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A Critical Analysis of Issues Relating to Valuation of Shares of a Company

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1. INTRODUCTION:

The share capital is the most important requirement of a company, which provides funds to run a company and in return gives ownership to shareholders. Share capital of a company refers to the amount invested in the company to carry out its operations. It is divided into a number of indivisible units of a fixed amount. These units are known as 'shares'. According to Section 2 (84) of the Companies Act, 2013, "a share means a share in the share capital of a company and includes stock". It represents the interest of a shareholder in the company, measured for the purposes of liability and dividend. It attaches various rights and liabilities. The person who is the owner of the shares is called 'Shareholder' and the return he gets on his investment is called 'Dividend'.

Each shareholder as an investor is interested in knowing the value of his investment in shares. In case of shares which are quoted on the stock exchanges, the value of the share can be obtained from the daily list of prices published by shock exchanges. Although in some cases, the stock exchange prices may reflect the proper value, in many cases, they do not reflect the true value of shares since the stock exchange quotations are subject to bullish and bearing phases, when the same share is quoted at considerably different prices. Stock exchange quotations are not related directly to the value of a company's assets or to the amount of its profits and consequently these quotations cannot form a fair and equitable basis for valuation of shares. Hence, the valuation of shares as regard to listed companies has to be done by an expert valuer by adopting sound and reasonable basis.

Besides, all shares are not quoted on the stock exchanges. Shares of private companies and some unlisted public companies in any case will not be quoted. If shares of such a company are to be transferred, the value of such shares will have to be ascertained.

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Need for the Valuation of Shares:

The necessity for valuation of a share arises in the following circumstances:

a) For Amalgamation and Absorption schemes

b) Purchasing shares for control

c) For discharge of debts and liabilities, in exceptional nature

d) For selling shares of a shareholder to a purchaser (which are not quoted in the Stock Exchange)

e) For the conversion of one class of share to another class

f) For the compensation made to a company when the said company is being nationalized

g) For granting loans on the basis of security of shares (i.e., when the shares are held as security, etc.)

2. REVIEW OF LITERATURE:

(Prusak, 2015) The author in his research examined the accuracy of different methods of share valuation used by Polish analysts in reports prepared in order to issue recommendations for companies listed on the Warsaw Stock Exchange. It was found that analysts who make share valuations by averaging the results of valuations carried out using difference methods or indicators obtain a higher degree of accuracy (lower error) than that of results achieved by means of individual valuation methods.

(Bhatt & Sumangala, 2013) The authors in their research focused on the strength of impact of book value on the market value of an equity share. The study is based on the cross-sectional time series data of 50 companies. It was realised that the explanatory power of the book value is smaller than that of earnings per share (EPS).

(Monga, 2012) The author has discussed various methods of valuation of shares, such as net assets method, dividend yield method, earning capacity method and fair value method. For the computation of value of share as per earning capacity method, profits after payment of debentures interest and preference dividend are considered, which is divided by capital employed, i.e., earnings available for equity shareholders. The author considers earning capacity method an improvement over dividend yield method, as it considers earning capacity of the company in place of rate of dividend.

(Tulsian, 2007) The author in his book, emphasized the importance of methods of valuation of shares stating the fact that stock exchange is mostly determined by bull and bear effects

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rather than fundamental factors like net assets, earnings, yield, etc. Stock Exchange price is basically determined by the forces of demand and supply and may not reflect a true value of shares, due to which methods of valuation of shares are required.

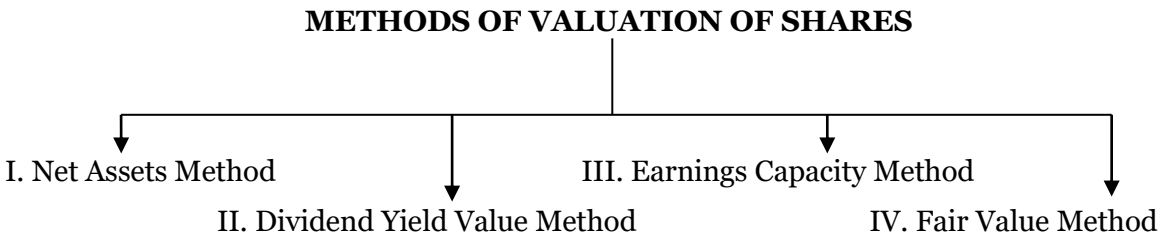
(Goel and Goel, 2014) The authors explained various methods of valuation of shares, such as net assets method, yield method and average method. The average method or fair value method is considered as the best method for valuation of shares, as none of the other methods give a true and fair value of the share due to the difference in the value of same share in case it is calculated under different methods.

(Golash, 2011) The author in his research tried to observe relation between market price of an equity share and value of the equity share calculated on the basis of three different forecasted or estimated factors – earnings per share, dividend per share, and earnings before interest, tax, depreciation and amortization – in a short term. Therefore, fundamental valuation methodologies are modified and altered to produce price of a stock on the basis of a given forecasted factor.

3. PURPOSE OF THE STUDY:

The study intends to critically analyse the various methods used for the valuation of shares. It aims to bring clarity among the readers regarding the various controversies or debates being involved in the methods of valuation of shares. The study further examines the difference in opinions of various authors as regard to the Dividend Yield and Earnings Capacity Method of valuation of shares and subsequently gives best alternative for valuation of shares as per these methods.

4. METHODS AND DISCUSSION:



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I. NET ASSESTS METHOD/ INTRINSIC VALUE METHOD:

In this method, a pessimistic approach is taken into consideration. This approach assumes that if the business is shut down, then what is the residual amount available for equity shareholders? This amount is called "net equity" or "net assets" for equity shareholders. For the computation of intrinsic value per share, net equity or net assets are divided by number of equity shares to know the intrinsic value per equity share.

$$\text{Intrinsic value per share} = \frac{\text{Net Assets for Equity Shareholders}}{\text{No. of Equity Shares}}$$

Computation of Net Equity/ Net Assets for Equity Shareholders:

	Rs.
All Assets at Market Price, individually:	
Plant & machinery	XXX
Land & building	XXX
Goodwill (market value)	XXX
Furniture & fixtures	XXX
Other fixed assets	XXX
Investments (trading & not trading, both)	XXX
Stock	XXX
Debtors	XXX
B/R	XXX
Cash	XXX
Bank	XXX
Prepaid expenses	XXX
Accrued income	XXX
Any other current assets	XXX
Total of all Assets (A)	**XXXX**
Less: External Liabilities:	
e.g., Debentures	XXX
Outstanding interest	XXX
Loan on mortgage	XXX
Creditors	XXX
B/P	XXX
Outstanding expense	XXX
Provision for taxation, etc.	XXX
Total of all Liabilities (B)	**XXXX**
Remaining balance available for Shareholders (A – B)	**XXXX**
Less: Preference share capital (if they have a priority)	(XXX)
Less: Preference dividend in arrear (if priority in payment)	(XXX)
Net Assets/ Net Equity for Equity Shareholders	**XXXX**

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Alternative Method for Net Equity:

	Rs.
Equity Share Capital (Paid-up)	XXX
Reserves (all types), such as:	
• General reserves	XXX
• Capital reserves	XXX
• Security premium	XXX
P/L A/c (Credit Balance)	XXX
Add: Profit on revaluation of fixed or current assets	XXX
Less: Loss on revaluation of assets	(XXX)
Less: Fictitious assets, e.g., Discount on issue of Debentures, etc.	(XXX)
Less: Debit balance of P/L A/c	(XXX)
Net Equity	**XXXX**

Following are the External Liabilities, which are often confusing, but are to be considered as external:

1. Employees' Security Deposit
2. Leasehold Redemption Fund
3. Staff provident fund
4. Workmen Saving Bank A/c
5. Employees Provident Fund
6. Unclaimed Dividend
7. Provision for Taxation
8. Rehabilitation Fund
9. Workmen Claim for Compensation (if payable)

If some equity shares are fully paid-up and other are partly paid-up, then method of notional call on partly paid-up should be preferred. For a while, assume that partly paid-up shares have paid the call money and then net equity was calculated. Once, intrinsic value is arrived at, then notional call money can be deducted from the intrinsic value.

When there are calls in arrears, in that case, notional recovery of calls in arrears shall be assumed so as to find out the value of each fully called up share. Net assets will include notional calls in arrears money, once intrinsic value is calculated, calls in arrears is deducted.

If shares have different face values, then it is strongly recommended to follow the approach of converting all shares into equivalent number of shares, thereafter, calculate intrinsic value and accordingly, intrinsic value can be changed.

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II. DIVIDEND YIELD VALUE METHOD:

As already stated, net assets method is applied on the assumption that if the company goes into liquidation, then what is the value of net assets which would be available for equity shareholders. Based on those net assets, intrinsic value of shares is computed, but this method totally ignores the earning or profitability aspect of business. Whereas, the investor treats the business as a going concern rather than relying on the assumption of liquidation. Yield value method, therefore, is considered as an improvement over intrinsic value method.

Dividend yield method can be interpreted based on the availability of profits for equity shareholders. It considers the available profits for equity shareholders on the assumption that maximum amount is available for the payment of dividend. Return on equity is also used as expected rate of return for equity shareholders.
Mathematically, yield value per equity share can be computed in the following two alternative ways, which will give same results.

Ist Alternative:

Yield value per equity share =

$$\frac{\text{Return on equity (Expected Rate)}}{\text{Normal rate of return}} \times \text{Paid-up value per equity share}$$

Where, Return on Equity or Expected rate of dividend =

$$\frac{\text{Profits available for Equity Shareholders}}{\text{Paid-up equity share capital}} \times 100$$

Return on equity is also called as expected rate of dividend by shareholders.

Normal Rate of Return: It is the rate of return that the investors, in general, expect on their investments in a particular industry. This rate differs from industry to industry. Following formula is used to arrive at normal rate of return, if it is not expressed clearly. Consider average dividend per share of the same industry as numerator and consider market price of the share in the similar company of the industry as denominator. Calculate the relationship in percentage, which is referred as normal rate of return.

$$\text{Normal Rate of Return} = \frac{\text{Dividend per share (DPS)}}{\text{Market price per share (MPS)}} \times 100$$

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Computation of Profits available for Equity Shareholders:

	Rs.
Earnings Before Interest and Tax (EBIT) or Profits Before Interest and Tax	XXX
(PBIT)	(XXX)
Less: Interest on Debentures &Loans	XXX
Profits Before Tax (PBT) or Earnings Before Tax (EBT)	(XXX)
Less: Corporate Income Tax	XXX
Profits After Tax (PAT) or Earnings After Tax (EAT)	(XXX)
Less: Transfer to General Reserve	(XXX)
Less: Preference Dividend	**XXXX**
Profits available for Equity Shareholders	

IInd Alternative (Same results will come):

In this alternative, profit for equity is to be capitalized and then divided by number of equity shares to know yield value.

$$\text{Yield value per equity share} = \frac{\text{Capitalized value of profits for equity shareholders}}{\text{Number of equity shares}}$$

$$\text{Where, Capitalized value of profits} = \frac{\text{Profits available for Equity Shareholders}}{\text{Normal rate of return}} \times 100$$

Dividend yield value per preference share:

Same pattern of valuation can be applied for valuing Preference shares.

Use "return on preference share" in place of "return on equity". We may also call it "expected rate of preference dividend".

$$\text{Yield value per preference share} = \frac{\text{Expected rate of preference dividend}}{\text{Normal rate of return}} \times \text{Paid-up value per Preference Share}$$

Where,

$$\text{Expected rate of dividend for preference share} = \frac{\text{Profits available for preference shareholders}}{\text{Paid-up preference share capital}} \times 100$$

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Alternatively, yield value per preference share can also be computed as under:

$$\text{Yield value per preference share} = \frac{\text{Capitalized value of profit for preference shareholders}}{\text{Number of preference shares}}$$

Where, Capitalized value of profits for preference shares =

$$\frac{\text{Profits available for preference shares}}{\text{Normal rate of return for preference shares}} \times 100$$

III. EARNINGS CAPACITY METHOD:

The main drawback of the yield method is that it values the shares on the basis of expected rate of dividend. It ignores the earning capacity of the business. The method considers similar formula as was applied in yield method, but in place of expected rate of dividend, return on capital employed is given due importance. It is appropriate to value the shares on the basis of earnings of the company as compared to capital employed rather than the dividend yield. In place of expected rate of dividend or return on equity, rate of earning term is used, which is very closely associated with return on capital employed. Hence, in earnings capacity method, the rate of earnings of the company is considered.

Value per equity share as per earnings capacity method=

$$\frac{\text{Rate of earnings}}{\text{Normal rate of return}} \times \text{Paid-up value per share}$$

Where, Rate of earnings = $\frac{\text{Estimated future earnings or Future maintainable profits}}{\text{Capital employed}} \times 100$

Estimated future earnings/ Future maintainable profits: Future maintainable profits will be computed by adjusting the profits of past years. In other words, certain adjustments are to be made in the past profits before tax, such as:

- Reduce abnormal incomes
- Add back abnormal losses
- Reduce income from non-trading investments.
- Any error occurred in the past to be rectified.

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Income from investments must be excluded from profits, since it is not earned through the normal trading operations of business.

Profits should be after tax but before the following items:

(a) Interest on debentures (Net of Tax)

(b) Preference dividend

(c) Transfer to Reserves

In short, following are the steps to get Future Maintainable Profits or Profits Earned against Capital Employed:

PAT + Income Tax = PBT
PBT + Abnormal Loss – Abnormal Gain – Income from Non-Trading Investments = PBT (Adjusted)
PBT (Adjusted) – Income Tax = PAT
PAT + Interest on Debentures (Net of Tax) = Profits Earned or Future Maintainable Profits against Capital Employed.

Interest on Debenture net of tax is included, as capital employed includes debentures as well.

Average of the past years' profits after adjustments is to be preferred, subject to availability. Sometimes, past years' profits are not available, then current year profits can be taken after all above adjustments on the assumption that there was no variation in profits in the past.

Alternatively, Profits earned or future maintainable profits, same as above, can also be obtained as per the following steps:

PAT + Income Tax + Interest on Debentures = PBIT
(PBIT + Abnormal Loss – Abnormal Gain – Income from Non-Trade Investments) (1 – Tax Rate) = Profits Earned or Future Maintainable Profits against Capital Employed

Computation of Capital Employed:

	Rs.
All Assets at Market Price (excluding Fictitious Assets & Non-Trading Investments)	XXX
Less: Current Liabilities	(XXX)
Capital Employed	**XXXX**

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Note: It is important to mention here that capital employed considers long term sources of finance for a company, which includes proprietor's funds and long-term debts. Considering the ingredients of capital employed, profit has been adjusted accordingly to find out the rate of earnings.

Alternatively, Capital Employed, same as above, can be computed as under:

	Rs.
Equity Share Capital	XXX
Add: Reserves and Surplus	XXX
Add: Preference Share Capital	XXX
Add: Debentures and Other Long Term External Borrowings	XXX
Add: Profits on Revaluation of Assets	XXX
Less: Loss on Revaluation of Assets	(XXX)
Less: Non-Trading Investments	(XXX)
Less: Fictitious Assets (Such as, Discount on issue of Debentures, Share Issue Expenses, etc.)	(XXX)
Capital Employed	**XXXX**

IV. FAIR VALUE METHOD:

The fair value method gives emphasis to all the average of the two methods. It can be average of intrinsic value and yield value or it can be average of intrinsic value and value of share as per earnings capacity method. The method considers the joint effect of two methods.
The value of share as per this method can be computed by following two approaches:

(a) Fair value per share considering intrinsic value and dividend yield value:

$$\text{Fair value per share} = \frac{\text{Intrinsic Value per share} + \text{Dividend yield value of an equity share}}{2}$$

(b) Fair value per share considering intrinsic value and value of share as per earning capacity method:

$$\text{Fair value per share} = \frac{\text{Intrinsic Value per share} + \text{Value of an equity share as per Earning Capacity Method}}{2}$$

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5. CONCLUSION:

The present study attempts to bring clarity among the readers regarding the various methods of valuation of equity shares by explaining all the methods in detail, which would help in removing confusion. The valuation of equity share as per earning capacity method is often found confusing due to the diverse opinions of various authors. An attempt has therefore been made in the present research to give clarity in relation to the same.

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