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Reserve Bank of India spanner in private equity valuation work

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The Reserve Bank of India's May 4 circular on foreign direct investment has raised fundamental questions on how investors, especially those in the private equity space, should value companies.

According to the circular issued on May 4, transfer of shares in unlisted companies will be on the basis of a price arrived at by the discounted cash flow method. The circular comes into force with immediate effect.

Discounted cash flow is a valuation method, which estimates the present value of an investment on the basis of the amount of cash that it would generate in the future.

Higher the future cash flows, the greater would be the value to be paid out in the present.

Questions are being raised on the validity of the measure, since many businesses and sectors use different valuation methods.

“Discounted cash flow is not the only method of valuation, investors may be willing to price differently on the basis quality of management, use of technology, the places where a company is present and so on,” said Mahendra Swarup, president, Indian Venture Capital Association (IVCA), a national organisation that represents venture capital and private equity firms.

The IVCA is set to make a representation to the central bank on the issue by the middle of next week.

Meanwhile, there appears to be lack of clarity on the exact manner in which the method could be used.

“It is difficult to rely on discounted cash flow method for PE investments, which are structured for 3-5 years. This method raises a number of questions such as how much discount should be used and the timeframe of the cash flows,” said Pranay Bhatia, associate partner, Economic Laws Practice (ELP).

According to Vyapak Desai, head of capital markets practice group at Nishith Desai Associates, the new pricing guidelines are positive to the extent that they streamline the methodology of arriving at entry and exit price for both listed and unlisted companies.

“But since only discounted cash flow method is prescribed for valuation, it will be susceptible to different assumptions for arriving at the valuation for different companies in various sectors (viz. infrastructure v/s IT company) and at various stage of growth (viz. startup v/s growth stage company) leading to inconsistencies in valuation,” he said.