Practical Insights on Valuation

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Valuation of a partnership firms

Valuation of Partnership Firms

Key Considerations	Remarks
Tax adjustment for Interest on partners capital	Interest on capital is an expense for the firm and accordingly would be reduced from the free cash flows of the partnership firm. However, any interest paid over and above the prescribed limit (12% p.a.) would be disallowed for the purpose of computation of income tax. Accordingly, relevant adjustment is required to be made while computing the tax expense of the partnership firm in the projected financial statements.
Tax on distribution of profits to partners	Partnership firm is not required to pay any taxes on distribution of profits to partners as in the case of Company. Accordingly, no impact of any distribution tax is considered for calculation of free cash flows.
Tax adjustment for partners remuneration	Partners remuneration is an expense for the firm and accordingly would be reduced from the free cash flows of the partnership firm. However, any remuneration paid over and above the prescribed limit would be disallowed for the purpose of computation of income tax. Accordingly, relevant adjustment is required to be made while computing the tax expense of the partnership firm in the projected financial statements.

Valuation of Partnership Firms

Key Considerations	Remarks
Calculation of discount rate	Partners of firm have an unlimited liability as compared to shareholders of a company who have the benefit of limited liability obligation. Due to this, the expected return of an investor in a partnership firm will be relatively higher and relevant risk premium should be added in the cost of equity while computing the discount rate.
Adjustments in relative valuation approach	Due to unlimited liability and lack of marketability (limited exit options), while valuing a partnership firm by using relative valuation approach, relevant adjustments need to be made in the comparable company and transaction multiples derived from public company database.

2 Valuation of Startups & handling of related tax issues

Valuation of Start-up

Key Considerations	Remarks
Method of Valuation	• As per Companies Act, 2013 preferential issue of share cannot be below the fair value and the value has to be computed as per generally accepted valuation methodology. • As per section 56(2)(viib) of Income Tax Act, 1961 preferential issue of share to Indian resident cannot be more then the fair value and the fair value need to be computed as per NAV or DCF methodology. • As per the provision of FEMA preferential issue of share to non resident cannot be below the fair value and the value need to computed as per internationally accepted valuation methodologies **Note** – In case of start-up companies NAV method is insignificant , Hence **DCF** is only valuation methodology available which works on management business plan which may not be reliable sometimes.
Angel Tax	Angel tax was introduced in Finance Act 2012 with an intention to prevent the transfer of shares at substantially less value done with the intention to facilities conversion of black money. Now, the problem arises because startups are often valued subjectively on the basis of discounted cash flows, without taking into account intangibles like goodwill. This can cause different interpretations of “fair value” and leave startups vulnerable to unduly high taxes because the assessing officers feels the investment is too high over their valuation.

Valuation of Start-up

Key Considerations	Remarks
PE/VC funds	The Rationale with these investor is that at a certain point in time, an early stage investor will want to exit the project. Therefore valuation are usually substantially higher than what can be realised at exit. They invest in a start-up as trade investment.
Discount Rate can not be computed by CAPM in case of a Start-up	Most young companies are not publicly traded Consequently, there is no way in which we can run a regression of past returns, to get an equity beta, or use a market interest rate on debt. Hence we use methods other than CAPM for calculating cost of equity. One such method is discussed in annexure -1.
Technical Issues	Due to complexity in dynamics of the start-up industry one has to address a range of technical issues. Some of them has been discussed in the annexure-2.

Valuation of Start-up

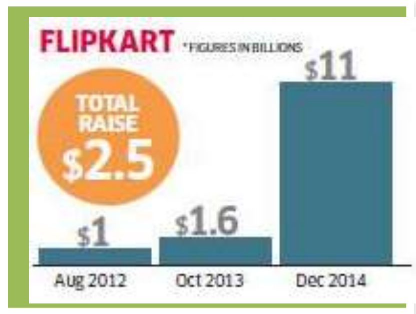
Regulatory Requirements

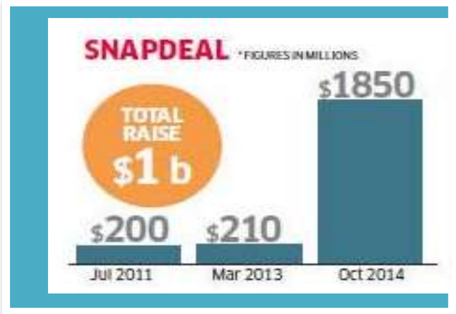
Key transactions and their valuation requirement (including suggested valuation methodologies) under Companies Act, Income Tax Act, and FEMA

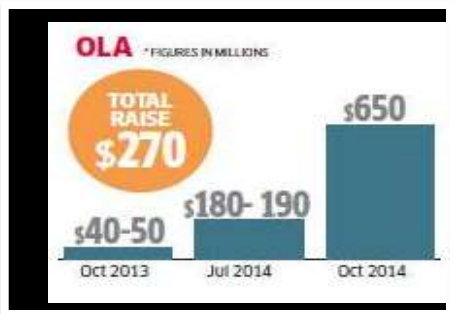
		Companies Act	Income Tax Act	FEMA
		Valuation methodologies		
		Generally accepted valuation methodologies	*Net asset value method or Discounted cash flow method*	*Internationally accepted valuation methodologies*
Key Transactions	**Preferential issue of shares to Indian resident**	*Shares can not be issued below fair value*	*Shares can not be issued at more than fair value*	NA
	Preferential issue of shares to Non-resident	*Shares can not be issued below fair value*	NA	*Shares can not be issued below fair value*
	Transfer of shares between resident (R) and non-resident (NR)	NA	*Shares can not be transferred below fair value*	***In case of R to NR**: Shares can not be transferred below fair value* ***In case of NR to R**: Shares can not be transferred at more than fair value*

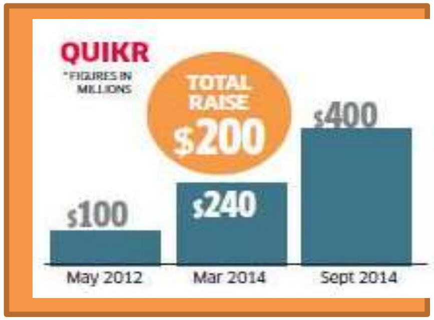
Valuation of Start-up

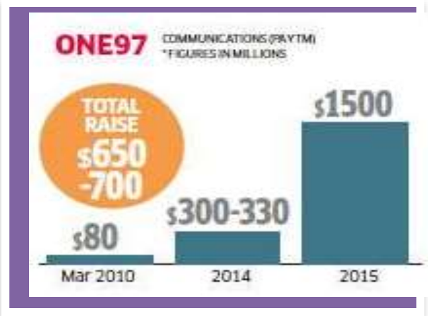
Unexpected jumps in valuation











FANNING VALUATIONS

Once an investor has set his target return multiple, he back-calculates on the basis of how much capital the startup will need to reach that multiple and what his shareholding will be when it achieves that multiple. Much of this so-called back calculation comes into play during Series A funding and becomes more pronounced in later rounds.

numbers. "Startup valuation is a kind of voodoo art," Rehan Yar Khan, founder of Mumbai-based Orios Venture Partners, quipped recently on the sidelines of a networking event when a wealth management executive quizzed him on the subject.

"Valuations are determined on the basis of what we (VCs) think could be the potential return multiple on an investment in 5-6 years. The present day valuation is back-calculated down from that target return multiple," said a Mumbai-based investor with a Silicon Valley firm.

The valuation of consumer internet companies, led by ecommerce ventures, has baffled several market observers and financial consultants. How can an online retailer losing tens of millions of dollars every month be worth more than the combined market capitalisation of all the listed retail businesses in the country?

Valuation of Start-up

Target Exit Multiple

- IRR matrix for investor (based on exit by 31st March 2020)

Investor's stake ↓ / Exit EV/ EBDITA multiple →	6	7	8	9	10	11
25%	19%	22%	25%	28%	30%	33%
30%	24%	27%	30%	33%	35%	38%
35%	27%	31%	34%	37%	39%	42%
40%	31%	34%	38%	40%	43%	46%

Investor IRR under various scenarios

Investor's Stake	Post Money Equity Value	Post Money Enterprise Value	Entry EV/EBDITA multiple (Based on FY 16 EBDITA)
25%	1,200	1,292	12
30%	**1,000**	**1,092**	**10**
35%	857	950	9
40%	750	842	8

- This method is based on value of the company at the time of exit by investor i.e. in FY 2020
- Based on proposed investor's stake in the company and exit EV/EBDITA multiple, investor IRR has been computed under various scenarios
- Entry EV/EBDITA multiple is also computed at various investor's stake level
- As per this working, target should be to get valuation of INR 1000 mn (i.e. investor's stake of 30%).

Proposed Valuation Range:

Minimum: INR 750 mn (investor's stake of 40%)

Maximum: INR 1200 (investor's stake of 25%)

Target: INR 1000 mn (investor's stake of 30%)

3 Valuation in case of limited information

Valuation in Case of Limited Information

Summary

Key issues	Possible methods that can be used for valuation
Historical Data not available for trend analysis	• In case of recent funding with the entity one can use Backsolve method. The Backsolve method uses the Black-Scholes option-pricing method (OPM) to model a group of call options which represent the different claims on the value of equity that a class of share may have in the company considering the time to maturity, within option pricing theory and assumptions • Comparable Transaction multiple method such as EV/EBITDA or EV/Revenue
Projections not provided	• Earning Capitalisation method • Normalised Discounted Cash Flow • Probability weighted (scenario analysis) DCF
Valuation of a company which belongs to unorganised market	• Real Estate Valuation – Yield Capitalisation

Annexure -1

AICPA study

Stage of Development	Plummer (1)	Scherlis and Sahlman (2)
Start Up	50% - 70%	50% - 70%
First Stage or ‘Early Development’	40% - 60%	40% - 60%
Second Stage or ‘Expansion’	35% - 50%	30% - 50%
Bridge/IPO	25% - 35%	20% - 35%

Note:
1.Plummer, James L., QED Report on Venture Capital Financial Analysis
2.Scherlis, Daniel R. and William A. Sahlman, “A Method for Valuing High, Risk, Long Term, Investments: The Venture Capital Method,” Harvard Business School Teaching Note 9,288,006, Boston: Harvard Business School Publishing.

As described in the publications referenced in this table:
1.Start-up stage investments typically are made in enterprises that are less than a year old. The venture funding is to be used substantially for product development, prototype testing, and test marketing.
2.Early development stage investments are made in enterprises that have developed prototypes that appear viable and for which further technical risk is deemed minimal, although commercial risk may be significant
3.Second Stage (expansion) investments are made when enterprises are in the expansion stage
4.Bridge/IPO stage financing covers such activities as pilot plant construction, production design, and production testing, as well as bridge financing in anticipation of a later IPO

Annexure- 2

Technical Issues

Issue arising as regards new clause 56 (2) (viib) which are dealt as under:

Company is widely held company at the time of receipt of consideration but is converted to a closely held company at the time of allotment of shares -

It appears that status of company at the time of receipt of consideration is relevant and not its status at the time of allotment of shares. Therefore, since company was not closely held co. at the time of receipt of consideration, clause viib doesn't applies.

Company is closely held company at the time of receipt of consideration but is converted to a widely held company at the time of allotment of shares -

It appears that status of company at the time of receipt of consideration is relevant and not its status at the time of allotment of shares. Therefore, since company was closely held co. at the time of receipt of consideration, question of taxability under new clause (*viib*) needs to be considered.

Consideration was received from a non-resident who became a resident at the time of allotment –

Since clause (*viib*) applies to consideration received from a resident, the residential status at the time of receipt of consideration by company and not residential status at the time of allotment is relevant. Therefore, as person from consideration was received is non-resident at the time of receipt of consideration, no question of taxability under new clause (*viib*) arises.

What happens if subsequently that share money is refunded and shares not allotted?

It appears that mere receipt of consideration will attract taxability under new section 56(2)(*viib*). Subsequent refund is irrelevant.

Thanks…

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