ICAI VALUATION STANDARDS 2018

June 7, 2019
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Table of Contents

Section Overview

01

Introduction

ICAI Valuation Standards 2018 (‘IVS’)
Introduction

- The Institute of Chartered Accountants of India (ICAI), recognising the need to have the consistent, uniform and transparent valuation policies and harmonise the diverse practices in use in India, constituted the **Valuation Standards Board (VSB)** on **28 February, 2017.**

- On **18 October 2017,** the Ministry of Corporate Affairs (MCA) notified **Section 247 of the Companies Act, 2013**.

- On the same day, the **Companies (Registered Valuers and Valuation) Rules, 2017** (“Rules”), were also issued by MCA. These Rules provide that the valuation standards would be notified by the Central Government (“CG”) on the recommendation of the committee set up for this purpose.

- Provided that until the valuation standards are notified or modified by the Central Government, a valuer shall make valuations as per-

    - Internationally accepted valuation standards;

    - **Valuation standards adopted by any Registered Valuer Organisation (‘RVO’)**

- **On 10 June 2018,** ICAI issued the preface to the ICAI Valuation Standards 2018 and IVS became effective **on 1 July 2018** till the time valuation standards are notified by the CG.

ICAI Valuation Standards 2018 ('IVS')
Reasons for Introduction of Valuation Standards

- Profound changes in economic and business environment.
- Development of new financial instruments
- Increase in public participation in the financial market
- Need for stakeholders to be updated of their investment

- VSB introduced the ICAI Valuation Standards ("IVS") as there were no prior standards for valuation
- IVS solves the two underlying issues:

Standardisation of various principles, practices and procedures to be followed

Setting out of internationally accepted concepts, principles and procedures

Internationally Prominent Valuation Bodies

- International Valuation Standards Council (IVSC),
- The Appraisal Foundation (TAF),
- The Royal Institution of Chartered Surveyors (RICS),
- The CFA Institute, the American Society of Appraisers (ASA) and
- The Canadian Institute of Chartered Business Valuators (CICBV).

Which International Standards are followed by Indian Valuers

- International Valuation Standards issued by IVSC
- Red Book by Royal Institute of Chartered Surveyors (RICS)
- USPAP (Uniform Standards of Professional Appraisal Practice)
- European Valuation Standards

- Actual status of valuation profession and practice is fragmented and not so consistent from global prospective.
- Many of the countries use their Local Standards

ICAI Valuation Standards 2018 (‘IVS’)
Distinguished Features

Distinguished Features

- ICAI Valuation Standards have been made **applicable for all the valuation engagements on mandatory basis under the Companies Act, 2013**.
- In respect of **valuation engagements under other** statutes like Income Tax, SEBI, FEMA etc it will be on **recommendatory** basis for the members of ICAI.
- ICAI Valuation Standards have been **formulated as per applicable laws, customs, usages and business environment prevailing in India**. They deal with India’s special needs and conditions arising from the country’s economic, social and legal environment.
- Principles adopted by the ICAI Valuation Standards are **globally accepted** (subject to few changes from India perspective).
- These standards have been formulated also considering the **fair value principles** as per Ind AS 113 as notified by Ministry of Corporate Affairs.
- **No guidance provided on valuation of Land & Building and Plant & Machinery.**

Valuation Requirements under the Companies Act, 2013

02

Valuation Requirements under Companies Act, 2013

S. No.	Section	Synopsis
1	39(4)	Allotment of securities for consideration other than cash
2	54(1)	Issue of Sweat Equity Shares in case of unlisted companies
3	62(1)(c)	Issue of shares/ convertible securities on preferential basis by unlisted company for cash or for consideration other than cash
4	67(3)(b)	Provision of money by company for purchase of its own shares by employees or by trustees for the benefit of employees
5	191	Payment (other than in cash) to directors by way of compensation for loss of office or as consideration for retirement from office in connection with transfer of undertaking, property or shares of the company
6	192(2)	Director of a company or its holding, subsidiary or associate company or any person connected with him acquires or wants to acquire asset from the company for consideration other than cash, or vice versa.

Valuation Requirements under Companies Act, 2013

S. No.	Section	Synopsis
7	230(2)(c)(v)	In case of any scheme of corporate debt structuring
8	230(11)	Offer of takeover of an unlisted company as a result of compromise or arrangement
9	230(3)	For valuation including swap ratio under a scheme of compromise or arrangement, copy of valuer to accompanied
10	232(2)	In case of any scheme for the reconstruction of the company or companies involving merger/ amalgamation or demerger
11	232(3)(h)(B)	Exit for dissenting shareholders of transferor company
12	236(2)	Purchase of minority shareholding
13	281(1)(a)	Submission of report by Company Liquidator in case of winding up order by NCLT

Valuation Standards: Structure

03

Valuation Standards: Structure

Preface to the Indian Valuation Standards: Formation of Valuation Standards Board, its Objectives, Functions, Scope, Procedure for Issuing Valuation Standards.

Framework for the Preparation of Valuation Report in accordance with the Indian Valuation: Standards The framework sets out the concepts that underlie the preparation of valuation reports in accordance with the Indian Valuation Standards for its users.

ICAI Valuation Standard (IVS)	Name of Standard	Synopsis
IVS 101	Definitions	To prescribe specific **definitions and principles** which are applicable to the Indian Valuation Standards, dealt specifically in other standards. The definitions enunciated in this Standard shall guide and form the basis for certain terms used in other valuation standards prescribed herein.
IVS 102	Valuation Bases	• Defines the important **valuation bases**; • Prescribes the measurement assumptions on which the value will be based; and • Explains the **premises of values**.
IVS 103	Valuation Approaches and Methods	• Defines the **approaches and methods** for valuing an asset. • Provides guidance on use of various valuation approaches/methods.

Valuation Standards: Structure

ICAI Valuation Standard (IVS)	Name of Standard	Synopsis
IVS 201	Scope of work, Analyses and Evolution	• Determining and **documenting the scope/terms** of a valuation engagement, responsibilities of the valuer and the client. • **Extent of analyses** and evaluations to be carried out by the valuer. • Responsibilities of the valuer while **relying on the work of other experts.**
IVS 202	Valuation report and documentation	• **Minimum content** of the valuation report; • Basis for preparation of the valuation report; and • Basis for maintaining sufficient and **appropriate documentation**.
IVS 301	Business Valuation	• **Guidance for business valuers** who are performing business valuation or business ownership interests valuation engagements. • Establish uniform concepts, principles, practices and procedures for valuers performing valuation services.
IVS 302	Intangible Assets	• Prescribes specific guidelines and principles which are applicable to the **valuation of intangible assets** that are not dealt specifically in another Standard.
IVS 303	Financial Instruments	• Establishes principles, suggests methodology and considerations to be followed by a valuer in performing valuation of financial instruments. • Supplements the other ICAI Valuation Standards by providing specific principles and considerations in relation to financial instruments.

04

Valuation Standards: Discussion

IVS 101 – Definitions
Brief Discussion

Objective

- To **prescribe specific definitions and principles** which are applicable to ICAI Valuation standards, dealt specifically in other standards.

- The definitions enunciated in this standard shall **guide and form the basis** for certain terms used in other valuation standards.

Scope

This Standard **does not apply** in cases where a valuer is required to use a definition that are prescribed:

- by **any law, Regulations**; or
- Rules or directions of any government or regulatory authority.

Definitions

These standard contains the **definitions** which are generally **used during** the terms of **valuation engagement**.

Definitions

1. Active Market

- Active Market is a market in which transactions for the asset or liability take place with **sufficient frequency and volume** to provide pricing information on an ongoing basis.

- For **listed securities**, active market would refer to one where **activity/transaction is ongoing** and as defined in the guidelines issued by SEBI.

2. As-is-where-is Basis

- The term as-is-where-is basis will consider **the existing use of the asset** which may or may not be its highest and best use.

IVS 101 – Definitions
Definitions

3. Control Premium

- Control Premium is an amount that a buyer is willing to pay **over the current market price** of a publicly-traded company to **acquire a controlling interest in an asset.**

- It is opposite of discount for lack of control to be applied in case of valuation of a noncontrolling/ minority interest.

4. Forced Transaction

- Forced transaction is a transaction where a **seller is under constraints** to sell an asset without appropriate marketing period or efforts to market such asset.

Definitions

5. Highest and Best Use

- The highest and the best use is the use of a **non-financial asset** by market participants that would **maximise the value of the asset** or the group of assets (e.g., a business) within which the asset would be used.

6. Liquidation Value

- It is the amount that will be **realised on sale of an asset or a group of assets** when an actual/hypothetical termination of the business is contemplated/ assumed.

Definitions

7. Market Participants

Market participants are **willing buyers and willing sellers** in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

- They are **independent of each other** i.e. they are not related parties. Although the price in a related party transaction may be used if the entity has evidence that the transaction was entered into at market terms;
- They are **knowledgeable**, having a reasonable understanding about the asset or liability and the transaction
- They are **willing to enter** into a transaction for the asset or liability, i.e., they are not forced or otherwise compelled to do so.

Definitions

8. Observable Inputs

- Inputs that are developed using **market data**, such as **publicly available information** about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability.

- **Example** of markets for observable inputs: **Exchange markets**, dealer markets, brokered markets

9. Unobservable Inputs

- Inputs for which **market data are not available** and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability.

- **Example: Management Cash flow projections**.

IVS 101 – Definitions
Definitions

10. Orderly Transaction

- Orderly transaction is a transaction that assumes **exposure to the market** for a period before the valuation date to **allow for marketing activities** that are usual and customary for transactions involving such assets or liabilities and it is not a forced transaction.

11. Participant Specific Value

- Participant specific value is the estimated value of an asset or liability **considering specific advantages or disadvantages** of either **of the owner** or identified acquirer or identified participants.

Definitions

12. Premise of Value

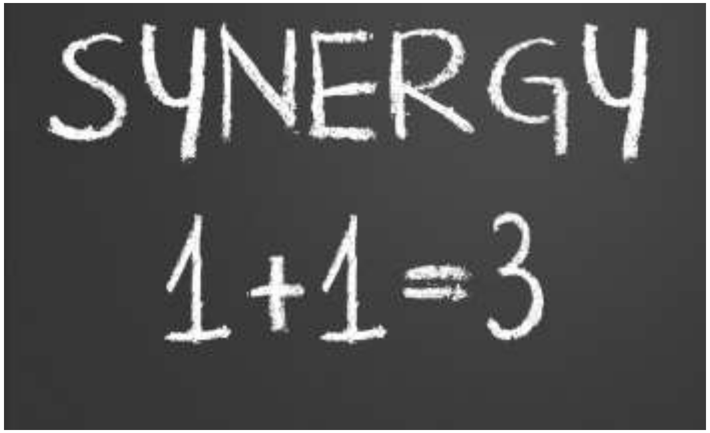
- Premise of value refers to the **conditions and circumstances** how an asset is deployed.

13. Valuation Base

- Valuation base means the indication of the **type of value being** used in an assignment.

14. Synergies

- Synergies is a concept which indicates that the **combining effect of two or more assets** or group of assets and liabilities or two or more entities in terms of their value and benefits will be or is likely to be, **greater than that of their individual values on a standalone basis.**



Definitions

15. Orderly Liquidation

- An orderly liquidation refers to the **realizable value** of an asset in the event of a liquidation **after allowing appropriate marketing efforts** and a reasonable period of time to market the asset on an as-is, where-is basis

16. Rule of thumb or Benchmark value

- Rule of thumb or benchmark indicator is used as a **reasonable check against the values** determined by the use of **other valuation approaches** in a valuation engagement.

IVS 102 – Valuation Bases
Brief Discussion

Objective

- Define **important valuation bases on which valuation is based**
- Explain premises of value
- Prescribes the measurement assumptions on which the value will be based

Scope

- This Standard shall be applied in selecting the appropriate valuation bases.
- This Standard does **not apply in cases where a valuer is required to adopt valuation bases that are prescribed:**

  i. by a Statute, or Regulations; or

  ii. in an agreement/ arrangement between the parties.

Application

IVS 102 provides **three Valuation Bases and five Valuation Premise** which are required to be chosen by a valuer considering the terms and purpose of the valuation engagement.

IVS 102 – Valuation Bases

Valuation base means the indication of type of value being used in an engagement

Valuation Bases

- Fair Value
- Participant Specific Value
- Liquidation Value

A valuer is responsible for ***selecting the appropriate valuation base considering the terms of engagement and the intended purpose of the valuation.*** *The valuer shall use the relevant valuation approach(es) and adhere to other assumptions associated with the valuation bases.*

IVS 102 – Valuation Bases

Fair Value	Participant Specific Value	Liquidation Value
Fair value is the **price** that would be **received** to sell an asset or paid to transfer a liability in an **orderly transaction between market participants** at the valuation date	• Participant specific value is the estimated value of an asset or liability **considering specific advantages or disadvantages** of either of the **owner** or **identified acquirer** or identified participants • **For example** participant specific value for **transfer of 2% stake** by a minority shareholder to a shareholder holding 49% stake will consider aspects such as **minority discount and control premium**	Liquidation value is the amount that will be **realised on sale of an asset** or a group of assets when an actual/hypothetical termination of the business is contemplated/assumed

Premise of Value

Premise of Value

*It refers to the **conditions and circumstances how an asset is deployed**. The premise of value as provided by IVS are as follow:*

Highest and Best Use

Going Concern Value

As is where is Value

Orderly Liquidation

Forced Transaction

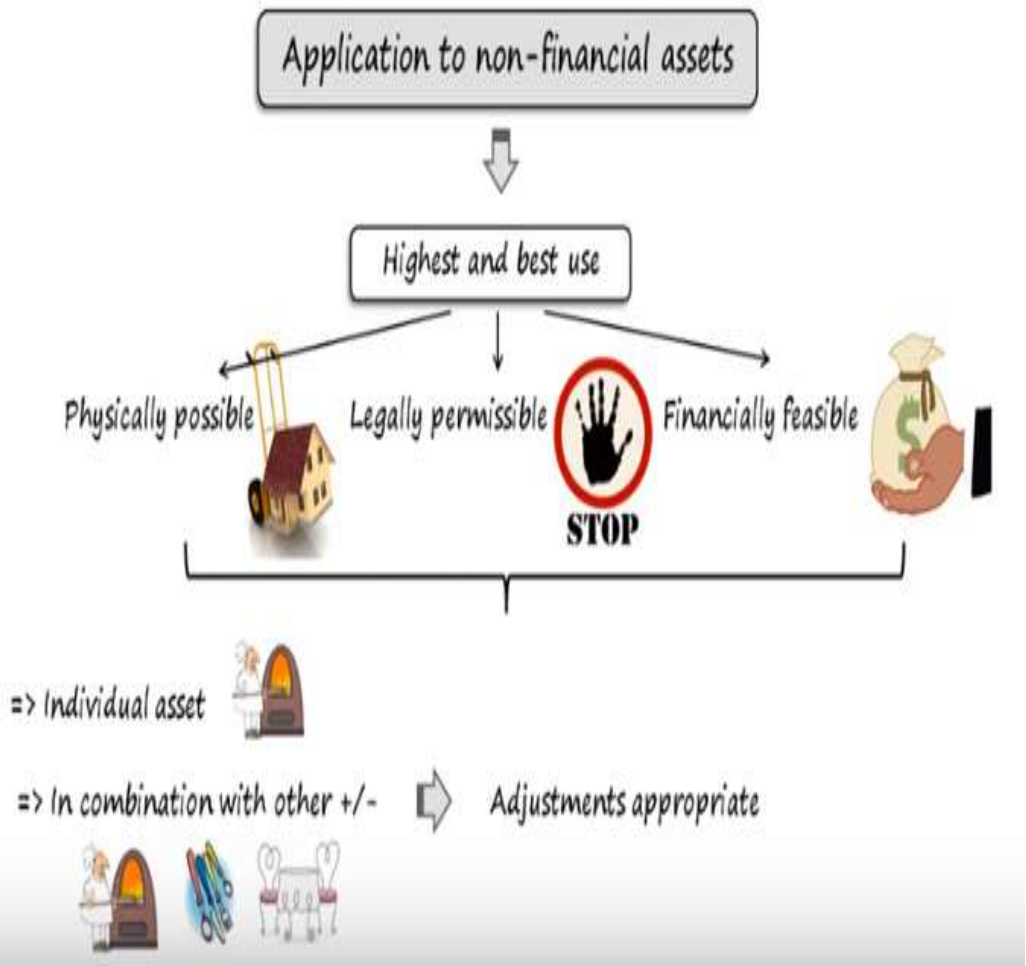
Premise of Value

Highest and Best Use

The highest and best use of an asset might provide **maximum value** through either:-

- Its **use** in **combination** with other assets and liabilities
  or
- On a **standalone** basis

- An entity is **not required** to perform an **exhaustive search** for other **potential uses** if there is **no evidence** to suggest that current use is not the best use



Application of Fair Value to Non Financial Assets (Illustration)

Illustration:

Company A owns a **factory property** comprising of **freehold land and building** which are accounted for in books as **different elements** and no depreciation on the land is claimed. Company A **accounts** for the factory property using **revaluation model** in accordance with Ind AS 16.

Taking into account all available market and other factors, Company A **determines** that the **highest and best use** of the property is to develop a **high rise commercial building** looking at redevelopment of nearby sites for high rise commercial building

Question:
How should Company A **determine the FV** of the property?

Answer:
The FV of the property should be determined on the **assumption** that Company A would dispose the factory building to market participants at the measurement date and such market participants would **demolish** the factory building and **use** the site to **develop a high rise commercial building**.

IVS 102 – Valuation Bases
Premise of Value

Going concern value

- Going Concern value is the value of a business enterprise that is expected **to continue to operate in the future.**
- The intangible elements of **going concern result** from factors such as having a ***trained workforce, operational plant, having necessary license etc***.

As-is-where-is-basis

- As-is-where-is-basis will consider the **existing use of the asset** which may or may not be its highest and best use.

IVS 102 – Valuation Bases
Premise of Value

Orderly Liquidation

- An orderly liquidation refers to the **realisable value of an asset** in the event of a liquidation after **allowing appropriate marketing efforts** and a reasonable period of time to market the asset on an as-is, where-is basis.

Forced Transaction

- Forced transaction is a transaction where a **seller is under constraints** to sell an asset without appropriate marketing period or effort to market such asset.

IVS 102 – Valuation Bases

Transaction Cost

These are the **costs to sell an asset or transfer a liability** in the principle (or most advantageous) market for the asset that are directly attributable to the disposal of the asset or transfer of liability and **which meet both the following criteria**:

- **They result directly from and are essential to the transaction**
- **They would not have been incurred, had the decision to sell the asset or transfer the liability not been made**

Note: *We don't make adjustment for the transaction cost while calculating the fair value of the asset.*

IVS 103 – Valuation Approaches and Methods
Brief Discussion

Objective

- To provide **guidance on various valuation approaches/ methods** that can be adopted while valuing an asset.
- Defines the approaches and methods for valuation

Scope

This Standard shall be applied in selecting the appropriate valuation approaches and methodologies in determining the value of an asset, liability or a business

except

where a *valuer* is required to adopt valuation bases that are prescribed by a statute or regulation.

Application

- This standard explain **various valuation approaches and methodologies** along with the likely situations in which the various methods could be applied.
- It provides to use combination of methods and give weightages**. A valuer shall consider the reasonableness of the range of values, when evaluating a value resulting from use of multiple valuation approaches/ methods**.

IVS 103 – Valuation Approaches and Methods
Valuation Approaches

Valuation Approaches

- **Market Approach**
  - Market Price Method
  - Comparable Companies Multiple Method
  - Comparable Transaction Multiple Method
- **Income Approach**
  - Discount Cash Flow Method
  - Relief From Royalty Method
  - Multi-Period Excess Earning Method
  - With and Without Method
  - Option Pricing Models
- **Cost Approach**
  - Replacement Cost Method
  - Reproduction Cost Method

The valuation approaches and methods shall be selected in a manner which would ***maximise*** *the use of relevant* ***observable inputs*** *and* ***minimise*** *the use of* ***unobservable inputs****. The price information gathered from an active market is generally considered to be a strong indicator of value.*

Market Approach

Market Approach

Meaning

- It is a valuation approach that **uses prices and other relevant information generated by market transactions involving identical or comparable** (i.e., similar) assets, liabilities or a group of assets and liabilities, such as a business

Applicability

This approach is easiest to use when

- there are a **large number of assets comparable** to the one being valued
- these assets are **priced in a market**
- there **exists some common variable** than can be used to standardize the price

Methods under Market Approach

Commonly used methods under market approach are:

Market Price Method	• In this method, valuer shall consider the **traded price observed over a reasonable period** while valuing assets which are traded in the active market.
Comparable Companies Method	• Comparable Companies Multiple Method, also known as Guideline Public Company Method, involves **valuing an asset based on market multiples** derived from prices of market comparable traded on active market.
Comparable Transaction Multiple Method	• Comparable Transaction Multiple Method, also known as 'Guideline Transaction Method' involves **valuing an asset based on transaction multiples** derived from prices paid in transactions of asset to be valued /market comparables (comparable transactions).

IVS 103 – Valuation Approaches and Methods
Steps under Market Approach

1	**Identify** the **Comparable Assets** (Public companies or transactions)
2	Obtain **market value** for these assets
3	**Convert these market values** into **valuation multiples** (EV/ EBITDA, EV/ Revenue, PE Multiple).
4	**Compare** the asset to be valued **with the market comparables** to understand material differences; and make **necessary adjustments** to the market multiple to account for such differences, if any;
5	Apply the **adjusted market multiple** to the **relevant parameter of the asset** to be valued to arrive at the value of such asset; and
6	If value of the asset is derived by using **multiples based on different metrics/parameters**, consider the reasonableness of the range of values

Market Approach

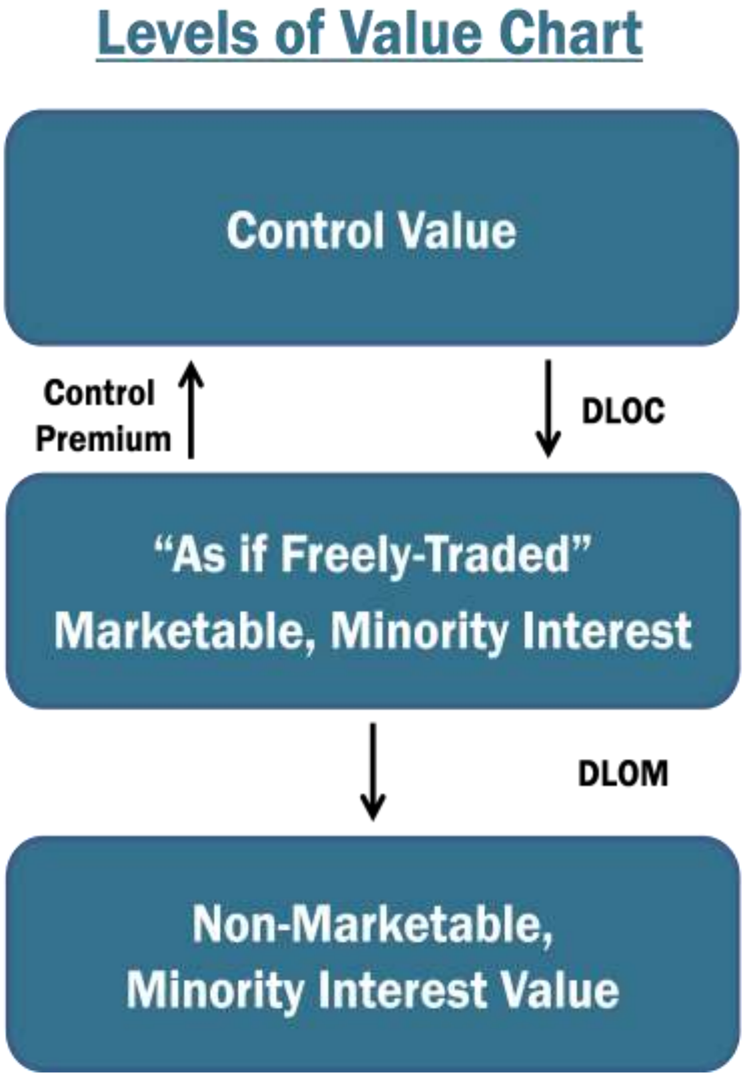
Examples of Market/ Transaction Multiple

Valuation Multiple	Formula	Remarks
EV/ Sales	Enterprise Value / Sales	• Provides Enterprise Value • Mainly used in case of technology companies or companies in early stage of development (incurring losses)
EV/ EBITDA	Enterprise Value / EBITDA	• Provides Enterprise Value • Mostly commonly used for valuing companies across industries specially manufacturing companies
PE Ratio	Price/ Earnings	• Provides Equity Value • Mostly commonly used for valuing companies across industries specially manufacturing companies • Need to evaluate impact of accounting policies
Price to Book	Market Cap/ Net Worth	• Provide Equity Value • Mainly used in case of asset heavy business such as financial institutes
Industry Specific Multiples	• EV/ User: Social Media • EV/ MW: Power Companies • EV/ Room: Hotel Companies	• EV/Tower: Tower Telecom Companies • EV/ARR: Enterprise SAAS Companies • EV/GMV: E-Commerce Companies

Market Approach
Other Key Considerations – DLOM/ DLOC

- As per para 38-48 of ICAI valuation standard 103, **DLOM and DLOCs may be applied on the professional judgement of the valuer** considering the factors such as
  - ➢ size and nature,
  - ➢ amount/ extent of control,
  - ➢ time and cost associated with marketing,
  - ➢ restriction on transfer of subject asset etc.

- Due to **lack of empirical data** specific to Indian markets, it is believed that DLOM/ DLOC shall be **left to the judgement of the valuer.**



Market Approach

Discount for Lack of Control ('DLOC')

- The **value of control** is a premium paid by an investor for the **ability to exercise a variety of rights associated with control** over the operations and financial performance of a business.

- **Holders of a non-controlling interest** are at a relative **disadvantage** due to lack of absolute voting power.

- **Some of the Common Elements of Control**:
  - To Elect directors and appoint management
  - To acquire and liquidate assets
  - To make changes in organizational documents
  - To do strategic decisions in the company

- ***For calculation of DLOC, control premium is converted into a discount for lack of control.***

DLOC = (1-1/(1+CP))

Market Approach
Discount for Lack of Marketability (‘DLOC’)

‘A closely-held entity cannot be considered as marketable as publicly traded entities’.

- Investments that **lack the liquidity** of publicly traded securities **are less attractive** than otherwise identical investments.
- Accordingly, **it is a logical** and accepted valuation practice **to discount the value** of illiquid interests to reflect this disparity.

Several empirical studies published in mature economies can be used which focus on two types of transactions: restricted stock transactions and pre-IPO transactions.

Some statistical models used for computing DLOM are:

- **Differential Put Method**
- **Protective Put Method (Chaffe)**
- **Average Strike-Put Method (Finnerty)**

Income Approach

Income Approach

- Income approach is a valuation approach that **converts maintainable or future amounts (e.g., cash flows or income and expenses) to a single current (i.e., discounted or capitalised) amount.** The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts.

- ***This approach is designed to use for assets that derive their value from their capacity to generate cash flows in future.***

- Two Common Valuation methods under the Income Approach for Business Valuation

Discounted Cash Flow ('DCF') Method

Capitalization of Earning Method

IVS 103 – Valuation Approaches and Methods
Capitalization of Earning Method

Capitalization method

Based on determination of two factors

Normalized earnings

Capitalization Rate

Business value = Normalized earnings/ (Discount rate – Long term Growth Rate)

Future Maintainable Profit (after tax) – Normalized Earnings

- Historical trend
- Non-recurring income & expenses
- Non-operating income & expenses (separate adjustment for value of surplus asset)
- Key changes in industry / company / product dynamics
- Suitable weights

IVS 103 – Valuation Approaches and Methods
Income Approach

Discounted Cash Flow Method ('DCF')

- The DCF method values the asset by **discounting the cash flows** expected to be generated by the asset for the **explicit forecast period** and also the **perpetuity value** (or terminal value) in case of assets with indefinite life.

- Following are the major inputs for DCF

Cash Flows
- **Free Cash Flows to Firm**
- **Free Cash Flows to Equity**

Discount Rate
- **Cost of Equity**
- **WACC**
- **IRR**
- **Cost of Debt**
- **Yield**

Terminal Value
- **Gordon Growth Model**
- **Variable Growth Model**
- **Exit Multiple Method**
- **Liquidation Value**

Discounted Cash Flow Method - Process

Process overview:

a) **Projections** – Consider the **projections to determine the future cash flows** expected to be generated.

b) **Analysis** – **Analyse the projections** and its underlying assumptions **to assess the reasonableness** of the cash flows

c) **Cash flows** – Choose the **most appropriate type of cash flows** for the asset, viz., pre-tax or post-tax cash flows, free cash flows to equity or free cash flows to firm

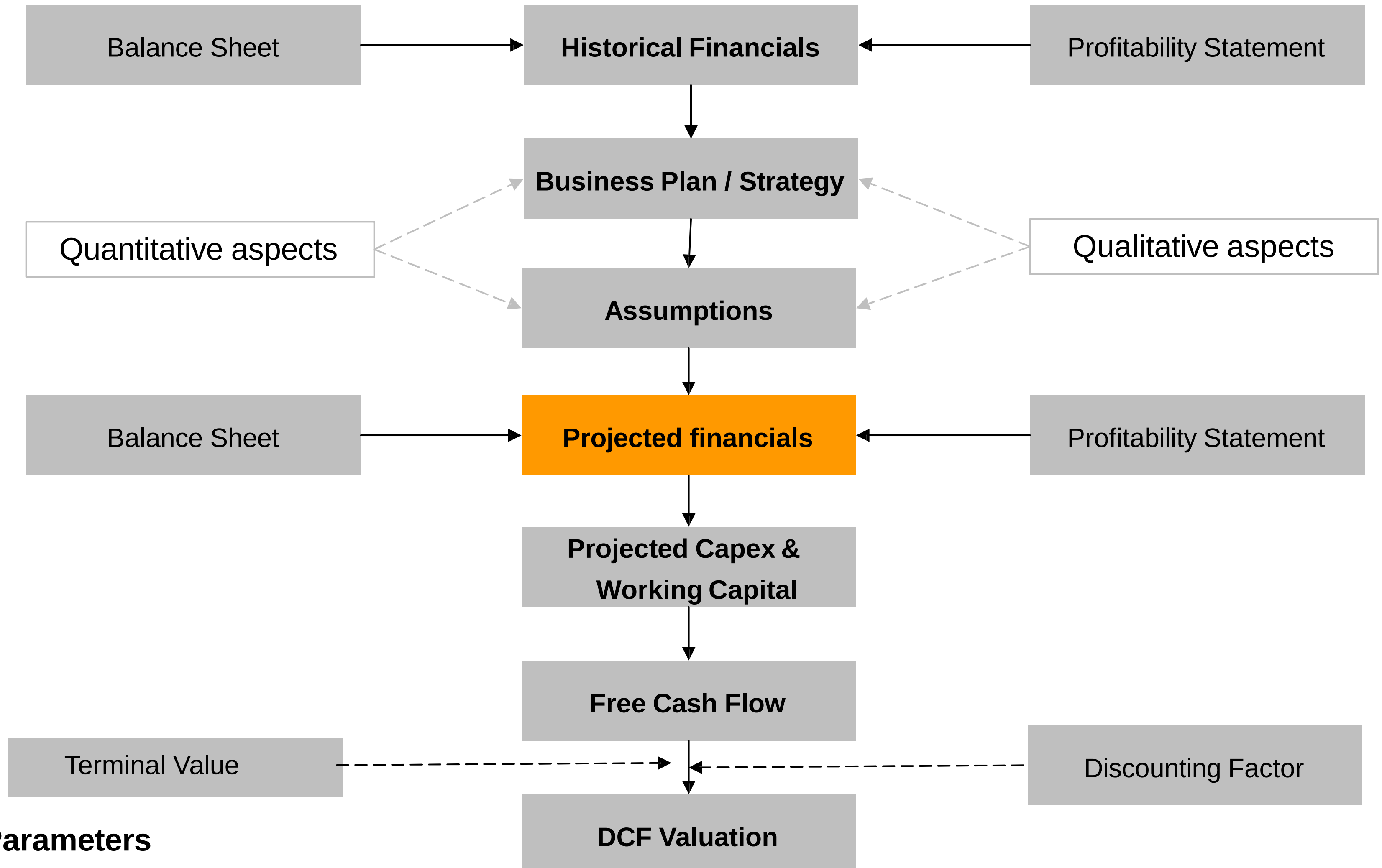
d) **Discount Rate** – Determine the discount rate

e) **Growth Rate** – Determine the **growth rate beyond the explicit forecast period**

f) **Present Value and Terminal Value** – Apply the discount rate to arrive at the present value of the explicit period cash flows and for arriving at the terminal value.

g) **Enterprise to Equity Value** – Adjustment in Enterprise Value to arrive at Equity Value

IVS 103 – Valuation Approaches and Methods
DCF – Key Steps



Key Parameters

- Free Cash Flows
- Discounting factor
- Terminal Value

Income Approach
Projections – FCFF Vs FCFE

The following are the cash flows which are used for the projections*:*

(a) ***Free Cash Flows to Firm (FCFF)****:* FCFF refers to cash flows that are **available to all the providers of capital,** i.e. equity shareholders, preference shareholders and lenders. Therefore, cash flows required to service lenders and preference shareholders such as interest, dividend, repayment of principal amount and even additional fund raising are not considered in the calculation of FCFF

(b) ***Free Cash Flow to Equity (FCFE):*** FCFE refers to cash flows available **to equity shareholders** and therefore, cash flows after interest, dividend to preference shareholders, principal repayment and additional funds raised from lenders / preference shareholders are considered.

Income Approach

Projections – FCFF Vs FCFE

Free Cash Flows to Equity

- Valuation of equity stake in business
- Based on expected cash flows - net of all outflows, including tax, interest and principal payments, reinvestment needs

	MINR
PAT	
Add: Depreciation	
Less: Capital Expenditure	
(Add) / Less: Increase / (Decrease) in Working Capital*	
Add / (Less): Borrowings / loan repayment	
Free Cash Flow to Equity (FCFE)	

Free Cash Flows to Firm

- Value of firm for all the stakeholders – lenders and equity investors
- Net of tax but prior to debt payments
- Measures free cash flow to firm before all financing costs
- Business Value independent of the capital structure

	MINR
EBITDA	
Less: Tax (tax on PBIT)	
Less: Capital Expenditure	
Less: Increase / (Decrease) in Working Capital*	
Free Cash Flow to Firm (FCFF)	

** Non-Cash Non-Debt Net Working Capital*

Income Approach
Projections – Key Considerations

- **Most important assumptions**:

Sales Growth: Use divisional, product-line or location-by-location build-up or simple growth assumption

Operating Margins: Evaluate improvement over time, competitive factors

Adjustment of related party transaction, owners' compensation at market level

Depreciation and Capex: Should confirm with historic and projected capex and Consider both maintenance and expansion capex

Changes in net working capital: Should correspond to historical patters and grow as business grows

Be prepared to articulate why projections may or may not be similar to past results (e.g. reasons behind margin improvements, increased sales growth, etc.):

Income Approach
Discount Rate

- Discount Rate is the return expected by a ***market participant*** from a particular investment and shall **reflect not only the time value of money** but also **the risk inherent in the asset being valued** as well as **the risk inherent in achieving the future cash flows.**

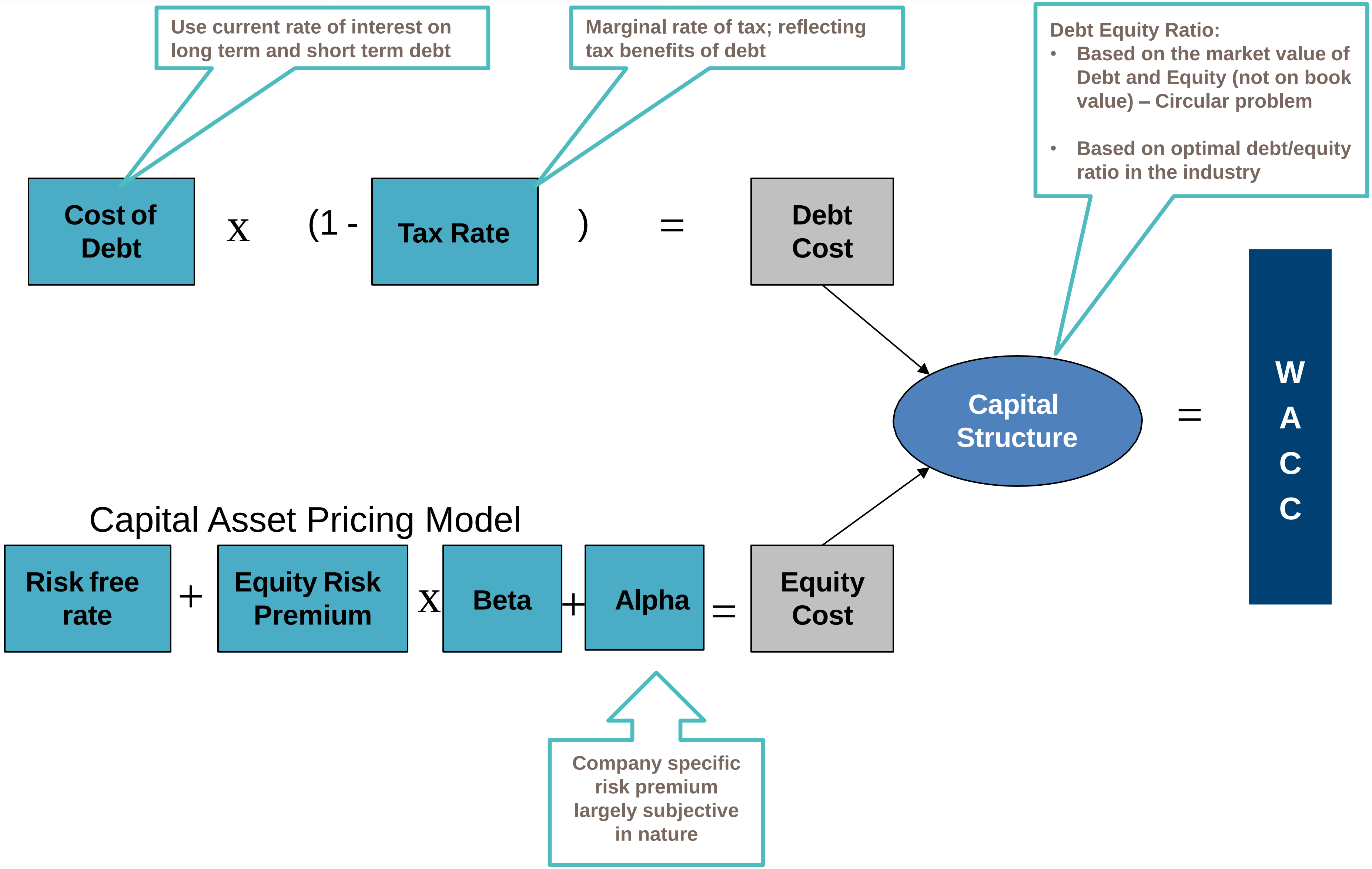
- **Discount rate should be consistent with both the riskiness and type of cashflow being discounted**

Equity versus Firm:

- If cashflows being discounted are cashflows to **equity,** the appropriate discount rate is a **cost of equity**.
- If the cash flows are cash flows to **firm**, the appropriate discount rate is the **weighted average cost of capital (WACC)**

Currency:
The **currency in which the cashflows** are estimated should also be the **currency which the discount rate** is estimated

Income Approach
Discount Rate - WACC



Discount Rate – Cost of Equity (CAPM)

Return on equity = Rf + β (Rm – Rf)

Components of CAPM

- **Rf (Risk free rate)** – Based on the **zero coupon yield curve** of Government securities having maturity of at least 10 years. It represents an alternative rate of return to the investor that is risk free and has liquidity.

- **Rm (Return from market)** - return from the equity market, is based on historical returns over a long period. Long term return on Sensex.

- **Rm - Rf (the market premium)** is the amount by which the historical equity returns from the market have exceeded the risk free rate.

- **Beta (β)** - is a measure of the **sensitivity of the movement in returns** on a particular stock to movements in returns on some measure of the market (i.e. BSE SENSEX, NIFTY etc.). Typically, higher the sensitivity, higher would be the beta thus implying that higher would be the risk.

Income Approach
Discount Rate – Cost of Equity (CAPM) - Beta

- **Obtaining Beta for Unlisted Companies**
  - Identify list of comparable listed companies
  - Obtain Betas for comparable listed companies
  - Betas can be obtained from databases, financial magazines, websites or computed in excel
  - Beta = Covariance of the Asset with Market Portfolio / Variance of Market Portfolio

- **Adjustment for Levered / Unlevered Beta**
  - Beta of listed comparable companies should be **unlevered using Debt/ Equity ratios** for each of the companies
  - The selected industry Beta should be **relevered** using the Debt/ Equity ratio of the company to be valued

$$B_U = \frac{B_L}{[1 + (1 - T_C) \times (D/E)]}$$

Discount Rate – Cost of Equity (CAPM) - Beta

Value of Beta and its Interpretation

- Beta < 0 (Negative Beta) Inverse relation to the market - is possible but highly unlikely

- Beta = 0 Regardless of which way the market moves, the value remains unchanged.
    - Eg: Cash and Government Securities

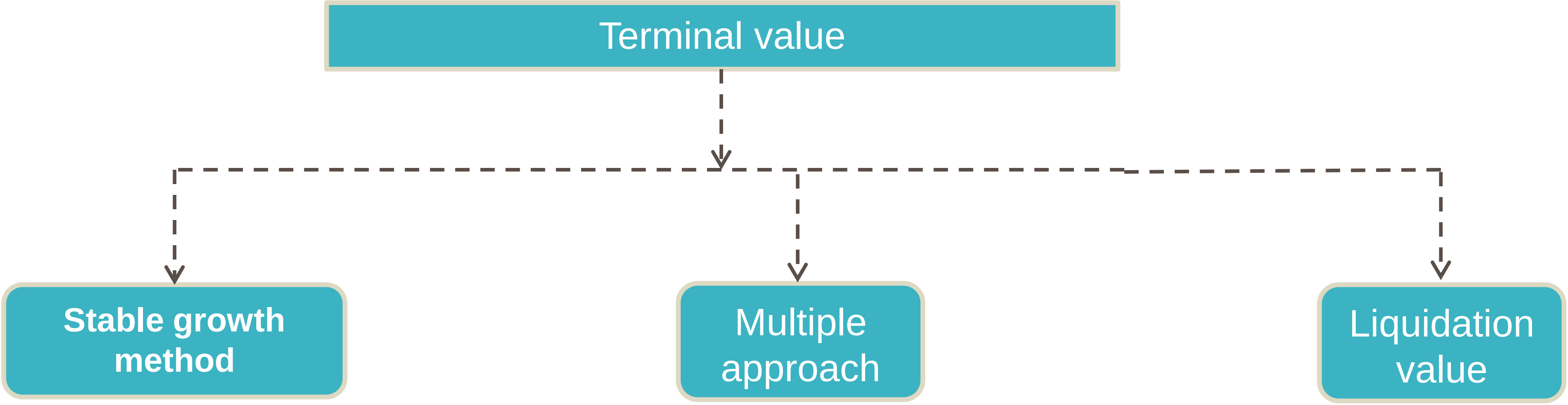
- 0<Beta<1 Companies have volatility lower than the market
    - Eg: FMCG stocks

- Beta = 1 Stock or portfolio tracks the market closely
    - Eg: Index funds

- Beta >1 Denotes a volatility that is greater than the market
    - Eg: Real estate stocks

Income Approach
Terminal Value

- Terminal value represents the **present value at the end of explicit forecast period** of all subsequent cash flows to the end of the life of the asset or into perpetuity if the asset has an indefinite life.
- In case of assets having indefinite or very long useful life, it is not practical to project the cash flows for such indefinite or long periods. Therefore, the valuer needs to determine the terminal value to capture the value of the asset at the end of explicit forecast period.



Income Approach

Terminal Value – Stable Growth Method

- **Calculation of Terminal Value** :

$$\frac{\text{FCF in the last year of projection}*(1+\text{growth rate})}{(\text{Discounting Factor} - \text{growth rate})}$$

- The **growth rate used** in the model has to be **less than or equal to the expected nominal growth rate in the economy** in which the firm operates

- Depreciation and capital expenditure should be equal or at a steady state

Terminal Value – Other Methods

Exit Multiple Methods

- The estimation of terminal value under this method involves **application of a market-evidence based on a market multiple** to the perpetuity earnings / income
  - EV/EBITDA multiple of industry etc.
- Mainly used in case of valuation of startup companies or valuation by PE/ VC Investors

Salvage or Liquidation Value

- In some cases, **such as mine or oil fields**, the **terminal value has limited or no relationship** with the cash flows projected for the explicit forecast period.
- For such assets, the terminal value is calculated as the salvage or realizable value less costs to be incurred for disposing of such asset.

IVS 103 – Valuation Approaches and Methods

Cost Approach

Cost approach is a valuation approach that reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost)

The following are some of the instances where a valuer applies the cost approach:

- an asset can be **quickly recreated** with substantially the same utility as the asset to be valued;
- in case where **liquidation value** is to be determined; or
- a business that derives value mainly from the **underlying value of its assets** rather than its earnings, such as real estate or investment businesses
- income approach and/or market approach cannot be used

IVS 103 – Valuation Approaches and Methods

Cost Approach

Two Common Valuation methods under the Cost Approach for Business Valuation

Replacement Cost Method

Reproduction Cost Method

Steps Involved in cost Approach

- estimate the costs that will be incurred by a market participant for creating an asset with comparable utility or creating a replica of the asset to be valued;
- assess whether there is any **loss on account of physical, functional or economic obsolescence** in the asset to be valued; and
- adjust the obsolescence value, if any as determined under (b) above from the total costs estimated under (a) above, to arrive at the value of the asset to be valued.

IVS 103 – Valuation Approaches and Methods

Cost Approach

Reproduction cost

- Refers to the **cost incurred to reproduce** the asset in its acquisition date condition.
- Estimate cost to construct, at **current prices**
- This would typically include **directly attributable cost** (wages, cost of material and so on) **as well as the 'cost of being out of the market' representing the additional cost incurred** or income lost during the time until the asset under review is ready for its intended use.

Replacement cost

- Represents what it would **cost today to acquire a substitute asset** of comparable utility.
- **Asset with equivalent utility** to the subject tangible asset
- Modern materials, production standards, design and layout

IVS 201 – Scope of Work, Analyses and Evaluation
Brief Discussion

Objective

This Standard prescribes the basis for

- **determining and documenting the scope/terms of a valuation engagement,** responsibilities of the valuer and the client;
- the extent of analyses and evaluations to be carried out by the valuer; and
- responsibilities of the valuer while relying on the work of other experts.

Scope

- A valuer shall follow the requirement of the Standard (applicable to all assignments) while acceptance of valuation engagement.
- It is applicable on **valuation engagement** covering
  - Arriving at an estimate of / providing an **opinion of value**
  - **Fairness opinions**
  - **Valuation review**

Application

- Scope of Work/ Terms of Engagement
- Contents of Engagement Letter
- Analyses and Evaluations
- Reliance on the work of other Experts
- Information required for valuation
- Subsequent events to Valuation Date

IVS 201 – Scope of Work, Analyses and Evaluation
Terms of Engagement

Key Elements of Engagement

- Scope;
- Responsibility;
- Authority;
- Confidentiality;
- Limitations;
- Reporting; and
- Compliance with Indian Valuation Standards

The terms of the valuation assignment shall be documented in writing in an engagement letter

Contents of Engagement Letter

- Details of the client;
- Details of any other user/s of the valuation report apart from the client, if any;
- Details of the valuer;
- Purpose of the valuation;
- Identification of the subject matter of valuation;
- Valuation date;
- Basis and premise of valuation;
- Responsibilities of the client and the valuer;
- Confidentiality obligations of the client and the valuer;
- Scope/ limitations;
- Fees ;
- Details of third party expert, if any, and their scope of work, scope limitations, and responsibilities.

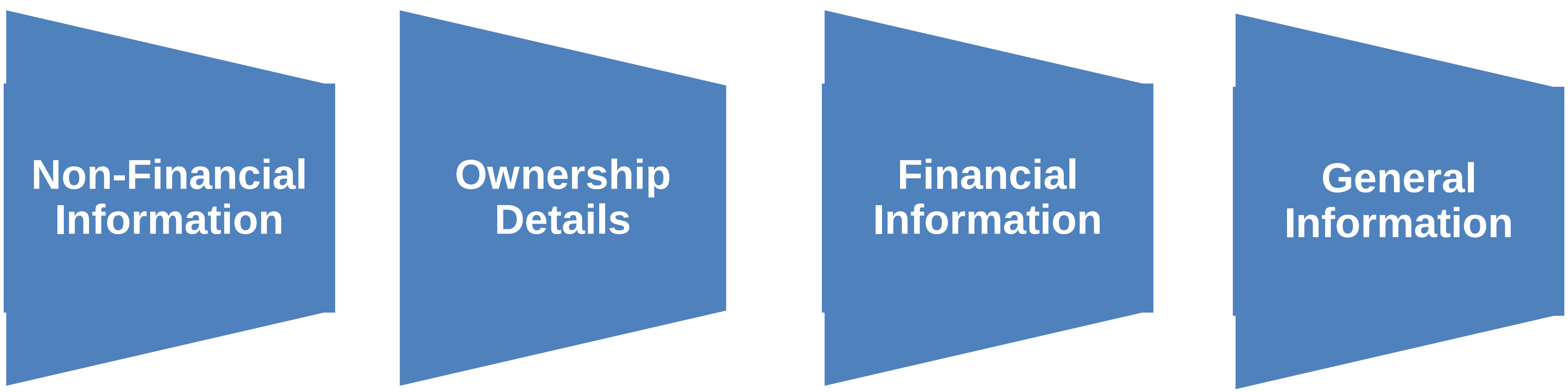
The valuation shall not be constituted as an audit or review in accordance with the auditing standards; accounting/ financial /commercial/ legal/ tax/ environmental due diligence or forensic/ investigation services; and shall not include verification or validation work.

IVS 201 – Scope of Work, Analyses and Evaluation
Analysis and Evaluation

- The **extent of analyses** to be carried out by the valuer shall be based on the **purpose of the valuation assignment** and the terms of engagement.

- A valuer shall obtain **sufficient appropriate data, information, explanations and perform appropriate analyses** to enable him to draw reasonable conclusions on which to base his opinions or findings.

  Information shall include:



IVS 201 – Scope of Work, Analyses and Evaluation
Analysis and Evaluation

Subsequent Events

An event that occurs **subsequent to the valuation date that** could affect the value; such an occurrence is referred to as a subsequent event.

Subsequent events are indicative of the **conditions that were not known or knowable at the valuation date**, including conditions that arose subsequent to the valuation date.

In the event such circumstances / events are considered by the valuer the same should be explicitly disclosed in the valuation report.

IVS 201 – Scope of Work, Analyses and Evaluation
Analysis and Evaluation

Reliance on the work of expert

Evaluate

A valuer shall evaluate the
- Skill
- Qualification and
- Experience of the other valuer.

Resources

A valuer should determine that the expert has sufficient resources to perform the work.

Extent of Reliance

The extent of reliance placed by the valuer on the expert's work shall be documented in the engagement letter.

IVS 202 – Report and Documentation
Brief Discussion

Objective

- Provide **minimum content** of the valuation report.
- Basis for preparation of the Valuation Report.
- Basis for maintaining **sufficient and appropriate documentation.**

Documentation to be maintained at least 8 years from the date of valuation report

Scope

The contents of the valuation report specified in this Standard are not applicable to the extent a valuer is required to follow the requirements prescribed by any law, regulations, rules or directions of any Government or regulatory authority, or Court order.

Application

- This Standard aims at **standardizing the quality** of a valuation report to certain extent.
- This Standard specifies the **documents to be maintained** to ensure that valuation assignment is carried out in accordance with the Indian Valuation Standards and support valuer's assessment.

IVS 202 – Report and Documentation
Content of Valuation Report

- The **contents of the valuation report** are selected by the valuer, based on the **specifics of the engagement**, in particular, the nature of the engagement, and the purpose of valuation

- A valuer shall at a minimum **include the following** in the valuation report:

• **Background information** of asset to be valued • **Purpose of Valuation** • **Identity of the valuer** and other experts involved	• **Disclosures of valuer's interest.** • Date of appointment**, Valuation date** and report date**.** • **Sources of information relied on**
• **Procedures adopted** in carrying out the valuation • Valuation methodology used	• **Restriction** on the use of **valuation report.** • **Caveats, limitations** and disclaimers.

Management Representation

Management Representation

- A valuer may obtain written representations from the management/client regarding information for performing the valuation assignment.

- **A written representation obtained from the management or those charged with governance becomes part of the evidence obtained by the valuer which forms a basis for his valuation report.**

- The existence of **a management representation letter shall not preclude the valuer from exercising reasonable skill and care** with respect to the information obtained regarding the valuation.

IVS 202 – Report and Documentation
Documentation

Documentation

A valuer shall maintain documentation which provides:

- **sufficient and appropriate record** of the basis of the valuation report;
- evidence that the **valuation assignment was planned and performed in accordance with the ICAI Valuation Standards** and applicable legal and regulatory requirements, as the case may be.

IVS 301 – Business Valuation
Brief Discussion

Objective

- Provides help and support to business valuers - performing business valuation or business ownership interests valuation engagements.
- Establishes uniform concepts, principles, practices and procedures for valuers performing valuation services.

Scope

This Standard describes the basic principles which govern the valuer’ s professional responsibilities and which shall be complied with whenever an engagement to estimate value is carried out.

Application

- A valuer shall apply valuation approaches and valuation methods, as described in Indian Valuation Standard 103 Valuation Approaches and Methods, and also use his professional judgment which is an essential component of estimating value.

IVS 301 – Business Valuation
Steps in Business Valuation

Steps of Valuation as prescribed by IVS

Define the premise of the value

↓

Analyse the asset to be valued and collect the necessary information

↓

Identify the adjustments to the financial and non-financial informationfor the valuation

↓

Consider and apply appropriate valuation approaches and methods

↓

Arrive at a value or a range of values

↓

Identify the subsequent events, if any

IVS 302 – Intangible Assets
Valuation Standards: Brief Discussion

Objective

- Prescribe specific guidelines and principles applicable to valuation of intangible assets
- Deals with-
  - Intangible assets
  - Goodwill
  - Categories of Intangible Assets
  - Valuation Approaches and Methods
  - Tax Amortization Benefits
  - Discount Rates

Scope

- This Standard shall be applied for valuation of identified intangible assets for the given purpose of valuation.

Application

- IVS 302 aims at providing specific guidance on valuation of an intangible asset. The standard provides a list of situations in which intangible assets would be required to be valued such as.
  - Purchase price allocation under Ind AS 103
  - Impairment testing under Ind AS 36
  - Transfer pricing when an intangible asset is being transferred/licensed in/out between geographies/companies etc.

IVS 302 – Intangible Assets
Significant Considerations

Categorization of Intangible Assets

- Customer based intangible assets
- Marketing based intangible assets
- Contract based intangible assets
- Technology based intangible assets
- Artistic based intangible assets

Significant Considerations

- **Discount Rate:** It is shall be indicative of the **risk associated** with the cash arising from the intangible asset to be valued.

- **Economic Useful Life: The economic and legal factors shall be considered together** as well as individually while determining the useful life of an intangible asset. Economic factors determine the period over which future economic benefits will be received by the entity. Legal factors may restrict the period over which the entity controls access to these benefits. The useful life is the shorter of the periods determined by these factors.

- **Tax Amortisation Benefit (TAB)**: Tax Amortisation Benefit (TAB) is a **hypothetical benefit available** to a market participant by way of amortisation of the acquired intangible assets, thereby **reducing the tax burden.**

IVS 302 – Intangible Assets
Valuation Approaches

Valuation Approaches

- **Market Approach**
  - Valuation multiples/ Capitalisation rates
  - Guideline pricing method
- **Income Approach**
  - Relief-from-royalty-method
  - Multi Period Excess Earning Method
  - With and Without Method
  - Greenfield Method / MEEM
  - Distributor Method
- **Cost Approach**
  - Replacement Cost Method
  - Reproduction Cost Method

Market Approach: Not commonly used

Income Approach: Preferred approach

Cost Approach: No connection to future financial benefits

IVS 302 – Intangible Assets

Valuation Approaches

Market Approach

- Provides an indication of the fair value **by comparing the asset to similar assets** that were bought and sold in recent market transactions.
- Intangible assets are typically transferred only as part of selling a business or in a licensing agreement.
- Observable **market data is therefore limited**
- Hence, market approach is **less frequently used**.

Cost Approach

- Estimate fair value by quantifying the amount of money that would be required **to repurchase or reproduce the asset** under review.
- cost of replacing or reproducing an intangible asset may be particularly **difficult to measure if the asset is unique.**
- Is **less widely accepted** than market and income approaches.

Income Approach

- Estimate the price an asset could be sold for in an arm s length transaction on the basis of the asset's **expected future income stream**.
- Involves estimating the **present value of future economic benefits**.
- In practice, income approach- based methods are **the most commonly applied**

IVS 303 – Financial Instruments
Brief Discussion

Objective

Establishes principles, suggests methodology and considerations to be followed by a valuer in performing valuation of financial instruments.

Deals with-

How value is determined

- Determination of Present Value
- Adjustments for Credit Risk
- Control Environment: Governance and control procedures of an entity

Scope

- Valuation of financial instruments is commonly carried out for transactional pricing and financial reporting purposes.
- Valuation of financial instruments is also important in case of business combinations, share-based payments, off-market transactions, risk management, tax allocations, dispute resolution, purchase-price allocations, liquidation, etc.

Application

- Indian Accounting Standards (Ind AS) (Ind AS 109, Ind AS 107 and Ind AS 32) requires financial instruments to be fair valued. This IVS 303 and Ind AS 113 prescribes specific guidance on valuation of financial instruments.
- In selection of the approach and method, a valuer is required to give due consideration to the control environment under which the entity and the instrument operates.

IVS 303 – Financial Instruments
Valuation Approaches

Valuation Approaches

Market Approach | Income Approach | Cost Approach

Valuation Methods

- The methods used for the valuation of financial instruments are based on the market, income and cost approaches as described in IVS 103.
- **Financial instruments being generally aligned to market linked factors, the usage of market linked methods with observable inputs is usually the preferred approach to arrive at a value.**

Financial Instrument : Case 1

Redeemable Non - Convertible Preference Shares ("RNCPS")

Particulars	Remarks
Conversion Event	Non-Convertible
Redemption Period	Mandatory: 20 years Voluntarily: Both holder and issuer has the right to redeem the preference shares before the mandatory redemption date.
Dividend	Non - Cumulative dividend - **0.001% p.a.**
Redemption Value	Redemption at par

Financial Instrument : Case 2

Compulsorily Convertible Preference Shares ("CCPS")

Particulars	Remarks
Conversion Event	• Mandatory: 10 years • Voluntary: Any time by holder of the instrument
Conversion Ratio (Fixed to Fixed)	1:1
Dividend	Cumulative Dividend - **8% p.a.**

Financial Instrument : Case 3

Compulsorily Convertible Debenture ("CCD")

Particulars	Remarks
Conversion Event	Mandatory: Each CCD shall compulsorily convert into such no. of equity shares as determined by the conversion formula at the end of the 10 years from the date of allotment. Voluntary: Holder has the right to convert CCD at anytime into such no. of equity shares as determined by the conversion formula.
Conversion Formula (Fixed to Variable)	No Equity upside to holder Formula: Face Value of CCD / Conversion Price **Conversion Price* shall mean ***price per equity share determined at the time of conversion*** *by a valuer appointed by the company.*
Coupon	**10% p.a. (Moratorium of initial 2 years)**

Financial Instrument : Case 4

Optionally Convertible Redeemable Preference Shares

Particulars	Remarks
Conversion / Redemption Event	Holder has the option to redeem or convert at the end of 20th year.
Conversion Formula (Fixed to Fixed)	1:1
Conversion Right	Holder has the right to opt for the conversion of OCRPS at the end of the tenure, if he doesn't redeem the OCRPS at the end of 20th year.
Dividend	Cumulative dividend - **0.001% p.a.**

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Thank You

Time to build trust and association