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Dispute Insights

Perspectives on Arbitration & disputes

Editor's desk

Dear readers,

We are pleased to present Dispute Insights, a periodic newsletter which captures recent developments and commentary on disputes and arbitration.

In our welcome edition, we look at the fundamentals of valuation in disputes.

With the extraordinary rise in deal volumes, there runs a risk of disputes and fallouts and the need for a subsequent robust valuation. We explore the principles of conducting a healthy valuation and methodologies commonly used by Experts in dispute resolutions, along with their associated strengths and weaknesses.

While it is our endeavour to assist you in fulfilling your business objective, we always look forward to better engage with you. Do let us know what you think and in case you want to hear something in particular, feel free to write to us.

Once again, we hope the information is useful and any feedbacks are most welcome!

Best,

Vidya Rajarao

Partner and National Leader

Opinion Matters

Rethinking valuation in disputes

Background

India has witnessed unprecedented deal volumes in the recent years. Estimates by Grant Thornton India Dealtracker which provides M&A and Private Equity Deal Insights, suggest M&A and PE activity having reached USD 280 billion over the last five years[1]. While the figure includes cross-border and domestic M&A and PE deals, it does not consider unreported JVs, other forms of partnerships and gain-sharing arrangements.

An upsurge in the deal activity, however, also brings with it increased likelihood of fall-outs and disputes.

Various developments could lead to the rise of a dispute, and some commonly observed situations in this context include:

- Contract disputes: Arise on account of breach of contract, unlawful termination, deficient services, delays in project commencement and the like by one or more contracting parties;
- Acquisition and shareholder dispute: Ascend from corporate M&A transactions and PE investments;

One may safely decipher that at the root of every dispute lies:

a. a financial loss to one or more parties and

b. the need of these parties to be compensated for such loss.

Moreover, computation and determination of loss or quantum of damages is not always simple and additionally, in the interest of fairness, it is imperative to meet two crucial requirements thereof, independence and expertise.

This in essence defines, both, the need for, and the role of, an Expert in dispute resolution or litigation and is captured succinctly in G L Sultania v SEBI, AIR 2007 SC 2172:

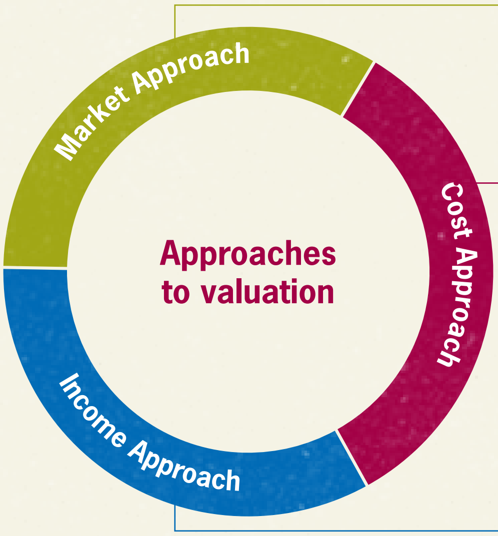
"It appears to us that the appellant expects this Court to act as an expert itself. This, we are forbidden from doing…

……..As noticed in Miheer H. Mafatlal (supra), valuation of shares is a technical and complex problem which can be appropriately left to the consideration of experts in the field of accountancy. So many imponderables enter the exercise of valuation of shares."

1. Includes cross-border as well as domestic M&A and PE deals

Fundamentals of a valuation

There exist three basic or over-arching approaches to valuation – Cost, Income and Market[2], which are represented in the graphic below:



- Principle of competition
- How much is a similar business worth?

- Principle of substitution
- How much would it cost to recreate the business/ create another business capable of generating the same economic benefits?

- Principle of expectation
- What economic benefits can I derive from this business if I invest adequately and appropriately?

While these approaches are relatively straightforward, the territory beyond is fraught with complexities ranging from lack of reliable (or any) data points, industry dynamics to subjective assumptions which eventually complicate valuations.

The three approaches to valuation - a deeper insight

I. The Cost Approach

The value arrived at under this approach is based on the latest available audited/ provisional financial statements of the business. Since it is the assets and liabilities that constitute a business, the excess of assets over liabilities, defined as Shareholders' Funds in accounting parlance, can be used to determine the 'net asset value' attributable to equity owners of that business[3].

When it works, the pros

- Certain businesses, by their very nature, are 'asset – heavy'. Consider Real Estate, where a primary component of value is the land and building parcels owned/ being developed by the company
- Businesses with high investments in fixed, tangible assets (ports, manufacturing plants) and in their early stage of lifecycle may be better represented by their net asset values when the assets have not reached optimum level of utilisation to be reflected in incomes, or when such incomes cannot be reliably predicted
- Loss - making businesses & liquidation scenarios

When it does not work, the cons

- It ignores the future return assets produce and is calculated using historical accounting data that does not reflect the worth of business to someone who may buy or invest in the business as a going concern, when, in actuality, contracting parties in a dispute will have invested to reap future returns which are not captured by this valuation approach.
- Owing to inter-asset synergies and intangible assets such as brand name, market standing, management team strength, etc., the 'whole is greater than the sum of the parts' This implies that since none of the crucial synergies and intangibles is captured on a balance sheet, the business may be under-valued.
- Under many accounting standards (including the ones currently followed in India), assets and liabilities are not held at 'fair value', which is indicative that the value that could be realised/ paid for assets/ liabilities could differ from that recorded on the balance sheet.
- Specifically, and most crucially, in the case of disputes, the nature and values of assets and liabilities constituting a business are often unclear and contested, rendering this method unusable. To exemplify, in case of a dispute involving a particular enterprise, a fall-out between the co-investors may result in no financial statements being finalised for the business. As a result, as on the date of valuation, financial statements either do not exist or may depict absurd results - e.g., respective borrowings estimated at INR 49 crore and INR 3300 crore.

In a nutshell, while valuation under this approach is likely to involve the least subjectivity, there also runs a risk of being distant from reality in as much that asset and liability values making up the business are concerned.

2. While this article uses the term 'business', note that many of these concepts are equally applicable to a specific asset/ asset bundle/ business division

3. In the event that a particular asset is being valued under this approach, certain methods exist that use the same philosophy – examples include Reproduction Cost method and Replacement Value method

II. The Market Approach

This approach assumes that markets are efficient in discovering value and a 'fair value' for a business is what is visibly transacted in the market for the business itself, or for 'comparable' entities. Three specific methods commonly used under the Market Approach are tabulated below:

Methodology	Associated description
Stock Exchange Quotation or Market Price Method	• Reflects the price that the market at a point in time is prepared to pay for shares of the business
Comparable Company Market Multiple Method	• Market multiples of comparable listed companies are computed and applied to the business being valued in order to arrive at a multiple based valuation • It is based on the premise that the market multiples of comparable listed companies are a good benchmark to derive the value of the company being valued, by looking at the price of the listed comparable relative to a common variable such as sales, earnings or other balance sheet metrics
Comparable Transaction Multiple Method	• Similar to the above Market Multiple Method, with the only exception that the companies used as guidelines are those that have been recently acquired • Acquisitions or divestitures involving similar companies are identified, and the multiples implied by their purchase prices are used to assess the subject company's value.

When it works, the pros

- By benchmarking value to what is actually being transacted, this approach is perhaps the closest to reality and largely eliminates subjectivity.
- Macro-economic factors, including investor sentiment, global risk perception and the like which cannot be de-linked from the valuation of a business are best captured by this method.
- Market prices are also believed to reflect the investor's view of the management's ability to deliver a return on the capital being used and the role played by off-balance sheet intangible assets and liabilities, if any.

When it does not work, the cons

- For listed companies, stock price can be construed as fair value only if the stock is frequently traded – disputes, however, seldom revolve around frequently traded stocks with efficient price discovery.
- The criterion of 'comparability' is an unyielding one. In order to state that the value accorded to a business should be the same as implied in the price of another listed company (ies), it is imperative that the 'comparable' company not only operates in the same industry and geography, but also sells similar products/ services, works on comparable operational and financial models, is in a comparable stage of lifecycle, targets similar customers, employs similar business strategies and accounting practices, etc.
- If these criteria are not satisfied, the multiples have to be disregarded or adjusted for incomparability, often based on judgment.

III. The Income Approach

This approach looks at the future returns or economic benefits that the business is capable of generating, in conjunction with the associated cost of time, delay in achieving such returns in the future. The most commonly used method under the Income Approach is the Discounted Cash Flow ("DCF") method, which uses the future 'free' cash flows available, after consideration of financing and investing needs, to the business, discounted by the cost of capital/ equity to arrive at the present value.

Any DCF, at its core, comprises two components, cash flows expected to accrue in the future, and a 'discount' rate used to estimate what these future cash flows are worth today.

When it works, the pros

- It is a robust and widely accepted valuation tool, as it concentrates on cash generation potential of a business. Ultimately, the cash generated for distribution to stakeholders is the truest estimate of economic returns that investors look for.
- Disputes often involve fairly unique businesses; by allowing the forecasting of business specific cash flows, the DCF method recognises this uniqueness.

When it does not work, the cons

- The DCF method is the most subjective valuation method – making any DCF valuation only as good as the assumptions it is based upon. Assumptions range from growth rates and profit margins that lead to cash flows, to investments needed and returns capable on such investments, to perceived risk inherent in these cash flows (which in turn affects the discount rate).
- Any robust DCF should primarily rely on the cash flows to represent a true (or, at the least, a reasonable) picture of the future, rather than the commonly seen practice of using the discount rate as a goal-seeking panacea[4]. However, and particularly in case of disputes, such cash flow projections are primarily supplied by the defendant/ claimant, thereby greatly increasing the probability of bias, often inadequately adjusted for in the valuation.
- In the contentious circumstances of disputes, the cash flow projections are themselves very hard to forecast. While scenarios and sophisticated option pricing models can be built to incorporate possible variations, this brings with it increased assumptions and subjectivity.

The above issues notwithstanding, the DCF method, to summarise, is relatively a robust valuation method since it offers the flexibility that the unique circumstances of a dispute demands; independence, expertise and experience of the Expert Valuer can go a long way in mitigating the weaknesses of the DCF method. Testimony to this is the fact that most dispute valuations continue to be performed using the DCF method.

Finally, DCF techniques have been universally adopted, including by numerous arbitral tribunals as an appropriate method for valuing business assets. Arbitral tribunals have relied on and used the DCF method to determine damages. In some instances, tribunals have appointed experts to calculate damages using DCF but with the Tribunal's logic, assumptions and data.

Determining the elements of a robust valuation

We revert to our initial stand in this regard, the Courts usually rely on the Expert to arrive at company valuations. Grounds for interfering with valuations of Experts mainly pertain to overall approaches rather than the specific (and numerous!) nuances of valuation (G L Sultania v SEBI, AIR 2007 SC 2172):

Conducting a robust valuation

- Departure from well accepted principle of valuation without any reason
- Adoption of a patently erroneous approach
- Non consideration of relevant factors
- Valuation made on fundamentally erroneous basis
- Adoption of a demonstrably wrong approach
- Fundamental error going to the root of the matter.

The specific valuation approach adopted will evidently rely on the circumstances of the case and it is common to use more than one method and the ability of the Expert to develop detailed and accurate valuation models is as crucial as their ability to convey their conclusions clearly and succinctly, in a form that can be appreciated by the presiding Judge/ Arbitrator.

Any valuation must always therefore, rest upon the pillars of independence, research, robustness of assumption, reasonableness and expertise.

4. All other things being equal, a higher discount rate decreases value and vice-versa

References: 'Business Valuation: the Three Approaches' http://www.valuadder.com/valuationguide/business-valuation-three-approaches.html

Editor's pick

Inching closer to effective Arbitration, Arbitration Ordinance 2015

Government of India cleared two ordinances for settling commercial disputes speedily as the Union Cabinet chaired by Prime Minister Modi approved one ordinance for constitution of commercial courts and another to amend the Arbitration and Conciliation Act 1996. These are now pending before the Parliamentary committee and once the winter session commences, the Government will have to seek Parliament's approval for the ordinances within six weeks or else they lapse[5].

It is clear that the government with this initiative **endeavors to create a responsive environment for arbitration** in the country and specifically **encourage foreign investors.** The existing framework has been a deterrent to foreign firms as arbitration may take more time than litigation creating a remarkable paradox to the whole concept of alternate dispute resolution. The amendments pave the way to stimulate ease of doing business as some of the changes are in line with international norms.

Key **highlights** of the proposed amendments are listed as below

- **Timelines –** A key amendment, addressing the massive delays ubiquitous in arbitrations in India, relates to laying down of timelines to **expeditiously complete arbitrations.** Specific timelines proposed for various stages in this regard are:
  a. **Appointment:** The Supreme Court or High Court shall attempt to appoint an arbitrator within 60 days of receiving such application
  b. **Award:** The arbitral tribunal shall make its award within 12 months, for arbitrations taking seated in India; this period is further extendable by another six months, where courts believe there is sufficient cause.
  c. **Further incentivisation to complete arbitrations expeditiously has also been provided –** arbitrators can be paid additional fees if the award is made within six months; if delay is on account of the tribunal, however, courts can impose reduction of fees at a capped rate of five percent per month of delay
  d. **Fast – track:** The parties can also agree to conduct a fast-track arbitration, i.e., within six months, in line with international norms in this regard
- **Criteria for appointment of Arbitrator -** Besides specific timelines, amendments pertaining to extensive disclosures establishing independence and **impartiality** of the arbitrator and a **cap on the fee** of the arbitrator have been proposed.
- **International commercial arbitrations –** The Ordinance makes a distinction between international and domestic arbitration; in international commercial arbitrations, seated in India and abroad, **only the High Courts would exercise jurisdiction,** thereby increasing confidence in Indian arbitrations for international parties through access to highly qualified and experienced High Court judges.
- **Interim reliefs –** In order to increase flexibility and alignment with international norms, it is proposed to allow parties to a foreign – seated arbitration to approach **Indian courts** for interim reliefs.
- **Increase enforceability –** The Ordinance also looks to give more teeth to arbitrations in India through increased enforceability:
  a. Interim orders passed by arbitral tribunals seated in India would be deemed to be order of Courts and therefore enforceable accordingly
  b. Tightened and narrowed conditions under which arbitration awards, including those in international commercial arbitrations, can be challenged
  c. Further, merely filing a challenge of the arbitral award would no longer result in the award execution being stayed, deterring frivolous applications for staying awards
- **Regime for costs –** New Section introduced wherein arbitral tribunals can award costs to either the unsuccessful party or a different order with reasons in writing. Note that the 'Costs follow the event' concept is a generally accepted practice in international arbitration.

While the Ordinance attempts to introduce significant changes to address issues plaguing the arbitration landscape, the actual implementation of these changes is some way off. However, it is clear that India is well on its way to using arbitration as an effective alternative dispute resolution mechanism in the future.

5. Source: http://barandbench.com/two-new-ordinances-commercial-courts-ordinance-and-amendment-to-arbitration-conciliation-act/

News Snippets

Chinese arbitration adapts to international market

Arbitration is witnessing a rapid growth steadily in China. With a percentage rise of 9% in the arbitration commission from last year. The rise reported, both in terms of the number of cases and the value of the claims involved has resulted in determined efforts from the Chinese government to improve the quality of its arbitration system and progress towards adopting international standards.

Putting arbitration on fast track

The Arbitration and Conciliation (Amendment) Ordinance 2015, recently promulgated by the President is a welcome step in the existing arbitration and legal framework in India. It focuses on speedy trials and addresses concerns regarding delays as well as unwarranted intervention by the courts besides permitting interim relief in foreign seated arbitration. Emphasis on the much needed aspect of neutrality of arbitrators is another landmark progress in the framework.

Arbitration drives out litigation in construction disputes

A recent survey by Queen Mary University of London (QMUL) in partnership with global law firm White & Case has revealed that a high inclination in favour of arbitration over other methods of resolving cross-border disputes. Owing to the benefits associated with international arbitration including the greater enforceability of arbitral awards, the inherent flexibility of the process, and the ability to avoid specific legal systems yet choose arbitrators, construction companies and project sponsors now favour the same.

To know how Grant Thornton can help, please contact our subject matter experts

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