**Valuation: Perspective of Insolvency Professionals under IBC.**

Background of need for Valuation: The spirit of any Corporate Insolvency Resolution Process is to first try to revive the Company and if that is not possible, then to wind up the Company and sell the assets of the Company on piecemeal basis to pay of its liabilities. Typically an IP is supposed to provide two sets of Value. One is Fair Value of the Company undergoing CIRP and second is Liquidation Value.

**Valuation Date**: First and foremost, the RP has to ensure that both the Fair Value and Liquidation Value are furnished by Valuer based on circumstances and events existing as on the valuation date. The Valuation date in case of IBC is the date on which CIRP petition is admitted by NCLT. RP has to check that Valuer has not considered any events which have occurred after the Valuation date. RP has to note that the Valuation Report can be of a date later than the Valuation Date.

**Limitations or Disclaimers:** RP should be very careful while going through the limitation section of the Valuation Report. In IBC cases, the conditions are generally hostile and relevant information is not forthcoming. When relevant information is not available, it restricts the Valuer in performing standard investigations and he might have to resort to assumptions to complete the engagement. RP should verify whether the restrictions and assumptions mentioned under Disclaimer section are real and Valuer is not attempting to disown his professional liability for the valuation analysis. It is to be noted that although Valuer remains accountable to regulatory authorities for his work, it will be a better idea for RP to go through this section of the Valuation Report and make it very clear to Valuer that if he has given a Valuation Report, he will be responsible for the same and cannot take defense of disclaimers. This still remains a very debated subject between RVO’s and Regulator.

**Approaches and Methods of Valuation:** The applicable Valuation Standard to select appropriate approach and method of valuation is covered under IVS 105 issued by International Valuation Standards Council. While reviewing the Valuation report for determining Fair Value, the RP has to check whether appropriate approach and method of valuation has been selected by Valuer.

**Current Malpractice:** Off late it is being observed that several valuers are providing Net Asset Value (Asset –liability) as a measure value of Fair Value of the Company under CIRP. It is to be noted that the Fair Value mentioned in IBC intends to capture the Enterprise Value of the Company under CIRP. The value of a Company is much more than aggregate of it’s recorded and unrecorded assets and liabilities. This basically implies that the value of a business is driven primarily from its future cash generating ability and less from its assets and liabilities.

**Two Value Indicators:** RP has to also check whether Valuer has considered at least two value indicators derived independently from two approaches before arriving at a value conclusion. The three approaches of valuation are Income Approach/Market Approach and Asset Approach. Valuer should have arrived at value indicator from at least two of the above approaches.

**Averaging of Value Indicators prohibited:** As per IVS, in case there is huge variance in values arrived from two indicators; Valuer is prohibited from assigning weightages to each value in order to arrive at a value conclusion. Valuer is required to check the underlying assumptions employed in calculation of each of the value indicators and reduce the gap between the two values to a reasonable level. This exhaustive reconciliation should be part of the Valuation Report and should be presented in such a manner that any person with reasonable knowledge of Finance and Valuation is able to comprehend the same.

**Difference between Business Value and Enterprise Value:** RP has to keep in mind that in case value of business is derived by employing Income approach or market approach, the value determined is of the business in which the Company is engaged and not of the legal entity. There is a possibility that the Company has certain non-operating assets. The fair value of the non-operating assets is to be added to the business value determined by SFA Valuer to arrive at Enterprise Value.

**Fair Value of Non-Operating Assets:** The Valuer for Securities and Financial Assets is not eligible to determine fair value of any Land/Building which classifies as Non-Operating Asset. If that is the case, there are two options. One option is that the Financial Valuer may internally engage a Valuer for determining fair value of land and/or building. The other option is that the RP separately assigns the scope of determining fair value of land and/or building to a Valuer for Land and Building along with Value of other Land/Building used by the Company within the business.

**Fair Value and Liquidation Value of Tangible Assets:**  If the Company is asset heavy, it will have significant amount of Plant and Machinery, Land, Building on its Balance Sheet. While assigning the valuation work to Valuers of Tangible Assets, RP should be very clear whether he wants the Fair Value of the Tangible Assets to be determined or only the Liquidation Value. There is also the additional possibility that RP might ask the Valuer to determine Fair Value of Non-Operating Assets. In that case the Value provided by SFA Valuer shall only be Business Value. RP has to add the fair value of non-operating assets to the business value to arrive at Enterprise Value.

**Understanding Value and Risk Drivers:** RP has to review the business model of the Company so as to reliably forecast the future maintainable cash flows. He should discuss the business model with the Valuer to ensure that the key value drivers are incorporated in the FCFF for the explicit period. RP should also check whether the growth factor considered by Valuer in determining the Terminal Value is reasonable keeping in mind the historical trend and future outlook of the industry. The FCFF and growth factor becomes very relevant in current times when the future prospects of economy and industries appears very bleak for years to come. The Risks associated in achieving future cash flows should be factored in the discounting factor considered by Valuer and RP should review the workings of the Discounting factor in the Valuation Report. The discounting factor is a very important assumption of the Valuer if value has been derived based on Income Based Approach. RP should note that basic responsibility of providing future cash flows lies with the RP himself and Valuer is supposed to not blindly rely on the figures provided by RP but cross check them for reasonability and contradiction with other data sets. So RP should take care while perusing the Valuation Report, that this important dialogue with Valuer has taken place.

**Purpose of Value**: While going through the Valuation Report, RP has to check the purpose and premise of value. The purpose of Valuation for IBC cases is to determine Fair Value of Company or Liquidation Value of tangible assets.

**Premise of Value:** Premise of Value should also be very clearly mentioned in the Valuation Report. Premise of Value means the intended use of the subject assets (including liability). Premise of Value can be either Highest and Best use, Current Use, Orderly Liquidation, Forced Liquidation. Highest and best use is relevant for Non-Financial assets and not to business or company valuation. Existing use presumes going concern which in turn leads to valuation of Fair Value of Company. Under IBC regulation, liquidation value shall be in orderly manner. The purpose and premise of value should be very clearly mentioned in the valuation report.

**Bases of Value:** Bases of Value are defined in IVS 104 and aim at laying down standard terms for different bases of value. Based on the purpose/premise of value the Valuer will select appropriate basis of value. The bases of value chosen by Valuer will in turn decide the approaches and methods of Valuation. Under IBC, the equivalent bases of Enterprise value of Company under IVS 104 is Market Value. The equivalent bases of Liquidation Value are Liquidation Value under IVS 104.

**Enterprise Value/Market Value as per IVS 104**: Valuer has to determine Enterprise Value (Equal to Market Value as per IVS 104) either by adopting the Income Approach or Market Approach or Asset Based (Cost Based) approach. Under each approach, there are several methods of valuation available to Valuer. RP can refer to IVS 105 for more details on approaches and methods of Valuation.

**Enterprise Value Income Approach:** RP has to see whether Valuer has properly applied the Discounted Cash Flow method along with Terminal Value to determine the value of the Company based on its inherent cash generating ability. As the Enterprise value has to be calculated, future cash flows have to be at FCFF level and discounting factor considered should be at weighted average cost of capital. There should be detailed workings by Valuer as to assumptions and methods of calculating Discounting factor. As per Financial Management, Cost of equity can be calculated under CAPM by using either regressive beta or bottoms up beta.

**Enterprise Value Market Approach:** In case RP has used market approach and not Income approach, RP should check the comparable data considered by Valuer as benchmark. Benchmark can be a similar business which is traded on stock exchange from which Price to Earnings multiple is derived and applied to the subject Company. If similar business are not traded on stock exchange, then one has to check private equity transactions in the past six months and use the multiples for valuing the subject Company. RP has to check that the comparable companies/transactions considered are under normal circumstances and not when the economic mood is very optimistic or depressed.

**Enterprise Value Asset Based (Cost Approach):** The Company is valued based on aggregate value of recorded/unrecorded tangible and intangible assets as well as financial assets. Here RP has to note that fair value of Tangible assets can be done by registered Valuer for Tangible Assets and the fair value of Intangible/Financial Assets has to be done by Registered Valuer for SFA. RP has to aggregate the Reports of respective valuers to determine Enterprise Value of the Company. Valuation under this approach should be mandatory in case the subject Company is asset heavy. Secondly in case this approach is considered essential, RP has to check whether Valuer has identified any unrecognized Intangible assets. Self-created intangible assets like brand, customer relationship, patents, copyrights, IPR are prohibited from being recognized as per accounting convention all across the globe. However as RP is trying to determine Fair Value of Company with idea of selling it to a Resolution Applicant, so intangibles have to be identified and measured.

**Liquidation Value in an Orderly transaction:** RP has to ensure that the liquidation value determined by Valuer of Plant & Machinery or Land & Building is not determined in an adhoc manner. For determining liquidation value, the Valuer has to make rough estimate of the different metals contained in various items of Plant & Machinery and the prevailing scrap price. The current practice of determining liquidation value after applying 70% discount to fair value is not a scientific practice and should not be acceptable.

**Inputs for Valuation:** The RP should go through this section of the Valuation Report. Valuer gets inputs and assumptions from management/RP or other sources. Valuer is supposed to assess the credibility of inputs for determining the value. RP should check the sources of inputs/assumptions and whether he has done due diligence on credibility of inputs.

**Normalization of Historical Data:** The Valuer predicts value based on trends of historical data. RP has to remember that a fundamental law of nature is that what happened in the past need not occur in the future. The current Corona pandemic has completely destroyed the future prospects of many companies and industries. So any valuation done now will have to make a fresh assessment of what the future holds rather than predicting the future based on past trends. Secondly, the Financials of Companies referred in IBC are embedded with fault lines and the RP has to check with Valuer, whether he has done both horizontal and vertical analysis, to identify outliers and recast the past financials sans the abnormal items, fraudulent/undervalued/preferential transactions. Ideally, RP should work in close coordination with Valuer in this critical area.

**Format of Valuation Report:** As per IVS 103, there is no specific format of Valuation report. As long as the report conveys the value to the intended user, the contents and format of Report may be mutually agreed between RP and Valuer. RP should ask for working papers for calculation of value based on Income/Market/Asset approach as the Report will only include the final value and will not enable RP to appreciate the stories behind the value. One can refer to IVS 103 to gauge the minimum information which should form part of the Valuation Report.

To sum it up, RP has to check whether Valuer has exercised reasonable care and skill, followed all valuation standards and exercise caution in arriving at Value conclusion. The traits for doing a good job are both technical as well as behavioral. To be fair to Valuer, his investigation and value analysis will be a function of the quality of information received and level of cooperation from Corporate Debtor. If the quality of information and cooperation is sub optimal, then RP has to appreciate that inherent risk is very high and he should pitch in with his own efforts to enable a Valuer to do a good job.