information, calculate the value of shares received by XYZ shareholders and the accounting treatment for the demerger.

Solution:

1. **Value per share in the new entity:**

   Value per share=Rs.50 million/1/2×Total shares of XYZ

   Since each shareholder receives 1 share in the new entity for every 2 shares in XYZ, the total number of shares issued to XYZ shareholders is 1/2×Total shares of XYZ. Therefore, the value per share in the new entity can be calculated once the total shares of XYZ are known.

2. **Value of shares received by XYZ shareholders:**

   Once we have the value per share in the new entity, we can multiply it by the number of shares each XYZ shareholder holds to find the total value of shares received.

Illustration 2: Tax Implications

In the demerger described in illustration 1, analyse the tax implications for both the parent company and the spun-off entity. Consider capital gains tax, stamp duty, and any other relevant tax considerations.

Solution:

Tax implications vary depending on the jurisdiction, applicable tax laws, and the specific circumstances of the demerger. Here are some potential tax considerations:

1. **Capital Gains Tax (CGT):**

   - The parent company may be subject to CGT on any capital gains realized from the demerger.

- The spun-off entity may also incur CGT if there is a transfer of assets at a value higher than their tax base.

2. **Stamp Duty:**

   - Stamp duty may apply to the transfer of assets or shares as part of the demerger, depending on the jurisdiction.
   - The rate and applicability of stamp duty vary based on the nature of the transaction and the assets involved.

3. **Tax Planning:**

   - Companies may engage in tax planning strategies to minimize the tax impact of the demerger, such as utilizing tax reliefs or exemptions available under the law.
   - Structuring the demerger efficiently can help optimize tax outcomes for both the parent company and the spun-off entity.

4. **Other Tax Considerations:**

   - Other tax considerations may include the treatment of tax losses, transfer pricing rules, and any specific tax incentives or concessions applicable to the industry or business sector.

PRINCIPLES AND TECHNIQUES OF REPORTING

Valuation Report exercise is based on the observation, inspection, analysis, and calculation. During this process, the valuer goes through various documents, records his observation, makes relevant calculation and records these calculations and analyses results. In this process, many documents are generated which forms the basis of his conclusion on the valuation of the subject matter. It is very necessary for him to preserve all such records so that these documents may help him to substantiate his conclusion on valuation. Moreover, all these documents also become the matter of reference in near future.

Contents of Summarized Valuation Report

An expert group of Ministry of Corporate Affairs suggested the following coverage in case of the Valuation Report for Corporate Strategies. Considering the share holder's interest and the need for transparency and upholding corporate governance principles and after taking into consideration aspects of minority interest, transparency and corporate governance the Expert Group recommended that the following matters should compulsorily be covered in the Valuation Report, in a clear, unambiguous and non-misleading manner, consistent with the need to maintain confidentiality:

1. Background Information
2. Purpose of Valuation and Appointing Authority
3. Identity of the valuer and any other experts involved in the valuation
4. Disclosure of valuer Interest/Conflict, if any
5. Date of Appointment, Valuation Date and Date of Report
6. Sources of Information
7. Procedures adopted in carrying out the Valuation
8. Valuation Methodology
9. Major Factors influencing the Valuation

10. Conclusion

11. Caveats, Limitations and Disclaimers.

1. Background Information

The valuation report should briefly cover the following:

- Brief particulars of company or business which is the valuation subject
- Proposed Transaction
- Key historical financials
- Capital structure of the company, if relevant, and any changes because of the proposed transaction
- Shareholding pattern, any significant changes (Promoters/FIs), and any changes as a result of the transaction (Note – a table of before and after shareholding patterns ought to be disclosed)
- High/low/average market volumes/price for last six months, where applicable
- Related party issues with respect to the transaction.

2. Purpose of Valuation & Appointing Authority

The context and purpose of the valuation and the appointing authority commissioning the exercise must be clearly stated e.g. the Management's decision to seek an advisory opinion should be disclosed, or, the Audit Committee Chairman's decision to appoint or the appointment of an independent valuer itself should be disclosed with the date of the decision.

3. Identity of the valuer and any other experts involved in the valuation

Identity of the Registered Valuer (with his registration number) as well as organization doing the valuation and any other experts consulted in the process of valuation. The separation of the advisory team and details of the Chinese walls maintained between the independent valuer team and the advisory team, if appointed with of the degree of strict separation and compliance of Chinese walls should be mentioned.

4. Disclosure of Valuer Interest/Conflict, if any

The Expert Group also recommends that a valuer shall disclose in his Report, possible sources of conflict and material interests, including association or proposed association/with the company, its associates, the counterparty to the transaction or its associates, in the form of auditor, lead advisor or in any other capacity, together with the nature of the fee arrangements for the same. If the valuer has a separate advisory engagement, the conflict disclosure should clearly record that neither the valuer or the members of the team working on the independent valuation have directly or indirectly, through the client or otherwise shared any advisory perspective or have been influenced or undertaken advocating a management position in determining the value.

5. Date of Appointment, Valuation Date and Date of Report

The Report should clearly state the date of the appointment of the valuer, Valuation Date (i.e. the date as of which the valuation assessment is done if this be other than the date of the report) and the date of the report.

6. Sources of Information

The valuer should clearly indicate in the report the principal sources of information, both internal and external, which have been relied upon for the purpose of valuation.

7. Procedures adopted in carrying out the valuation

Procedures adopted in carrying out a valuation may vary with circumstances, nature, and purpose of valuation as well as information and time available. The principal procedures adopted by the valuer in carrying out the valuation should be set out briefly in the report. Such procedures may typically include:

- Review of past Financials
- Review and analysis of financial projections
- Industry analysis
- SWOT analysis
- Comparison with similar transactions
- Comparison with other similar listed companies
- Discussions with Management
- Review of principal agreements/documents etc.

The valuer should also include in his report:

- an affirmative statement that information provided and assumptions used by Management/Others in developing projections have been appropriately reviewed and enquiries made regarding basis of key assumptions in the context of analysis of business being valued and the industry/economy; and
- an affirmative statement on adequacy of information and time for carrying out the valuations; with such modifications as may be appropriate and warranted. The affirmative statement shall not negate the professional liability for expertise applied in determining value and if the degree of inadequacy of information is severe, fundamental questions and information as assessed by the valuer as key for the appropriate stage of valuation needs to be disclosed.

8. Valuation Methodology

Where as one method may be more or less applicable to a particular case, they are often used in conjunction to arrive at the fair value of a company/asset/business. The following are some of the methods which are often used for valuations. The methods enumerated below are merely illustrative and not exhaustive.

- Asset Approach
- Book Value, Adjusted Book Value, and Liquidation Value
- Income Approach
- Capitalization of Earnings, Capitalization of Excess Earnings, and Discounted Future Earnings/ Cash Flows.
- Market Approach

Current Market Prices, Historical Market Prices, Price to Earnings, Price to Revenue, Price to Book Value, Price to Enterprise Value, etc.

- Comparable transactions/Valuations

Comparable International and Domestic Transactions.

The valuation methodology adopted by the valuer must be disclosed. The valuer should mention in the report the rationale and appropriateness for the adoption of a particular method, or a combination of methods and emphasis/reliance placed on the chosen method/combination of methods in reaching the final conclusion.

9. Major Factors influencing the Valuation

The valuer should also mention any key factors which have a material impact on the valuation of shares, including inter- alia the size or number of the corporate assets or shares, its/their materiality or significance, minority or majority holding and changes on account of the transaction, any impacts on controlling interest, proposed dividend, or past profit of the company, proportion of assets and liabilities, diminution or augmentation therein and marketability or lack thereof.

10. Conclusion

In conclusion, the report must contain clear statement of the value ascribed to the business/assets in question.

11. Caveats, Limitations and Disclaimers

Any caveats, limiting condition or other disclaimers to the report must be clearly stated with appropriate specificity i.e. the valuer shall not disclaim liabilities for his expertise or deny his duty of care.

RELATIVE VALUATION AND SWAP RATIO

Relative valuation is a method of valuing a company or asset by comparing it to similar companies or assets in the same industry or market. It involves analyzing various financial and non-financial metrics of comparable companies and using them as benchmarks to determine the relative value of the target company.

Swap ratio, on the other hand, is the ratio at which shares of one company are exchanged for shares of another company in a merger, acquisition, or demerger. It determines the proportionate ownership of shareholders in the combined or newly formed entity.

In the context of a merger or demerger, the swap ratio is determined based on the relative valuation of the companies involved.

Here's how the swap ratio and relative valuation are interconnected:

1. Relative Valuation Analysis:

- Comparable Company Analysis: Comparable companies in the same industry are identified, and their financial metrics such as price-to-earnings ratio (P/E ratio), price-to-sales ratio (P/S ratio), or enterprise value-to-EBITDA (EV/EBITDA) are analyzed.
- Relative Multiples: The financial metrics of the comparable companies are used as multiples. For example, if the average P/E ratio of comparable companies is 15, it implies that investors are willing to pay 15 times the earnings for similar companies.
- Application to the Target Company: The multiples derived from the comparable company analysis are applied to the target company's financial metrics (such as earnings, sales, or EBITDA) to determine its estimated value.

2. Determining Swap Ratio:

- Valuation of Companies: The relative valuation analysis helps determine the value of each company involved in the merger or demerger.
- Negotiation and Agreement: The swap ratio is then negotiated between the companies based on their respective valuations and the ownership stake desired by each party.
- Share Exchange: The agreed-upon swap ratio determines the number of shares of the acquiring company that will be exchanged for each share of the target company or vice versa.

The swap ratio is typically expressed as a fraction or ratio. For example, a swap ratio of 1:3 means that for every three shares of the target company, the shareholders will receive one share of the acquiring company.

The swap ratio considers the relative value of the companies to ensure a fair exchange of shares between the merging or demerging entities. It takes into account factors such as market conditions, financial performance, growth prospects, synergies, and shareholder interests.

It's important to note that the swap ratio is subject to negotiation and agreement between the companies involved, and it can be influenced by various other factors beyond relative valuation, including strategic considerations, regulatory requirements, and management decisions.

Professional advice from financial advisors, valuation experts, and legal professionals is essential to ensure that the swap ratio is fair and equitable for all parties involved and complies with applicable laws and regulations.

Illustration:

Company XYZ, the parent company, is demerging its subsidiary, SubCo, into a separate entity called NewCo. Let's assume the following information:

1. Company XYZ:
   - Number of outstanding shares: 10 million
   - Market price per share: Rs. 50
2. SubCo:
   - Number of outstanding shares: 5 million
   - Market price per share: Rs.30

To determine the swap ratio, we need to calculate the relative value of SubCo compared to Company XYZ. We can do this by comparing the market capitalization of the two companies.

Market capitalization of Company XYZ = Number of shares * Market price per share = 10 million * 50 = 500 million

Market capitalization of SubCo = Number of shares * Market price per share

= 5 million * 30 = 150 million

Now, let's calculate the swap ratio:

Swap ratio = Market capitalization of SubCo / Market capitalization of Company XYZ = 150 million / 500 million = 0.3

This means that for every 0.3 shares of SubCo, shareholders of Company XYZ will receive one share of NewCo.

Let's assume a shareholder of Company XYZ owns 1,000 shares. Based on the swap ratio, they would receive:

Number of NewCo shares = Number of Company XYZ shares * Swap ratio

= 1,000 * 0.3 = 300 shares of NewCo

Please note that this is a simplified numerical example to demonstrate the concept of a swap ratio in a demerger. The actual swap ratio would depend on various factors, including the valuation of the companies, negotiations, and regulatory requirements.

Case Study -1

Surendra Industries Inc. is a manufacturing company specializing in the production of electronic components. The company has been operating for the past ten years and has established itself as a market leader in its niche.

Valuation Date: December 31, 2023

Financial Information for Surendra Industries Inc.:

- Revenue for the year ending December 31, 2023: Rs.20 million
- Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) for the year ending December 31, 2023: Rs.4 million
- Net Income for the year ending December 31, 2023: Rs.2.5 million
- Total Assets as of December 31, 2023: Rs.30 million
- Total Liabilities as of December 31, 2023: Rs.10 million
- Weighted Average Cost of Capital (WACC): 8%

Market Information:

- Industry Average Price-to-Earnings (P/E) Ratio: 12
- Industry Average Price-to-EBITDA (P/EBITDA) Ratio: 8

Calculate the valuation of Surendra Industries Inc. using the following methods:

a. Market-Based Approach (based on P/E ratio)

b. Market-Based Approach (based on P/EBITDA ratio)

c. Income-Based Approach (Discounted Cash Flow method)

d. Asset-Based Approach (Net Asset Value method)

Solution:

a. Market-Based Approach (P/E Ratio):

- Calculation:
  - Industry Average P/E Ratio: 12
  - Net Income of Surendra Industries Inc.: Rs.2.5 million
  - Valuation = Net Income x Industry Average P/E Ratio
  - Valuation = Rs.2.5 million x 12
  - Valuation = Rs.30 million

b. Market-Based Approach (P/EBITDA Ratio):

- Calculation:
  - Industry Average P/EBITDA Ratio: 8
  - EBITDA of Surendra Industries Inc.: Rs.4 million
  - Valuation = EBITDA x Industry Average P/EBITDA Ratio
  - Valuation = Rs.4 million x 8
  - Valuation = Rs.32 million

c. Income-Based Approach (Discounted Cash Flow):

- Projection of Future Cash Flows:

- Assume a conservative growth rate of 3% for the next five years.
- Projected Free Cash Flows (FCF) for the next five years:
  - Year 1: Rs.2.5 million x 1.03 = Rs.2.575 million
  - Year 2: Rs.2.575 million x 1.03 = Rs.2.651 million
  - Year 3: Rs.2.651 million x 1.03 = Rs.2.729 million
  - Year 4: Rs.2.729 million x 1.03 = Rs.2.810 million
  - Year 5: Rs.2.810 million x 1.03 = Rs.2.894 million

- Discounting Future Cash Flows:
  - Calculate the present value of projected free cash flows using the WACC of 8%.
  - Present Value (PV) of Future Cash Flows (FCF):
    - PV = FCF / (1 + r)^n
    - Where r is the discount rate (WACC), and n is the number of periods.
- Calculation of Terminal Value:
  - Estimate the terminal value of the business using the perpetuity growth method.
  - Terminal Value (TV) = FCF * (1 + g) / (r - g)
    - Assuming a perpetual growth rate (g) of 2%.
- Discounted Cash Flow (DCF) Valuation:
  - Sum the present value of projected cash flows and the terminal value to determine the total enterprise value (TEV) of the company.

d. Asset-Based Approach (Net Asset Value):

- Calculation:
  - Net Asset Value (NAV) = Total Assets - Total Liabilities
  - NAV = Rs.30 million - Rs.10 million
  - NAV = Rs.20 million

Conclusion:

Based on the above four valuation methods:

- Market-Based Approach (P/E Ratio): Rs.30 million
- Market-Based Approach (P/EBITDA Ratio): Rs.32 million
- Income-Based Approach (DCF): The total enterprise value (TEV) would be the sum of the present value of projected cash flows and the terminal value.
- Asset-Based Approach (Net Asset Value): Rs.20 million

The actual valuation of Surendra Industries Inc. may vary depending on factors such as industry dynamics, market conditions, growth prospects, and qualitative aspects of the business. It's essential to consider multiple valuation methods and factors to arrive at a comprehensive valuation estimate.

Case Study -2

AMBA Tech Solutions Ltd. is a software development company specializing in cloud-based applications. The company has been in operation for five years and has experienced rapid growth in revenue and market share.

Valuation Date: December 31, 2023

Financial Information for AMBA Tech Solutions Ltd.:

- Revenue for the year ending December 31, 2023: Rs.15 million
- Earnings Before Interest and Taxes (EBIT) for the year ending December 31, 2023: Rs.3 million
- Net Income for the year ending December 31, 2023: Rs.2 million
- Total Assets as of December 31, 2023: Rs.25 million
- Total Liabilities as of December 31, 2023: Rs.5 million
- Growth Rate: 15%

Calculate the valuation of AMBA Tech Solutions Ltd. using the Discounted Cash Flow (DCF) method.

Solution:

Discounted Cash Flow (DCF) Method:

1. **Projection of Future Cash Flows:**
   - Assume a growth rate of 15% for the next five years.
   - Projected Free Cash Flows (FCF) for the next five years:
     - Year 1: Rs.2 million x 1.15 = Rs.2.3 million
     - Year 2: Rs.2.3 million x 1.15 = Rs.2.645 million
     - Year 3: Rs.2.645 million x 1.15 = Rs.3.042 million
     - Year 4: Rs.3.042 million x 1.15 = Rs.3.498 million
     - Year 5: Rs.3.498 million x 1.15 = Rs.4.023 million
2. **Discounting Future Cash Flows:**
   - Calculate the present value of projected free cash flows using a discount rate.
   - We'll use the Weighted Average Cost of Capital (WACC) as the discount rate, assuming it's 10%.
   - Present Value (PV) of Future Cash Flows (FCF):
     - PV = FCF / (1 + r)^n
     - Where r is the discount rate (WACC), and n is the number of periods.
3. **Calculation of Terminal Value:**
   - Estimate the terminal value of the business using the perpetuity growth method.
   - Terminal Value (TV) = FCF * (1 + g) / (r - g)
     - Assuming a perpetual growth rate (g) of 5%.
4. **Discounted Cash Flow (DCF) Valuation:**
   - Sum the present value of projected cash flows and the terminal value to determine the total enterprise value (TEV) of the company.

Calculation:

- **Present Value of Future Cash Flows (FCF):**
  - Year 1: PV1 = Rs.2.3 million / (1 + 0.10)^1 = Rs.2.09 million
  - Year 2: PV2 = Rs.2.645 million / (1 + 0.10)^2 = Rs.2.13 million
  - Year 3: PV3 = Rs.3.042 million / (1 + 0.10)^3 = Rs.2.26 million
  - Year 4: PV4 = Rs.3.498 million / (1 + 0.10)^4 = Rs.2.38 million
  - Year 5: PV5 = Rs.4.023 million / (1 + 0.10)^5 = Rs.2.43 million
- **Terminal Value (TV):**
  - TV = Rs.4.023 million * (1 + 0.05) / (0.10 - 0.05) = Rs.104.46 million
- **Discounted Cash Flow (DCF) Valuation:**
  - DCF Valuation = PV1 + PV2 + PV3 + PV4 + PV5 + TV
  - DCF Valuation = Rs.2.09 million + Rs.2.13 million + Rs.2.26 million + Rs.2.38 million + Rs.2.43 million + Rs.104.46 million
  - DCF Valuation ≈ Rs.115.75 million

Conclusion:

Based on the Discounted Cash Flow (DCF) analysis, the total enterprise value (TEV) of AMBA Tech Solutions Ltd. is approximately Rs.115.75 million. This valuation approach accounts for the company's projected future cash flows and terminal value, discounted back to their present values using the weighted average cost of capital (WACC).

LESSON ROUND-UP

- Business valuation is necessitated in many circumstances such as mergers, acquisitions, demerger, takeovers, sale of a division, sale of intangible assets such as brands, patents, technical know-how, Goodwill, etc.
- Broadly there are three approaches to Valuation namely – Asset-based approach, Income-based approach and Market-based approach.
- Asset based valuation method is based on the simple assumption that adding the value of all the assets of the company and subtracting the liabilities, leaving a net asset valuation, can best determine the value of a business.
- Under Income based approach the methods are, Discounted cash flow method, Earnings capitalisation method, Excess earnings method, Incremental cash flows method.
- Under the Market based approach the methods are market price and comparable transaction multiple methods.
- Economic value added is another parameter to measure the financial performance of an enterprise.
- Valuation in takeovers, delisting, ESOPs of listed companies are subject to SEBI regulations.
- Valuation in a slump sale is governed by Income-tax Act, 1961.
- Swap ratio is the exchange ratio in a merger or acquisition between two entities.

GLOSSARY

- In 2018, IDFC Bank and Capital First announced merger between the two to form a combined entity with assets under management of `88,000 crore, branch network of 194 and customer base of over 5 million. As per the agreement, IDFC Bank will issue 139 shares for every 10 shares of Capital First. So, the swap ratio here is 1:13.9.
- The "Discovered Price" is the minimum price per Offer Share payable by the Acquirer for the Offer Shares it acquires pursuant to the Delisting Offer, as determined in accordance with the Delisting Regulations, which will be the price at which the shareholding of the Acquirer Group reaches 90% pursuant to a reverse book-building process conducted in the manner specified in Schedule II of the Delisting Regulations and shall not be lower than the Floor Price.
- Sweat equity shares are issued for consideration other than cash such as technical know-how, brand equity, design, patent or any other intangible asset. The intangible asset could come from promoters or director or even employee of the company.
- The financial performance can be determined by excess earnings of the enterprise over and above the cost of capital. This is known as the "economic value added" (EVA).

TEST YOURSELF

(These are meant for recapitulation only. Answers to these questions are not required to be submitted for evaluation.)

1. What is meant by business valuation?
2. What are the different approaches in business valuation?
3. What are the methods under Asset approach?
4. What are the methods under Income approach?
5. How business valuation is done under market approach?
6. What is slump sale? How the value is determined under the provisions of Income Tax Act, 1961?
7. What is meant by swap ratio? Where is it used?
8. Discuss in detail Contents of Summarized Valuation Report

LIST OF FURTHER READINGS

- Business Valuation in India, Wolters Kluwer Publications
- Valuation by Registered Valuers by Kamal Garg, Bharat's Publication
- Mergers and Acquisitions by Sheeba Kapil, Wiley Publications
- Mergers & Acquisitions and Corporate Valuation by Dr. Manu Sharma, Dreamtech press.

REFERENCES

- International Valuation Standards Council (IVSC) - www.ivsc.org
- American Society of Appraisers (ASA) - www.appraisers.org
- International Institute of Business Valuers (IIBV) - www.iibv.org
- Damodaran, Aswath. Investment Valuation: Tools and Techniques for Determining the Value of Any Asset.
- Peterson, David L., and Popp, Pamela M. Guide to Business Valuations.