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Business Appraisers

Valuation updates | Is valuation under FEMA restricted to DCF?

April 2017

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This thought leadership paper provides insights on valuation under FEMA regulations

Back in July 2014, FEMA updated the valuation guidelines and mandatorily required the use of internationally accepted valuation methodology for determining value of securities of un-listed companies. However, in our experience, even post the revised guidelines, we continue to see a lot of valuations solely relying on the discounted cash flow approach to derive the fair value of securities. This thought leadership, summarizes the revised regulations and valuation requirements in existence post 2014.

Background

The Foreign Exchange Management Act, issued by the Reserve bank of India, list downs valuation guidelines that need to be followed at the time of transfer of securities to non-residents. The erstwhile valuation guidelines required use of the discounted cash flow method to determine the value of securities to be transferred. The use of the discounted cash flow approach method, meant dependency on the accuracy of information, namely financial projections received from the company to derive the fair value of securities. Such financial projections include assumptions relating to potential working capital, capital expenditure and other information, which may not always be available.

The RBI revised these guidelines in July 2014, and stated that, the issue/ transfer price of unlisted equity instruments, shall be determined as per internationally accepted valuation methodology for valuation of shares on an arm's length basis, duly certified by a Chartered Accountant, of a SEBI registered Merchant Banker.

The introduction of internationally accepted valuation methodology implies that, a practitioner is free to use market based approaches to determine the fair valuation. Such modification help reduce the subjectivity required for conduction the valuation using the discounted cash flow approach. Internationally accepted valuation methodology includes:

I. Income approach
   a) Discounted cash flow approach
   b) Relief from royalty approach
   c) Capitalized cash flow approach
II. Market based approach
   a) Guideline public comparable company method
   b) Guideline transaction method
III. Asset/ Cost based approach

The flexibility with respect to the use of the above approaches is left with the practitioner. The following table summarizes valuation guidelines for various scenarios

Scenario	Valuation guidelines and methodology	Valuation by whom
<u>Issue of Equity Shares by an Indian Company to a Non-Resident</u>		
Issue by Listed Companies	Price worked out in accordance with the ICDR Regulations issued by the Securities and Exchange Board of India ("SEBI Guidelines")	Can be determined by a Merchant Banker or a CA
Issue by Unlisted Companies	The shares must be issued at price not less than the fair value as per any Internationally accepted pricing methodology for valuation of shares on arm's length basis.	Can be determined by a Merchant Banker or a CA

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Scenario	Valuation guidelines and methodology	Valuation by whom
<u>Issue of Compulsorily Convertible Preference Shares (CCPS) / Compulsorily Convertible Debentures (CCDs) by an Indian Company to a Non-Resident</u>		
Issue by Listed Companies	The securities can be issued at price determined based on the valuation guidelines prescribed under the SEBI (ICDR) Regulations.	Can be determined by a Merchant Banker or a CA
Issue by Unlisted Companies	The securities can be issued at price not less than the fair value of shares as per the Internationally accepted pricing methodology. The conversion formula has to be determined or fixed upfront. The price at the time of conversion should not be less than the fair value worked out at the time of issuance of these securities.	Can be determined by a Merchant Banker or a CA
<u>Transfer / Sale of Shares by a Resident Indian to a Non-Resident</u>		
Shares of Listed Companies	The shares can be transferred at a price not less than the price determined as per the Preferential Allotment Guidelines of the SEBI (ICDR) Regulations, 2009.	The price should be certified by a Merchant Banker or a CA.
Shares of Unlisted Companies	Transfer price to be not less than fair value worked out as per any internationally accepted pricing methodology for valuation of shares on arm's length basis.	Fair value of shares to be determined by a SEBI Registered Merchant Banker or a CA
<u>Transfer / Sale of Shares by a Non-Resident to a Resident Indian - Transfer covers sale, buyback, reduction of capital. Thus, an exit to a private equity investor, buyout by the promoters, etc., would be covered within these guidelines.</u>		
Shares of Listed Companies	The shares can be transferred at a price not more than the price determined as per the Preferential Allotment Guidelines of the SEBI (ICDR) Regulations, 2009.	The price should be certified by a Merchant Banker or a CA.
Shares of Unlisted Companies	Transfer price to be not less than fair value worked out as per any internationally accepted pricing methodology for valuation of shares on arm's length basis.	Fair value of shares to be determined by a SEBI Registered Merchant Banker or a CA
<u>Downstream Investment by an Indian company in another Indian company</u>		
Downstream investment means indirect foreign investment, by one Indian company, which is not owned and / or controlled by resident Indian entities, into another Indian company. Issue/transfer/pricing/valuation of capital shall be in accordance with applicable SEBI/RBI guidelines. The share investment, even in such a case, must comply with the valuation guidelines explained above for an FDI investment. Thus, the downstream is put on par with an FDI investment.		

Valuation under FEMA regulations

Scenario	Valuation guidelines and methodology	Valuation by whom
Overseas investment for acquiring existing companies	Any internationally accepted methodology	**Investment is > USD 5 million**, valuation of the shares of the company shall be made by a Category I Merchant Banker registered with SEBI or an Investment Banker / Merchant Banker outside India registered with the appropriate regulatory authority in the host country; and, in **all other cases by a Chartered Accountant or a Certified Public Accountant.**
Overseas investment through stock swap	Determination of share prices of both entities using any internationally accepted methodology	Valuation of the shares by a Category I Merchant Banker registered with SEBI or an Investment Banker outside India registered with the appropriate regulatory authority in the host country. Approval of the Foreign Investment
Disinvestment – Transfer of shares of joint venture/ wholly owned subsidiary		
Shares of listed company	Traded share price	NA
Shares of unlisted company	Any internationally accepted methodology for pricing	Certified public accountant or Chartered accountant

About us:

Indé Global Inc. specializes in international business valuation and tax advisory and is a member firm of KNAV International Ltd ('KNAV').

Our team comprises of over 350 professional executives with office in India, USA, Canada, Netherlands, Switzerland, France, UK and Singapore. Our valuation services encompass business valuation, intellectual property valuation and valuations for financial reporting purposes.

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