

Corporate Finance/M&A - India

Valuation in a Global Downturn

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Since July 30 2008 only a handful of companies have filed their red herring prospectus, an offer document filed with the Securities and Exchange Board of India (SEBI) for listing on the stock exchange. The situation is gloomy. At such a time, it might be asked whether it is timely and appropriate to plan mergers, takeovers, disinvestments and acquisitions. Some say it is a buyers' market, since the value of business assets is low - but does that mean it is also a good time to sell? How do companies determine the value of an asset and what is the legal impact of the valuation? Both buyers and sellers must consider these questions before entering into negotiations.

Background

The Companies Act 1956 states that if a company's articles of association or memorandum of association provides that the company cannot merge or amalgamate with another company, such provision will be deemed void. Quite often a company's growth is achieved by utilizing the strengths of another company where common synergies exist and can be tapped. Post-liberalization, India has experienced a remarkable increase in mergers and acquisitions. Various conditions must be considered before any deal can be successfully closed, but one of the most important conditions is the valuation. Unless there is consensus on the valuation of the target company, no transaction can proceed. Clearly, the question of how to arrive at the deal price assumes crucial significance.

Listed and Unlisted Companies: Regulatory Framework

If the target is a private company, the Companies Act applies and the scheme of the merger must be approved by the relevant court (ie, the high court with jurisdiction). The merger scheme is first approved by the board of directors and then by the shareholders. This scheme is then presented to the high court in e-Form 21 of the Companies (Central Government's) General Rules and Forms. Once the order is received, it is filed with the registrar of companies in e-Form 61 of the General Rules and Forms and the scheme is deemed approved.

If a listed company has seen its stock fluctuate in a volatile market, its shareholders will be in two minds as to whether to sell during a recessionary phase. Clearly, the power to negotiate and close a deal rests with all parties to a transaction. If the target company is a limited company, it is governed by the relevant provisions of the Listing Agreement, the SEBI (Substantial Acquisition of Shares and Takeover) Regulations 1997 and other guidelines issued by the SEBI. Anyone that acquires more than 5%, 10% or 14% of the shares of a listed company must make a disclosure to the company and the relevant stock exchange. If the acquirer wishes to obtain more than 15% of shares, it must make a public announcement according to the aforementioned SEBI regulations and also make continual disclosures, on a yearly basis, in respect of its holdings within 21 days of the close of the financial year.

Therefore, for a merger for listed companies and an acquisition for unlisted companies, the value at which each share is bought or transferred will be subject to scrutiny by the SEBI and the high court respectively.

The Reserve Bank of India keeps a close watch on the price at which shares are either issued or transferred to a foreign entity. Each time fresh shares are issued to non-residents, the investment is to be reported to the Reserve Bank of India in the FC-GPR form, and each time there is a transfer of shares to non-residents, it must be reported

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in the FC-TRS form. Both these forms require a certificate from the statutory auditors or chartered accountant indicating how the price of the shares to be issued or transferred to the non-resident was determined. Therefore, no arbitrary valuation techniques can be adopted to determine the face value of a share.

Methods of Valuation

All investment decisions are taken on the basis of the financial strength of a company. Therefore, realistic estimates are taken to determine a company's value based on its previous history and scope for profits and growth. Previously, the Controller of Capital Issues Guidelines were relied upon to value shares, but these have now been abolished. Despite this, unlisted companies still use the guidelines to value their share price for the purpose of reporting the transaction to the regulatory authorities. The following methods of valuation are used to arrive at a fair value of shares.

Net asset value

Net asset value is calculated with reference to the book value of assets and liabilities as they exist on the date of the proposed transfer. The basis for arriving at the net asset value is usually the audited balance sheet of the year preceding the date of the proposed transfer. Adjustments on the basis of the projected results until the last quarter (prior to closing) are also taken into account, including any prospective liabilities. However, the net asset value does not factor contingent liabilities and non-tangible assets which are self-generated.

Profit-earning capacity value

Profit-earning capacity value is one of the traditional methods of business valuation. Future net profits are ascertained on the basis of the past earnings of the company. These profits are then capitalized on the basis of a price-earnings ratio (ie, the ratio between the share price of the company and its earnings). The calculation is made by dividing the rate of dividend by the paid-up share value, and multiplying this by the normal rate of return.

The crux of estimating the profit-earning capacity value lies in the assessment of the future maintainable earnings of the business. While past profit and profitability trends serve as a guide, it is important to remember that the valuation is for the future and the future earning stream is of greater significance in the valuation process. All relevant factors that have a bearing on the future earnings of the business must be given due consideration.

Market price basis

The method of market price basis valuation is used to determine the price offered to shareholders in a takeover bid of listed companies. According to the Controller of Capital Issues Guidelines, the weighted average market value per share is calculated after considering the traded value and the traded volume of transactions in the previous three years. Therefore, the stock market plays a valuable role in arriving at such valuation. As mentioned above, listed companies must also conform to the SEBI regulations.

Discounted cash flow

Used in business valuations, the discounted cash-flow method is based on the hypothesis that the value of any business has a direct relation to its cash-generating ability. The amount available for distribution to the capital providers, after considering cash which is reinvested into the business to sustain operations and growth, is discounted for a pre-determined forecast period to the present at a discount factor (ie, the number by which a future cash flow must be multiplied in order to obtain the present value). This method of valuation is based on projections and estimations, and hence much depends on the quality of information available at the company level.

Earn-out method

The earn-out method is widely employed in a variety of industries and companies when the views of the parties on the value of the target business are too conflicting and divergent, preventing an agreement on a price. During a recessionary phase, this method of valuation can be most effective, since the bargaining power lies with all parties involved. Here, the valuation is not closed in one go; the buyer allows the seller to run its business and prove its projections within appropriate timelines (earn-out period). The buyer merely agrees to make future payments to the seller, in addition to the amount paid at closing, if certain pre-determined targets are achieved after closing.

To avoid future disputes, it is essential to agree on reasonable parameters for the operation, functioning and control of the company during the earn-out period. For those companies that intend to follow this approach, and simultaneously wish to minimize and mitigate risks, it is prudent to consider a cap on the annual earn-out limit, as it further reduces the risk associated with the earn-out structure. Another suggestion to curtail disputes is to attach budgets for the earn-out period to the agreement so that expectations are realistic.

Pursuant to the Controller of Capital Issues Guidelines, the average of net asset value and profit-earning capacity value was computed to determine the fair value of a share,

and market price basis was used only for 'fine tuning'. In all the above methods of valuation, failure to get the details right can be disastrous. It is imperative that the method of valuation undertaken by the parties be similar, if not identical, so that they can mutually negotiate with each other for a successful closing.

Due Diligence

The concept of due diligence originates from the legal concept of *caveat emptor* (ie, let the buyer beware). Therefore, whenever a buyer wishes to acquire a company, it is expected to examine and scrutinize all the target's records and documents to evaluate the risks of the acquisition.

In relation to mergers and acquisitions, the scope of due diligence is wide and involves the investigation of a company's operations at various levels. Due diligence has tremendous significance in any business environment, since it leads to a clear understanding of the exposures, risks and benefits for an acquirer. However, in a world plagued by corporate scams, recessions and market volatility, and with ever-tightening purse strings, it is essential that the level of questioning be exceedingly stringent, with a specific focus on the target's behavioural patterns, in order to evaluate and prevent risks.

The liquidity crunch and the lack of credit add to the risks of both buyer and seller. The buyer may not have enough money to buy and the seller will want to gain as much as possible. In view of the recent economic downturn, the common objective of all parties is to do what is necessary to reduce risks and losses as much as possible. As a practical measure, it is prudent for acquirers and their advisers to take the following steps while conducting due diligence:

- Use expert consultants to check a company's references;
- Discuss future integration plans with the target;
- Ensure that integration, planning and expectations match;
- Verify who the real partners are and check their perceptions of the target;
- Consider whether the acquirer really wants those partners or customers going forward;
- Determine whether the potential transaction is a strategic fit; and
- Involve the operational team from the start so that projections are realistic.

Comment

Today's challenging conditions appear to be here to stay, at least for the foreseeable future. Many experts feel that the recession and market conditions may trigger sector-specific consolidation. Companies performing poorly will need buyers to survive, while the rest will seek to take advantage of the lower valuations and buy competitors at discount prices. Therefore, timing becomes critical when divesting or expanding. The price at which the transaction takes place invariably depends on the timing of valuation. With a lack of credit in the market, tougher and expensive norms making financing difficult and widespread risk aversion from corporations, decisions will be contingent upon whether acquirers feel that they are getting a good deal. During these troubled times, the role of the advisers to acquirers and target companies will increasingly require a different level of diligence altogether.

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Dhruv Suri assisted in the preparation of this update.

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