State Trading Corpn. Ltd., Hindustan Cables Ltd., Instrumentation Ltd., Jessop and Co. Ltd., NEPA Ltd., Tungabhadra Steel Products Ltd., Videsh Sanchar Nigam Ltd., Bharat Brakes and Valves Ltd., HTL Ltd., NIDC, Bharat Heavy Plates & Vessels, Hindustan Salts and Engineering Projects (India) Ltd.,

Of these, PSUs that were making losses, as of 31.3.2000 are as follows:—

Air India, Hindustan Copper Ltd., Hindustan Organic Chemicals Ltd., India Tourism Development Corpn. Ltd., Paradeep Phosphates Ltd., Sponge Iron India Ltd., Hindustan Cables Ltd., Instrumentation Ltd., Jessop and Co. Ltd., Bharat Brakes and Valves Ltd., NIDC, Bharat Heavy Plates & Vessels, Hindustan Salts and Engineering Projects (India) Ltd.

Methodology for valuation of Air India

2276. SHRI SHATRUGHAN SINHA; Will the Minister of DISINVESTMENT be pleased to state:

(a) the methodology used by Government for the valuation of Air India and for setting the reserve price;

(b) the criteria used to determine the value and the worth of the unutilized traffic rights; and

(c) whether a detailed listing of all the real estate of Air India has been taken into consideration?

THE MINISTER OF STATE OF THE DEPARTMENT OF DISINVESTMENT (SHRI ARUN SHOURIE): (a) The Government, in consultation with various organizations, has put in place a transparent procedure including standardization of nationally and internationally accepted valuation methodologies. A Note on Valuation Methodologies being followed in respect of all the ongoing disinvestment transactions in CPSUs is enclosed (*See* below). In the case of Air India (AI), apart from the valuation to be done by the Advisors in accordance with the approved methodologies, it has been decided that two other reputed valuers will also be asked to carry out an independent valuation of the Company according to mutually agreed methodologies and the C&AG/CVC have also been approached to agree to approve these methodologies, in order to have utmost objectivity and transparency in making fair assessment of the value of the Company.

(b) The business plan of AI assumes utilisation of its unutilized traffic ; valuation under Discounted Cash Flow method would capture the n utilization of the unutilized traffic rights, as it would take into e case flows from the operations.

'es, Sir.

Statement

'Methodology for valuation of Air India'.

Note on valuation Methodologies for Disinvestment in CPSUs.

1. Valuation of the Company under disinvestment is a key component of the process of disinvestment that is undertaken by the Government. Since most of the PSUs are either not listed on the Stock Exchanges or their shares are often undervalued, deciding the worth of a PSU is indeed a challenging task.

2. The Disinvestment Commission recognized the problems and importance of valuation in case of disinvestment of PSUs, which are not listed or in cases where capital markets may not fully reflect the intrinsic worth of a share disinvested earlier. In a Note published in December 1996, the Commission, while emphasizing that valuation should be independent, transparent and free from bias, outlined the following basic approaches of valuation:—

(i) The **Discounted Cash Flow Methodology**—The present value of expected future cash flows of the Company, discounted at an appropriate discount rate.

(ii) The **(Relative Valuation Methodology)—Transaction Multiple Method** determining the value of a Company looking at the pricing of comparable Companies relative to a common variable like earnings, cash flows, book value or sales.

(iii) The **(Net Asset Value Methodology)—Balance Sheet Method** based on the computation of the present market value of assets less liabilities.

(iv) **The Asset Valuation**—In cases where strategic sale is done with transfer of management control, the Commission felt that asset valuation should also be done. The Commission observed that *"In such cases, the valuation of land and other physical assets should also be computed at current market values in order to fix the reserve price for the strategic sale."*

3. The Disinvestment Commission also sought to correct some erroneous perceptions about valuation. The Commission observed that there is a general perception that since valuation models are quantitative, valuation is objective. The Commission felt that though it is true that valuation does make use of quantitative models, yet the inputs leave plenty of room for subjective judgments. At the same time, there may be no such thing as a precise estimate of a value. Even after the end of the most careful and detailed valuation of a company, there could be uncertainty about the final numbers, as they are shaped by assumptions about the future of the company and of the economy.

4. Another wrong perception sought to be corrected by the Commission was the relationship attributed between valuation and market price. It stated that the benchmark for most valuations remains the market price (either its own price, if it is listed or that of a comparable company). The Commission felt that the valuation done before listing takes into account anticipated factors, whereas market prices reflect realized events that are influenced by unanticipated factors. However, a specific valuation itself may not be valid over a period of time as it is a function of the competitive position of the company, the nature of market in which it operates and the Government policies. Therefore, it may be appropriate to update or revise valuations.

5. In line with the recommendations of the Disinvestment Commission and in accordance with the best national and international practices, the Advisors (to the previous disinvestments like MFIL Food and BALCO as well as to the others that are in the process) have been using the aforesaid four methodologies, viz., **DCF, Balance Sheet, Transaction Multiple and Asset Valuation,** to determine a range of values of the PSUs being divested.

6. However, the observation made by the Commission with regard to **"determining the current market values of the asset to fix the reserve price"** has raised some serious issues that need consideration as discussed hereunder.

7. The **Asset Valuation** takes into consideration the market values of all the tangible assets of the company to determine its value. In theory, there are two different approaches to determine asset based valuation, (1) Replacement Cost Approach and (2) Liquidation Value Approach.

Replacement Cost Approach—This approach takes into account the amount of money that may be required to create a similar infrastructure (*i.e.* all the assets) that the company being valued owns as on a particular point in time when valuation exercise is undertaken.

Liquidation Value Approach—The Liquidation Value approach, on the other hand, takes into account the amount of money that can be generated by the company through the sale of all its assets.

In both the cases, it may however be noted that all the liabilities of the company are required to be deducted to determine the net value of the company, *i.e.* the value of the company for its equity shareholders or to arrive at the value per share.

However, the **Asset Valuation** approach suffers from certain very serious limitations detailed below:

(i) Practically, it is extremely difficult to determine the exact replacement cost of the assets owned by a company. This is so on account of number of reasons, such as (a) changes in technology over a period of time (resulting in certain assets not being produced at all or being produced with far more efficiencies than earlier), (b) absence of a marketplace where such assets are or can be traded, (c) inability of the seller to be able to actually realise the value of assets in one go should the company be liquidated, (d) changes in the duty structure (like excise, import duties, etc. which may impact the value of asset over different periods of time) etc.

(ii) The **Asset Valuation** approach also does not take into account the very purpose for which a company acquired the assets, *i.e.*, for future economic benefits. Hence, the historical or replacement cost of a particular asset may tend to convey a wrong picture of the value that the buyer may perceive in the asset. These factors often tend to result in a higher value being attributed to the assets and the companies if the asset valuation approach is followed. Assets are bought and sold for their future economic benefits, and for established and running businesses, the economic benefits of owning the assets are far more relevant than the historical cost or replacement cost of the assets.

(iii) **The Asset Valuation** also tends to overlook the intangible assets that a company, over a period of its existence tends to build, such as goodwill, brands, distribution network, customer relationships, etc., all of which are very important to determine its true intrinsic value.

(iv) In the case of a majority of the PSUs it may be found that the replcement cost or liquidation value is higher than the intrinsic value of the company, if determined on the basis of the company's future profitability (cash flows). As against this, a company, which has been generating very healthy returns and has built strong brand equity, goodwill etc. will tend to command a value that is far higher than the value of its tangible assets.

8. The abovementioned limitations of the asset valuation approach have been highlighted very clearly in the valuation reports submitted by the Advisors of MFIL and BALCO. In case of strategic sales, the Advisors have expressed that the **Discounted Cash Flow** approach may be the most appropriate methodology to be relied upon for valuing businesses on a going concern basis where the companies are not actively listed and traded on the stock exchange.

The DCF methodology expresses the present value of the business as a function of its future cash earning capacity. This methodology works on the premise that the value of a business is measured in terms of future cash flows, discounted to the present time at an appropriate discount rate. The methodology is able to capture the value of all the tangible and intangible assets of the Company (those which are directly related to the business, but which are not surplus) based on the possible future cash flows. The value of all the intangibles of a company such as brand, marketing and distribution network and goodwill get captured either in the form of higher sales or as higher profits of the company in comparison to its competitors who may not have as strong or similar brand or distribution network. It also takes into account the risk factor to which an enterprise can be exposed. The discount rate is based on the risk perception of the business and the expected rate of return. It also takes into account the value of the core assets of the Company.

Standarising the Valuation Approach & Methodologies

9. Although the aforesaid valuation methodologies being followed are based on the recommendations of the Disinvestment Commission and the best market practices, it is necessary to standardize the valuation methodology for all PSU disinvestments so that there are no variations from case to case.

Therefore, the following four methodologies for valuation should be followed for all PSU disinvestments, with further improvements in respect of DCF Method and Asset Valuation Method as detailed below, for arriving at a range of valuation figures, which could be the indicative Benchmark or Reserve Price.

(A) DCF Method

DCF method, while computing the cash flows, cash out flows for renovation and modernization of plant and machinery should also be discounted for arriving at realistic figures. Since non-core assets are not reflected in the cash flows, the non-core assets should be separately valued by the Asset Valuation Method and they should be added to the valuation figure arrived at by the DCF method.

(B) Asset Valuation

The Asset Valuation would be more realistic, if we compute the value of only the realizable amount, after discounting the non-realizable portions. The realizable market value of all real estate assets, either owned by the company as freehold properties or on a lease/rental basis will be determined, assuming a non-distress sale scenario. The value would be assessed after taking into account any defects/restrictions/encumbrances on the use/lease/sublease/sale etc. of the properties or in the title deeds etc.

Since Asset Valuation normally reflects the amount which may need to be spent to create a similar infrastructure as that of a business to be valued or the value which may be realised by liquidation of a company through the sale of all its tangible assets and repayment of all liabilities, adjustments for an assumed capital gains tax consequent to the (hypothetical) outright sale of these assets as also adjustments to reflect realization of working capital, settlement of all liabilities including VRS to all the employees will have to be made.

(C) Balance Sheet Method

(D) Transaction Multiple Method

Valuation of AI and IA

2277. SHRI SHATRUGHAN SINHA: Will the Minister of DISINVESTMENT be pleased to state the steps taken to ensure that the valuation is fair and equitable and that full weightage is given to all the assets and properties of the two airlines?