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This thought leadership paper provides insights on the various issues relating to intercorporate investments in valuation.

Introduction

Multinational, multi-business companies often have complicated structures, with intercorporate investments (i.e., investments in other companies) across various geographies and across various business lines.

Companies commonly make equity or debt investments in other companies. Ownership can be minority (less than 50%) or majority (greater than 50%) and the degree of operational influence can be passive or active.

Accounting categorization

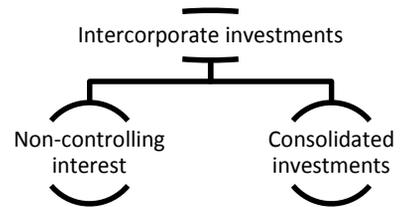
The accounting treatment of intercorporate investments is based on the degree of influence or control that the investor is able to exercise over the investee.

The following table shows the categories of ownership recognized by U.S. GAAP for the purposes of financial reporting:

Investment category	Level of investor influence	Investor ownership level	Accounting treatment
Investments in financial assets	Not material	Less than 20%	1) FVTPL ¹ 2) FVOCI ² 3) Amortized cost
Investments in associates	Significant	20% – 50%	Equity method
Business combinations	Control	More than 50%	Consolidation

Accounting treatment

Based on the categorization as discussed above, for valuation purposes, the intercorporate investments are broadly classified as depicted in the below chart:



1. Non-controlling interest

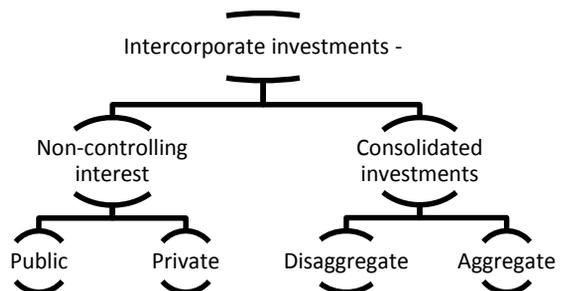
Investments in financial assets and investments in associates are classified as non-controlling interest. Such investments are companies in which the parent company holds less than 50% equity stake or the degree of influence over the investee company is non-controlling.

2. Consolidated investments

Business combinations are classified as consolidated investments. Here the ‘parent – subsidiary’ relationship arises whereby the parent company exercises formal control over these subsidiaries.

Valuation considerations

The alternatives to value intercorporate investments vary depending upon their classification as well as on the availability of full or partial information -



¹ Fair value through profit and loss

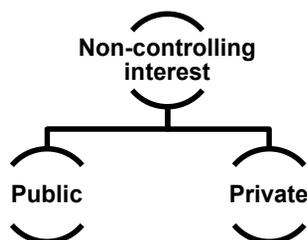
² Fair value through other comprehensive income

Valuing intercorporate investments

Valuation consideration (cont...)

1. Non controlling interest

The primary consideration in the process of valuing non-controlling interest is the trading nature (*i.e. publicly traded or privately held*) of the investment as well as the availability of information



- **Publicly traded investments**

For publicly traded investments, the market value of the investment is preferably used as the value estimate. However, before relying on this methodology the market value must be verified as to whether any indicator exists that might suggest that the share price does not reflect current information.

In a case, where the share price does not reflect current information but full access to the financial information of invested company is available, a separate DCF valuation is performed to arrive at the value of equity shares of the invested company. Subsequently, the value of the investment is arrived at by applying the percentage proportionate stake of the holding company in the invested company.

- **Privately held investments**

If the invested company is not listed but full access to its financial statements is available, a separate DCF valuation of the equity stake as discussed above is considered for valuation purpose.

However, where full access to information is not available and holding company's accounts are the only source of financial information for the investment, then the following alternatives are relied upon–

Capitalization approach:

This is a feasible approach in case of minority active investments as only the net income and book equity of the invested company are generally disclosed. All that is required is an estimate of net operating income for the subject company being valued and an estimate of the overall capitalization rate relevant to that company.

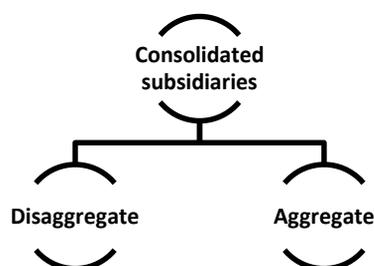
Multiples valuation:

Under this approach, multiples are extrapolated from publicly traded guideline company data to derive the value estimation for the subject company being valued.

Since typically net income and book value are available, the multiple of book value or net income at which companies in the same business (*as the private business in which you have holdings*) trade at are applied to the book value or net income of the invested company being valued.

2. Consolidated investments

The primary consideration in the process of valuing consolidated investments is perhaps the most critical, since it will determine how to approach the valuation process. It involves deciding, at the start of the process, whether to value the company as a whole (*aggregated*) or value its individual businesses separately (*disaggregated*).



- **Disaggregate valuation**

The viable way to deal with consolidated investments is to value the equity in such holding separately using either an income or market approach to estimate the final value of the proportionate holding.

The reason for separate valuations is that the parent and the subsidiaries may have very different characteristics – costs of capital, growth rates and reinvestment rates.

E.g. Company A is a steel company and Company C is a chemical company. Valuing them on a combined basis under these circumstances may yield misleading results.

Valuing intercorporate investments (cont...)

Following steps are involved in valuing a consolidated parent company with intercorporate investments -

Step 1: Value the parent on standalone basis

To arrive at the value estimate, the standalone financial statements of the parent company are used. If only consolidated statements are available, adjustments to the income, assets and debt of the subsidiary from the parent company's financials is required as failure to do so may double count the value of the subsidiary.

Step 2: Value the subsidiaries independently

Applying the crux of disaggregate approach, here each of the subsidiaries that the parent company has holdings in are valued as independent companies, using risk, cash flow and growth assumptions that reflect the businesses that the subsidiaries operate in. The value estimate is arrived at by applying the percent stake of parent in subsidiary to estimate the proportionate value owned by the parent.

E.g. if Company A holds 60% of Company C, then value of subsidiary C that would be considered for valuation of Company A

$= \% \text{ owned in Company C} * (\text{Value of Company C} - \text{Debt of Company C})$

Step 3: Consolidation of value

Once the value of parent and subsidiary is separately arrived (*estimated in step 1 & 2*), they are added up to determine the final value of the equity in the parent company with the cross holdings.

• Aggregate valuation

Aggregate valuation is relied when the characteristics – costs of capital, growth rates and reinvestment rates, of the parent and subsidiary do not vary. This might be the case when both the companies belong to the same industry or are similar in operations.

When valuing the company as an aggregated whole, the portion of the equity in the subsidiary that the parent company does not own i.e. non-controlling interest should be subtracted.

The important issue that needs to be addressed is that how to value these non-controlling interest. One way of doing this is to convert the minority interest from book value to market value by applying a price to book ratio (*based upon the sector average for the subsidiary*) to that minority interest.

$\text{Estimated market value of minority interest} = \text{Minority interest on balance sheet} * \text{Price to book ratio for sector (of subsidiary)}$

Using the accounting estimates

In many cases, the information that is provided on the investments, especially in the context of minority holdings, is not enough to value them. These companies often report an estimated value for the holdings on the balance sheet, though that estimated value is not necessarily a market value or even a fair value. When faced with multiple minority holdings, analysts often use these accounting values as estimates of the intrinsic value of the holdings.

Although using the accounting estimates of the holdings is the most commonly used approach in practice it should be the last resort especially when the values of the intercorporate investments are substantial.

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