CHAPTER IX
VALUATION OF SHARES IN SOME SPECIFIC CASES

Introduction:

This chapter is intended to be devoted to the peculiar problems of valuation of shares that may arise in certain circumstances. For instance a company may have issued different types of preference shares for which valuation may be necessary. Another company may issue right shares while still another company may issue bonus shares. Valuation problems and their solutions are not identical in all these situations. Again the problems of valuation of shares as also the principles of valuation will vary according to the nature of the company. Thus valuation of shares in an investment company will be different from that in a holding company. The peculiarities of valuation of shares in a private company are not the same as those in a public company. Naturally, a valuer has to face varieties of peculiar problems while valuing shares in multifarious situations. In this chapter an effort will be made to outline some of the peculiar problems of valuation of shares in some specific cases. At the same time a reference will be given to the basic principles that may be applied for the valuation of shares in these peculiar situations. It is conceded at the outset that dealing with each and every case requiring valuation of shares is neither feasible nor essential, because situations differ, situations change. Flexibility is the order of the day. Expert valuers will take stock of the changing situations and will apply their logical mind to solve the problem of valuation of shares. However, some of the very common cases in which a valuer may face problems in the valuation of shares are discussed below. These cases include ——
1. Valuation of Preference shares.

The valuation of Preference shares as in the case of valuation of equity shares, depends to a large extent on the clear conception of the rights and privileges attached to the preference shares. These rights and privileges attached to the preference shares vary from company to company and have material effect on the value of the preference shares.

It is true that a share shall never be a preference share, if it does not carry the two fundamental preferential rights referred to in clause (a) and clause (b) of subsection (1) of Sec. 85 of the Companies Act, namely, preferential right as to dividend during the life-time of the company and preferential right as to return of capital in the event of liquidation of the company. But the preference shares may carry some other rights and privileges which are not essential ingredients of a preference share, but nevertheless are some of the preferential rights and privileges and all these depend on the terms of issue and provisions of the memorandum and articles of association of the company.
Thus it is necessary for the valuer to examine the memorandum and articles of association governing the rights and privileges of the preference shareholders. Each of these rights and privileges does have certain weights. Accordingly, each should be considered while valuing preference shares.

In valuing preference shares, the valuer should direct his attention to another very important aspect.

Preference shares, particularly in unlisted companies are becoming more and more unpopular because of the continuous inflation. Once issued, the preference shares generally remain indefinitely as part of the capital structure of a company. But the fear of continuing inflation has made an irredeemable investment with a fixed income unattractive and unpopular. This point should not be lost sight of in valuing preference shares.

Principles of Valuation:

The valuation of preference shares may be necessary for both statutory and non-statutory purposes. The principles of valuation of preference shares for statutory purposes have already been discussed in an earlier chapter. So far as the valuation of preference shares for non-statutory purposes is concerned, it is to be noted that the preference shares which are dealt with in the stock exchange and no manipulation is suspected, the stock exchange markings provide the generally acceptable values of the preference shares.
Valuation of unquoted preference shares may create problems. Valuation, normally, does not create much difficulty, provided the company earns profits with a comfortable margin and the dividend is paid regularly. Because of the limitation placed on dividend for the preference shares the considerations applicable for the valuation of ordinary shares are not wholly applicable to the valuation of preference shares. Here the two dominant factors that will influence valuation are payment of dividend and the repayment of capital.

Some Important Considerations:

(a) Effect of preferential right as to arrears of dividend -

In the case of preference shares with the cumulative rights as to arrears of dividend, safety regarding the payment of dividend is assured. The lower risk involved has a diminishing effect on the percentage yield to be sought. Generally, in a prosperous company the cumulative rights may be of very little consequence, but in a company where uncertainty regarding payment of future dividends prevails, a preference share which does not carry this right will be valued at a low figure. The valuer must deduct a token sum to provide for the absence of the cumulative rights.

(b) Effect of participating rights -

Participating rights attach to the participating preference shares. A participating preference share carries a right to
participate, whether fully or to a limited extent, with the ordinary shareholders in surplus profits by way of additional dividend or in surplus assets which may remain after the repayment of the entire capital in the event of liquidation of the company. This type of preference shares has got the characteristics of other preference shares, but undoubtedly, it partakes of the characteristics of equity shares at least to a limited extent. Accordingly, the valuation of this type of preference share is to be made in two parts, the first part as a simple preference share and the second part involving the valuation of the participating rights. The most important participating right of the participating preference shareholders is the right of participation in surplus profits by way of additional dividend. A different rate of capitalisation is to be used for the capitalisation of additional dividend. The rate of capitalisation in respect of the fixed dividend of the preference shares will not apply, because the payment of normal fixed dividend on simple preference shares and the payment of additional dividend for the participating preference shares are not the identical situations. Now the payment of additional dividend may be restricted or unrestricted. If the additional payment is without any restriction, the rate of capitalisation for the additional dividend may be taken as equal to the rate of capitalisation used for the valuation of equity shares on the basis of maintainable profits. The simple reason is that so far as this right to unrestricted payment of additional dividend is concerned, the distinction between participating preference shares and equity shares is deemed to be vanished for the time being at the point
of distribution of the surplus profits. If some restrictions are imposed on the quantum of the additional dividends, a new rate of capitalisation for the additional dividend has to be computed and this rate will lie somewhere between the general rate of capitalisation for the equity shares and the rate of capitalisation for the fixed dividends on preference shares, depending upon the exact terms of the issue of the preference shares. In connection with the capitalisation of the additional dividend, one question may be raised about the possibility of the additional payment in future. The problem can be resolved by appropriate determination of maintainable profits of the company. The dividend policy of the company, its pay out ratio and the terms for the payment of additional dividend to participating preference shareholders are also to be considered for the purpose of determining the possibility of the payment of additional dividend in future. If, however, it appears that this right to participate in the surplus profit by way of additional dividends is not to be considered as a regular feature, then the present worth of the additional dividend expected to be paid in future from time to time may be considered by the valuer.

It is now clear that the valuation of participating preference shares can be made in the following manner:

- Value of a participating preference share as a simple preference share.
- Add: Appropriate value of the participating rights.

So far the discussion was related to the participating right as to additional dividends. Apart from this right,
another right of the participating preference shareholders relating to participation in surplus assets is also a very valuable right. But the value of this right is heavily discounted because of the remote possibility of the earlier accrual of benefit from this right. In fact the flow of benefit from this right is contingent upon the happening of two events, namely, the liquidation of the company and the availability of surplus after the repayment of the entire capital of the company. Delay and uncertainty together with the contingent element present in this right will reduce its value to a great extent. However, where the net tangible assets cover for the equity shares is too high, the valuer may add a token sum for the presence of this right with the value of the participating preference shares determined in the manner laid down above.

(c) Effect of the Privilege of redemption -

The redeemable preference shares carry a special privilege of being redeemed during the lifetime of the company. The position of the holders of this type of preference shares further improves, if they are also entitled to receive some premium on redemption.

The valuation of this type of preference share is greatly influenced by the right of redemption. The possibility of earlier redemption tends to enhance the price.

Where the date of redemption approaches near or at least where it is known that the date of redemption is not far away,
normally, all receipts which a preference shareholder is expected to receive in near future by way of dividend and capital are estimated and the amount so estimated is then reduced to its present worth. All possible future receipts shall also include premium, if any, payable on the redemption of preference shares. The value of the redeemable preference shares can be mechanically computed with the help of the following formula, provided the exact date of redemption is known and the expected yield is determined:

\[
\text{Value of a redeemable preference share} = \frac{100 + r t}{100 + ty} \times \text{par value of a share.}
\]

Where:
- \( r \) = rate of dividend on preference shares,
- \( t \) = exact time after which the redemption will take place,
- \( y \) = Expected yield.

Illustration

A company has 100 5% Redeemable Preference shares of Rs.100/- each, redeemable after three years. The expected yield is 10%. The value of a share will be:

\[
\frac{100 + (5 \times 3)}{100 + (3 \times 10)} \times 100 = \frac{115}{130} \times 100 = \text{Rs.} 88.46
\]

In case of redemption at a premium, the formula will be modified as follows:

\[
\frac{(100 + \text{Premium on redemption}) + rt}{100 + ty} \times \text{par value of a share.}
\]
The privilege of redemption attaching the preference shares will carry no special weight in cases where the date of redemption is uncertain. The yield required for the redeemable preference shares is generally the same as other non-redeemable preference shares. The possibility of redemption and consequently the early refund of the invested capital may slightly reduce the rate of general expectation.

(d) **Effects of voting rights**

Preference shares carry voting rights in certain circumstances referred to in Sec.87 of the Companies Act.

The valuation of preference shares carrying voting rights under section 87 should be made like simple preference shares. Normal voting rights carry no extra price. If the facts and circumstances of a company so demand, an additional value for this right may be considered.

(e) **Effect of conversion right**

Sometimes a company issues preference shares which may have a right of conversion into equity shares. Preference shares with conversion rights are issued as an inducement to the investors during a period of tight money. "During periods of rising interest rates and tight money, Convertibility offers a sweetener to induce investors to accept a lower dividend or interest rate."

There is no doubt that conversion privilege calls for a sacrifice on the part of the preference share holders, generally
in terms of lower dividend. But since the holders of preference shares with a right of conversion into equity shares can have the future benefit of capital appreciation enjoyed by the ordinary shareholders, they can claim an extra value for this special privilege attached to their shares. The additional value to be placed on the preference shares with conversion privilege will, however, depend on the exact terms of the right to convert. For instance, if certain preference shares are convertible into equity shares after the expiry of (say) three years, then the fixed dividends on such preference shares for the next three years may be determined and reduced to their present worth. The value of the preference shares after the end of the three years may be taken on the same basis as for equity shares. The value may also be reduced to its present worth. The total of the two values will give the value of the preference shares.

On the whole the value of preference shares with conversion rights may be computed by capitalising the preference dividends to be received up to the period of conversion and the equity dividends expected to be received after the period of conversion at appropriate rates of capitalisation. Two rates, one for preference dividend and the other for equity dividends may be used.

The value of the equity shares into which the preference shares will be converted is also relevant. Usually, when the price trend of the equity shares is upward, convertible preference shares will sell at premiums. Conversely, when the trend
of prices of equity shares is downward, the preference shares with conversion privilege will be sold at their intrinsic values or at their values, if converted into equity shares, whichever is higher.

So far the discussion related to the consideration of important rights and their effects on the valuation of preference shares. Before concluding, it is thought to be essential to direct attention to some other considerations which may have a bearing on the rate of capitalisation and other aspects of the valuation of preference shares.

1. The right of the preference shareholders to subscribe for a proportionate number of any new issues of equity shares at a price which may be less than the market price is a valuable right which can command additional value for the preference shares.

2. "The valuer of a preference share in a private company would have in mind the current yield of a preference share in a public company. He would be aware of the difficulties of disposing of any holdings. The smaller the company the greater the difficulty."  

3. The valuer may face a situation in which substantial preference dividend is in arrear. If the company is not fading away or if there is a real prospect of recovery, theoretically, the valuer may assume that the preference shareholders are in a strong position. But practice may differ from theory. Where dividend is in arrear for a number of years, the company may
adopt a scheme of reconstruction and the preference sharehold- 
holders may be forced to agree to a scheme which is unfavoura- 
ble to them. In view of these likely unfavourable situations, 
the valuer may consider the preference shares on which divi- 
dends are in arrear for a large number of years to be of 
interest only to a speculator and he may discount the value 
accordingly. But where the company has reached the profit 
earning stage and there is every possibility of declaring 
dividend in the near future, the value of the arrears of 
dividend may be added to the value of the shares. The value 
of the arrears of dividend can be calculated by ascertaining 
the present value of a series of annuities discounted at an 
appropriate rate.

4. The valuation of preference shares is also largely 
affected by ruling rates of interest. An illustration is 
given to show bow value of the preference shares is influenced 
by the ruling rates of interest even where a company earns 
enough profits. Supposing, in normal circumstances, a person 
can expect 4% return on a Rs.100/- preference share. He may 
be prepared to pay Rs.150 for a Rs.100/- 6% preference share. 
Now with the interest rates becoming harder in the market, such 
a share which formerly yielded 4% might be required to yield 
(say) 6% and the result would be that a decline in the share 
value cannot be resisted.
2. Valuation of Bonus shares :

(a) Meaning of bonus shares :

Bonus shares are the shares issued by a company to its existing shareholder by capitalising a portion of its surplus profits. The issue of bonus shares results in the conversion of accumulated profits and reserves into capital. Thus declaration of bonus shares is popularly known as a process of capitalisation of profits and reserves.

In an ordinary sense bonus share may seem to be an extra dividend paid to shareholders. The Oxford English Dictionary gives the ordinary meaning of bonus shares in the following words:

"An extra dividend paid to shareholders in a joint stock company from surplus profits."

But in the legal sense a bonus share is not a dividend unless it is an issue to preference shareholders.

(b) Principles of valuation of bonus shares :

With the issue of bonus shares the value of shares normally falls. If need arises, the valuation of bonus shares can be done by applying the general principles of valuation of shares. But at times it may be necessary to determine the cost of bonus shares and in this context the 1964 - Dalmia decision of the Supreme Court established a landmark in the process of determination of the cost of bonus shares. In this case the Supreme Court laid down the fundamental principles of determination of the cost of bonus shares.
M. Hidayatullah, J., speaking for himself and for J. C. Shah, J. (constituting the majority of the Supreme Court in this case) stated the following:

"... there are four possible methods for determining the cost of bonus shares. The first method is to take the cost as the equivalent of face value of the bonus shares. ........

.................................

....... The second method adopted by the department is that as the shareholder pays nothing in cash for the shares, cost should be taken at nil. The third method is to take the cost of the original shares and to spread it over the original shares and bonus shares taken collectively. The fourth method is to find out the fall in the price of the original shares on the stock exchange and to attribute this to the bonus shares."

It appears, therefore, that the Supreme Court considered four possible methods of determination of the cost of bonus shares before giving its sanction to the third method, i.e., the average cost method.

Average cost method:

This method provides for spreading the cost of the original shares over the original shares and bonus shares taken collectively. Since the Supreme Court approved of this method
in the Dalmia case and later on in C.I.T. Vs. Gold Mohore Investment Co., Ltd. and in C.I.T. Vs. Gold Co., Ltd., it is considered necessary to go into the details of this method of valuation of bonus shares.

The principles of determination of the cost of bonus shares enunciated by the Supreme Court in the case of C.I.T. Vs. Dalmia Investment Co., Ltd. (1964) 52 ITR 567(SC) are the following:

Where bonus shares are issued in respect of ordinary shares, held in a company by an assessee (who may be a dealer in share), their real cost to the assessee can not be taken to be at nil or their face value. They have to be valued by spreading the cost of the old shares over the old shares and the new issue, viz. the bonus shares, taken together, if they rank pari passu. When they do not, the price may have to be adjusted either in the proportion of the face value they bear (if there is no other circumstance differentiating them) or on equitable consideration based on the market price before and after the issue.

1. Where bonus shares rank pari passu - Where bonus shares rank pari passu with the original shares, the total cost of the old shares and the new shares remain the same and it is not a question of determining any extra cost for the new shares, but the average cost of both the new shares and the old shares taken together is to be fixed. In this context, the observation of the Supreme Court in the Dalmia case is interesting. The Court stated as follows:
"When the shares rank pari passu the result may be stated by saying that what the shareholder held as a whole rupee coin is held by him, after the issue of bonus shares in two 50 np. coins. The total value remains the same, but the evidence of that value is not in one certificate but in two. This was expressed forcefully by the Supreme Court of the United States of America, quoting from an earlier case in Eisner vs. Macomber."

The actual calculation may be shown with the help of the following illustration:

Company - X. Ltd.

Original Shares - 20,000

Cost price of

Original shares - Rs.2,00,000
Bonus shares issued (number) - 20,000.

Cost of a bonus share is calculated below:

Total cost of all shares (both old and new) = Rs.2,00,000/-
Total number of shares = 40,000

Cost of a bonus share = \[
\frac{\text{Total cost of shares}}{\text{Total number of shares}}\]

= Rs.2,00,000/- = Rs.5/-.

(ii) Where the bonus shares do not rank paripassu with original holding -

In this case the price may have to be adjusted either in
the proportion of the face value (if there is no other circumstance to differentiate) or on equitable consideration based on the market price before and after the issue. In this connection, the observation of the Supreme Court in the Dalmia case is very much helpful and noteworthy. The Court stated the following:

Where the shares do not rank pari passu, -

"It may be necessary to compare the resultant price of the two kinds of shares in the market to arrive at a proper cost valuation. In other words, if the shares do not rank pari passu, assistance may have to be taken of other evidence to fix the cost price of the bonus shares. It may then be necessary to examine the result as reflected in the market to determine the equitable cost."

In this case problem will arise in valuing the bonus shares on equitable basis, if the original shares are not quoted on the stock exchange. Then the market value may have to be estimated on some reasonable consideration.

In connection with the valuation of bonus shares, three interesting questions may be raised. Firstly, what will happen, where an assessee sells the original shares purchased by him, but retains the bonus shares issued to him? Is it necessary to spread the cost of original shares over the old shares to spread and bonus shares for the purpose of determining the profit or loss from the sale of original shares? Secondly,
Is it necessary to value the bonus shares as stock-in-trade in a case where the assessee holds the original shares as stock-in-trade? Thirdly, does the principle of determination of the cost of bonus shares enunciated by the Supreme Court in the 1964 Dalmia case apply equally to all owners irrespective of whether they are dealers or investors? The answer to the first question is to be found in Emerald & Co. Ltd. vs. C.I.T.\textsuperscript{10} In this case the Supreme Court held that where an assessee had sold the original shares purchased by him, but retained the bonus shares issued to him the profit or loss on the sale of the original shares was to be computed by considering solely the purchase price and sale price of the original shares and the bonus shares were to be ignored altogether in the said computation. Thus there is no question of spreading the cost of original shares over old shares and new bonus shares taken together. The answer to the second question is to be found in C.I.T. vs. Madan Gopal Radhey Lal and C.I.T. vs. Kunji Lal Gupta.\textsuperscript{11} In these cases the Supreme Court held that where an assessee is holding original shares as his stock-in-trade, bonus shares issued in view of the original holding do not ipso facto become part of assessee's stock-in-trade. The Court was of the view that bonus shares are normally deemed to be distributed by the company as capital and the shareholder receives the shares as capital.

So far as the third question is concerned, the simple answer may be that the principles established in the 1964 -
Dalmia case are applicable equally to the owner of the shares either as a dealer or as an investor. It makes no difference whether the interested party is a dealer or an investor. The fact is that the purchase of shares automatically entitles the purchaser to receive the bonus shares and that is the basis for spreading the cost of the purchased shares over those shares and the bonus shares taken together. The basis is not affected by the character of share owner either as a dealer or as an investor.

3. Valuation of right shares.

(a) Introduction:

Under Section 61 of the companies Act, the Indian companies are required to offer the further issue of shares initially to the existing holders of equity shares. Since the equity shareholders can acquire the additional shares as a matter of legal right conferred on them, these additional issues of shares are known as right shares. The right to subscribe to the additional shares is a valuation property because only this right entitles the holder of equity shares to participate in the further issue of capital by a company. The valuation of this right presents an interesting problem.

(b) Principles of valuation of rights:

A right to subscribe to a new issue is a movable property which can be bought and sold. Thus it may be necessary
to ascertain the value of rights in a cum-rights quotation. Normally, after the right offering has been announced by a company, its equity shares sell cum-rights and it may be necessary to make some calculations to find out the value of rights particularly when some existing shareholders do not wish to increase their holdings and prefer to sell the rights for cash.

The valuation of rights is an exercise to calculate the theoretical value of rights. This theoretical value is the value at which the rights can be expected to sell on the market after the right offering has been announced by a company.

Normally, the right shares are offered at a discount i.e. at a price which is something below the current market value of the shares. Where no broad-based market is available for the shares, the new offering is still made at a price somewhat below what is considered to be a reasonable market value of shares. The argument behind the offering of new shares at a discount is that the issue of the new shares to succeed must be made at a price that at least compensates for the 'dilution effect' caused by the appearance on the market of additional shares. The theoretical value of the rights is related to the discount at which the new shares are offered and the dilution effect of the new issue being added to the existing capital structure of the company.

According to the Principles laid down by the Supreme Court
In Miss Dhun Dadabhoy Kapadia Vs. Commissioner of Income-tax, Bombay (1967) 73 I.T.R. 651, the valuation of rights attached to shares is to be done as follows:-

Market value of original shares before the issue of right shares.

\[ \text{minus} \]

Market value of the same shares after the issue of right shares.

In other words the fall in the market value of the original shares after the issue of right shares is the measure of the value of rights.

However, in practice the actual market value of the rights may be more or less than the theoretical value. The difference between the market price of the rights and the theoretical value may be due to speculative reasons or share market conditions.
4. Valuation of cum-dividend and ex-dividend shares:

(a) Introduction:

The two terms, 'cum-dividend' and 'ex-dividend' are attached to the price quotations of stock exchange securities. Yorston, Smyth and Brown in their book, Advanced Accounting defined the terms cum-dividend and ex-dividend in the following manner:

"Cum-div." - Literally "with dividend", is a term applied to investments such as Government Bonds and Inscribed stock, shares and debentures, signifying that the valuation at which they are quoted includes the accrued interest or dividend.

"Ex-div." - Literally "without dividend", is a term applied to investments such as Government Bonds and Inscribed stock, shares and debentures, signifying that the valuation at which they are quoted does not include the accrued interest or dividend. It is the opposite of "cum-div.".

The significance of cum-dividend securities is that the buyer of the security is entitled to receive the dividend included in the quotation.

In the case of shares of companies, the price quoted will be cum-dividend only after a dividend has been declared by the company. Normally, the stock exchange rules provide for the period during which the shares will remain cum-dividend.

On the other hand, a person who buys securities are not entitled to receive the next payment of dividend.
pays for the proposed dividend. The situation may be compared with the purchase of a tree with ripe fruits. The purchaser will be prepared to pay for the fruits an amount which is just equal to the market price of the fruits and nothing more than that.

5. Valuation of shares in a Private Limited Company:

In the valuation of shares in a Private Company, some special considerations deserve adequate attention. It is particularly expedient to consider the effect of some of the peculiar features of a Private Company. Some special clauses in the articles of association of a Private Company may be relevant to the valuation of shares in such a Company.

(i) Restriction on transfer of shares:

Under section 3(1)(iii) of the Companies Act, a Private Company is one which, by its articles restricts the right to transfer its shares. The primary effect of these restrictions is that sale of shares is usually infrequent and does not take place in an open market condition. Shares in Private Companies take the nature of blocked investments. Sales of the shares are generally negotiated privately.

According to one school of thought the restrictive provisions in the articles of private companies have a depreciating effect on the value of the shares of such companies. The comment of T.A. Hamilton Baynes, the author of the well-known book, "Share valuation" is noteworthy. He stated:
"Articles which in any event prevent a would-be seller from exploring the outside world have a greater depreciating effect on share values than others without such prohibitions. It is clear that the greater the restriction on transfer the greater the effect on the value of a share."

Some courts also upheld the above view that restrictions in the articles would have a depreciating effect on share values. Lord Fleming seemed to have expressed a representative view of the courts, when he emphatically stated in Salvesen's case, "......I regard these restrictions as depreciating their value very considerably."17

If the above opinion is to be duly honoured, it is necessary that some allowance must be made to provide for the lack of transferability and other restrictive provisions in the articles. What amount is to be allowed is a question of fact. It has to be determined with reference to the facts and circumstances of each case.

There is, however, an opinion which is opposed to the above school of thought. Some valuers are of the view that the restriction on transfer is not necessarily depreciatory. They argue that the chance of acquiring the shares of other members in the company on advantageous terms is itself a special benefit. Moreover, when shares are valued on the basis of the assets of the company, restrictions in the articles are of...
William, J., in Abrahams' case supported this opinion. In this case, he was reluctant to concede any allowance for the difficulty of disposal.

Thus a controversy still persists as regards the depreciatory effect of restrictive clauses on the value of shares in a private company.

Under the Indian laws at present in operation, private companies are to be registered with restrictions, limitations and prohibitions. The question is whether these may have a depreciatory effect on the value of the shares of private companies. Apparently, the lack of negotiability inherent in private company shares together with the bundle of restrictions and limitations should have a depressing effect on the value of shares. But in reality, the other side of the picture never displays a distressing view. Firstly, investors in private company shares in India are well aware of the restrictions and limitations. When they are purchasing shares in private companies, it can eventually be presumed that the potentialities of the company are very great. This factor can easily command a higher value for shares, or at least the factor is sufficient to dispel the doubt about the depressed value of shares. Secondly, it is wrongful to think that the directors will exercise their absolute and uncontrolled discretion to refuse to register any transfer arbitrarily. They are bound to act bona fide for the greater interest of the company. Thirdly, if
non-listing of shares is an evil for private companies, a good number of public companies also suffer from the same evil. Some companies purposely do not go for listing. Others may be refused permission for shares being listed by recognised stock exchanges. Still they may conduct their businesses very efficiently and with comfortable margin of profit. Success of a business does not depend to a great extent on whether the company shares are listed or not listed on a stock exchange. But value of shares definitely depends on the success of the business operations. Thus in the Indian context, there is no need to allow any discount for restrictions, limitations and prohibitions.

(ii) Value of shares fixed by articles of association:

The articles of association of a private company may contain clauses with/provision for determining "fair value," of shares for their transfer from one hand to another.

Sometimes articles provide no clue for the valuation of shares of private companies.

On the whole, the problem of valuation of shares in private companies continues to draw the attention of the expert valuers. Unless the articles provide some reasonably satisfactory clues for the purposes of non-statutory valuation of shares, experts must proceed to value the shares on the basis of some recognised principles. The question of adjustment to be made from value for restrictions in the articles has already been discussed.
6. **Valuation of shares in a public limited company:**
   *(For non-statutory purposes)*

The valuation of shares in a Public Company depends on whether the shares are quoted or not. The Principles of valuation are different for both the quoted and the unquoted shares.

(i) **Valuation of quoted shares:**

Quoted shares are those which are quoted on a recognised stock exchange. Shares of a public company may or may not be listed on the stock exchange.

The fundamental principle of valuation of quoted shares as laid down by the Supreme Court in Mahadeo Jalan's case, is that the quoted shares are to be valued on the basis of the stock exchange quotations which are genuine and more or less regular.

In practice, however, market conditions and other extraneous factors may sometimes influence the market quotations. Thus in non-statutory valuation a question may be raised as to what extent the market quotations can be treated as an accurate or a reliable measure of value of shares.

Generally stock exchange quotations should not be discarded, because the verdicts of market place are generally considered to be the best indicators of real value. In view of the share prices which are, at times, subjected to unreasonable fluctuations, the market quotation may be avoided. Where the
shares of a public company are to be valued by bargaining, the stock exchange quotations are of no use.

(ii) Valuation of unquoted shares in public companies

In valuing the unquoted shares of public companies the Principles laid down by the Supreme Court in C.W.T. Vs. Mahadeo Jalan and C.G.T. Vs. Kumaben Mahadevia may be followed. In other words the valuation of shares is to be done on the basis of some recognised principles already discussed.

7. Valuation of shares in holding companies:

The present discussion is intended to throw some light on the valuation of shares in holding companies as defined in the Companies Act for any non-statutory purposes.

Although legally the holding company and its subsidiaries are separate entities, there is one unbreakable link between them and that is through the holding of a controlling interest by the holding company in its one or more subsidiaries. Naturally, in valuing the shares of the holding company, the question of valuation of the investment of the holding company in its subsidiary or subsidiaries can not be overlooked. In practice, the holding and subsidiary companies operate as one and the whole group. Their policies and Programmes are directed to serve the interest of the group as a whole. Thus, the profitability, financial standing and
implications of the holding company are coherently linked up with those of the subsidiaries. But since the shareholders of the holding company are not, per se, shareholders of the subsidiary company in which the holding company has a controlling interest, "it is the true profits of the holding company itself which must be the subject of capitalisation for a value based on earning capacity." Dispute amongst the valuers may arise regarding the definition of true profits of the holding company. Sidey was in the forefront to state that by true profits of the holding company, "it is not intended to mean solely the profits disclosed in the profit and Loss Account of that company, as adjusted by the valuer." The valuer must care to take note of the adjusted profits and losses of the subsidiaries also. Similarly, the break-up value of the holding company's shares cannot be determined without the consideration of the net assets of its subsidiaries. It is, in this context, that the valuer is under an obligation to consider the earning capacity and the financial position of the subsidiaries in determining the value of the shares of the holding company. If the shares of the holding company are quoted on the recognised stock exchanges and there are regular dealings in the shares in the stock market, the market quotations can be adopted as the value of the shares under all normal circumstances.

Where the holding company remains unlisted or the market quotations can not be accepted for any reason whatsoever, the value of its shares can be determined by applying the maintainable profits basis or net assets basis of valuation of shares,
depending on the facts and circumstances of each case. If the maintainable profits basis is adopted, the following procedure may be followed in order to ascertain the profit-earning capacity of the holding company for capitalisation at an appropriate rate:

**Profit** as shown in the profit and loss account of the holding company over the determined averaging period after proper adjustments

\[ \text{Less Any dividends actually received from the subsidiaries and included into the above mentioned P/L A/o of the holding company over the averaging period} \]

\[ \text{Add Adjusted profits of the subsidiaries over the averaging period} \]

\[ \frac{X - Y + Z}{X - Y + Z} \]

( Note - If the holding company does not hold the whole of the shares in the subsidiaries, the addition will be limited to the quantum of the profits attributable to the holding of shares in the subsidiaries by the holding company. The profits of the subsidiaries are to be apportioned between the holding company and the minority shareholders in the ratio of their shareholding in the subsidiaries )
Less: Any loss made by the subsidiaries during the averaging period

In adopting capitalisation of earning capacity method, it is necessary to remember that it is the earning power of the whole group that is of vital importance. Sidey holds the same view. He stated as follows:

"... any attempt to separately value the shares in the Holding Company and its Subsidiaries, has no real bearing on the valuation of the shares in the Holding Company based on a capitalisation of its earning capacity, because that earning capacity is the totality of the earning capacity of the whole group less a proportion attributable to outside holders in the subsidiaries (if any)."

If the net assets basis of valuation is to be adopted, the net value of the assets in the group less the minority interest in the subsidiaries may be considered as the total value of all the shares in the holding company. There remains one vital point to be remembered and that is relating to the adjustment to be made in the accounts of holding and subsidiary companies for inter-company transactions at the time of valuation of shares of the holding company. Thus while valuing shares of holding companies,
care should be taken to see that inter-company balances and internal trading operations are correctly adjusted. While making adjustment for inter-company transactions, care should be taken to ensure that contingent liabilities shown in the balance sheets of holding and subsidiary companies are properly considered and rationally split into internal and external. The latter will continue as contingent liability, but the former will appear to be the actual liability of the group as a whole. For instance a bill of Rs.500 drawn by X.Ltd. (Holding company ) on Y.Ltd. (Subsidiary company) was discounted by X.Ltd. The balance sheet of X.Ltd, will show a contingent liability for/bill discounted by means of a note. The balance sheet of Y.Ltd. will show the item as Bills/Now payable. From the point of view of the group as a whole, there is no question of a contingent liability for the bill discounted with the bank. On the contrary, it is an item of actual liability payable to an outsider.

The Practical application of the above principles of valuation of shares in holding companies will, however, be made after a careful consideration of the following two factors:

(i) Nature of operations carried on by a holding company.

(ii) Volume of share holding in the subsidiaries.
Some holding companies may carry on trading operations independently of the subsidiaries, while others may not carry on any trading operations. Holding companies may have a 100% interest or less than 100% interest in the subsidiaries.

(a) **Holding companies carrying on trading operations**

If a holding company carries on separate trading operations, the maintainable profits from such operations are to be capitalised at an appropriate rate. This value may be added to the capitalised value of earnings from assets not used for trading.

(b) **Holding companies not carrying on trading operations**

If a holding company does not carry on any trading operations independently of the subsidiaries, the following steps may be taken for the valuation of its shares:

(i) Determination of the capitalised value of the earning capacity of each subsidiary company at an appropriate rate.

(ii) Application of the values of shares of the subsidiaries determined under (i) to the shares owned by the holding company and ascertainment of the total value of the shares of subsidiaries held by the holding company.
(iii) Addition of the net value of any other assets of the holding company with the total value determined under (ii) above. The net value of other assets is ascertained by deducting the liabilities from the total value of all other assets of the holding company.

(iv) Deduction from the total value of the shares of the holding company determined under (iii) of the capitalised value of any overhead expenses of the holding company other than interest (which is covered by deducting liabilities). The capitalisation of the overhead expenses may be done at the average percentage rate used for the subsidiaries.

(v) The figure obtained from (iv) would give the total net value of the shares of the holding company.

(c) Holding companies having wholly owned subsidiaries -

If a holding company has subsidiaries in which it has 100% interest or where all the shares of the subsidiaries are owned by the holding company and all the companies work on the similar lines of operation as component units for the attainment of one common objective, the valuation of shares of the holding company can proceed on the basis that the holding company and its wholly owned subsidiaries were, in fact, one single company. The general principles of valuation of shares of holding companies may be applied accordingly. Where the holding company has 100% interest in the subsidiaries which operate in different spheres of activity, the maintainable profits and the appropriate rate of capitalisation
for each subsidiary will have to be determined separately.

(d) Holding companies having partly owned subsidiaries -

Where the holding company does not own the entire share capital of the subsidiaries, but holds only more than half of it, the valuation of shares of the holding company should be made after making appropriate provision for the minority interest in the subsidiaries.

Where the proportionate interest of the holding company in certain subsidiaries are the same and the operations and structure of these subsidiaries also justify the same rate of yield, the valuation of these subsidiaries may be combined for convenience.

8. Valuation of shares in investment companies -

The discussion on valuation of shares of investment companies as defined under Rule 1A(g) of the Wealth-tax Rules, 1957 has already been done in an earlier chapter.

The present discussion will be directed towards the valuation of shares of investment companies as referred to in section 372 of the Companies Act. The Proviso to sub-section (10) of section 372 of the Companies Act, 1956 has briefly referred to an investment company as a company whose Principal business is the acquisition of shares, stock, debentures or other securities. An investment company earns income not only through the holding of shares and securities by earning dividends and returns thereon regularly or occasionally, but also through...
dealing in shares and securities. Generally speaking, the two basic principles of valuation of shares, namely maintainable profits basis and assets basis can be applied for the valuation of shares of investment companies also.

In calculating the maintainable profits, attention should be given to the following peculiar considerations pertaining to the investment companies:

(1) Running Expenses to be allowed and provision to be made for appropriate tax liability:

It is said that a shareholder in an investment company would hardly expect to receive a lower rate of return than what he would have earned if he himself were the direct holder of the separate investments.

But in an investment company, the return to the shareholders is to be determined after deducting running expenses and taxes. It is, therefore, contended that to the extent the investment company's earning capacity is reduced for expenses and taxes, the value of its shares would be depleted. But this contention is not tenable. So far as an individual investor is concerned, his income from an investment company as compared with what he would not expect by his separate investments, may be discouraging,
particularly when it is considered that the small investor
gets a valuable opportunity of participation in a highly
diversified portfolio covering a wide range of industries
which he could not have achieved on his own.

(2) Retention for reserves -

There are two opposing views about the retention
of profits for reserves in an investment company.

The valuers who are not in favour of retention for
reserves put forward the following arguments:--

(i) The sum allocated to reserves represents the
profits retained for the benefit of the share­
holders and not a provision for contingency.

(ii) In an investment company, profits on sale of
investments are in some cases transferred to a
reserve which may be utilized for meeting all
capital losses and future contingencies. Such
reserve may have to be considered sufficient
for the purpose of valuation of shares of an
investment company.
(iii) The companies in which the investment company has made investments must have retained sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient profits as reserves which may be considered as sufficient growth security for any unknown contingencies of future.

The valuers who are in favour of deduction of a certain sum for reserves in determining the maintainable profits argue in the following manner :-

(i) Stock markets are subject to both short-term and long-term fluctuations. The fluctuations are unknown and uncertain. Sometimes remarkable variations between assets backing and share prices take place. This explains why a certain percentage of profit should be retained as reserve.

Whatever may be the controversy about the retention for reserves, it is clear that in determining the profit-earning capacity of a company, the focus is on "the profits which the company has been making and should be capable of making". In this context, retention of reserves does not appear to have much significance. However, in view of the peculiar nature of an investment company which may be subjected to loss due to fluctuations in share prices, it is possible for some valuers may consider to allocate an amount to
reserves under certain circumstances. The matter is then left to the best judgement of the valuer who will decide according to the facts and circumstances of the case.

(3) **Dividends and interest received**

The actual amount of dividend and interest received after deduction of tax at source should be considered, because an income which the company will never receive can not be taken into the maintainable profits. Having determined the maintainable profits of an investment company the next point is at what percentage rate these profits should be capitalised.

Where the investments held are in types of securities for which approximately ruling rates at the time of valuation are available the appropriate rate of capitalisation is the average rate applicable to the investments held. Where the investments held are in shares of companies which yield various rates, the rate of capitalisation would be the percentage which the total dividends received by the investment company bear to the total market value of the investment. Where, however, the capitalisation rate can not be directly determined because the investment company holds some securities for which ruling rates are available, and also others which yield various rates and also derives some
income from some other avenues, an appropriate rate of capitalisation may be fixed by the valuer according to the facts and circumstances of the case on the basis of the principles already discussed in an earlier chapter.

In the case of valuation of shares on the basis of net assets, the valuer may be required to face two problems.

(1) Problem of valuation of shares held as fixed investment
   and (2) problem of valuation of shares held as stock-in-trade.

1. Shares held as fixed investment

   Since fixed investments are not normally meant for re-sale, consideration of their market value is normally of little significance. The shares, in these cases, may be valued at cost price. If, however, a liquidation value of the company's shares is to be computed, the market value of the shares must be taken into consideration. But in this context one question seems relevant and that relates to whether fixed investments are subjected to depreciation like fixed assets or not. There is no doubt that fixed assets and fixed investments are two different varieties of assets with differing nature and purpose. Naturally therefore, the reality and application of the deprecating process for fixed assets like plant, machinery etc. can not be taken to be common for fixed investments also.
Some investments are, of course, subject to fluctuations in their value and there is substance in the argument that fluctuations in themselves divorce market values from real values. If the nature of the industry in which the investment has been made is such that it is likely to be affected by serious fluctuations in future so that there is a strong possibility of failing to realise the principal sum invested in shares, there may be no objection to the creation of a provision for contingency arising out of fluctuations in prices of shares. The provision for fluctuation may be particularly recommended for an investment company which has failed to compile a carefully selected and well-balanced portfolio in order to minimise the risk of capital loss in future.

(2) Shares held as stock-in-trade

In the process of trading in securities some shares may be left out and shown in the balance sheet as stock-in-trade of an investment company.

The well-known principle of valuation of stock-in-trade, namely, "cost or market, whichever is lower" may be applied for the valuation of shares held as stock-in-trade. Apparently very simple,
the application of this principle may raise some controversies. Firstly, the controversy surrounds the notion of "cost" of shares. There may be various versions of cost. So far as shares are concerned, cost means the sum of expenditure directly or indirectly incurred in buying the shares and in getting them registered in the name of the company. This simply means "cost of acquisition" of the shares.

But in an investment company which is holding some shares as stock-in-trade a new problem of determining cost of the stock-in-trade arises due to the accretion to the stock-in-trade by way of issue of bonus shares in favour of the company free of cost. The first question is whether bonus shares received by the company in respect of its stock-in-trade become part of the stock-in-trade. The question was settled by the Supreme Court in C.I.T. Vs. Madan Gopal Radhey Lal and C.I.T. Vs. Kunji Lal Gupta. The Supreme Court held that where an assesses is holding ordinary shares as his stock-in-trade, bonus shares received in respect of the said ordinary shares do not ipso facto become part of the assesses's stock-in-trade.
They can be converted by the receiver into his stock-in-trade or can be retained by him as capital asset.

If the bonus shares received free of cost are converted into stock-in-trade their real cost may be found out in accordance with the principles laid down by the Supreme Court in the Dalmia case. Where the shares are quoted, the market quotations may be available. In case of unquoted shares, approximate market values of the shares may have to be estimated with reference to the shares of closely comparable companies in the same industry.

The discussion on valuation of shares of investment companies will be concluded by referring to an important point and this relates to whether a reduction in the value of shares of investment companies is required for non-diversified portfolios. Because of the investment companies' non-diversified portfolios, the value of the shares may be required to be reduced to some extent. There is no doubt that an investment company runs high risks with its non-diversified portfolios and on this account a reduction in the value of its shares may be recommended. In the case of Estate of William T. Piper Senior (deceased) Vs. C.I.R., [Piper], J., allowed a reduction from the net asset values of two private investment companies by way of portfolio discount. The learned Judge stated :-
The parties agree that because of the investment companies' non-diversified portfolios, the value of the stock of Piper Investment and Castanea was less than their net asset values. Therefore, we find that 17% is an appropriate discount from net asset value to reflect the relatively unattractive nature of the investment portfolios of Piper Investment and Castanea.

However, there is a lot of controversy regarding the need for portfolio discount. The size of the discount necessary in each case is also a matter of dispute.

Before concluding the present chapter, a brief discussion on the peculiarities of the valuation of shares of Government Companies is considered desirable.

Valuation of shares in Government Companies:

Under Section 617 of the Companies Act, 1956, a Government Company means any company in which not less than 51% of the paid up share capital is held by the Central Government, or by any State Govt. or Governments, or partly by the Central Government and partly by one or more State Governments and includes a company which is a subsidiary of a Government Company.

In a Government Company, the determination of the rate of capitalisation is comparatively easier. Since the Government holds majority of the shares in the company, its security and stability is almost assured. Moreover, legislative control, enormous resources and technical know-how at the disposal of the Government can make the company, a national institution with its
products finding a vast market throughout the country. The shares of the Government Company under these circumstances may assume the nature of semi-fixed investment. Naturally, the rate of capitalisation in such a company will be relatively lower than that of a comparable non-Government company. The concept of "tyranny of the minority" is virtually irrelevant for a Government Company. Justice, fair play and effectiveness are normal expectations of Government ownership.

The question of liquidation of a Government Company is never left in the hands of individual holders of shares in such a company. Therefore, in valuing shares of Government Companies, the calculation of liquidation value or break-up value of shares is of great significance.

It is to be appreciated that this discussion is relevant only where the Government Company has some shares owned by persons other than the Government. Where all the shares are held by the Government, the question of valuation of shares is merely an academic question.
1. Pay-out ratio - Dividend per share (DPS) / Earnings per share (EPS)

This ratio indicates the amount of equity dividend as a percentage of earnings for equity shares. A ratio lower than 100% signifies retention of earnings, in the company. A ratio higher than 100% signifies the distribution of a part of the reserves for the payment of dividend.

2. Geo. ovens and Donald I. Beach, - Business and Securities valuation, - (1972), - P.83.


"S. 81. Further issue of capital - (1) where at any time after the expiry of two years from the formation of a company or at any time after the expiry of one year from the allotment of shares in that company made for the first time after its formation, whichever is earlier, it is proposed to increase the subscribed capital of the company by allotment of further shares, then -

(a) such further shares shall be offered to the persons who, at the date of the offer, are holders of the equity shares of the company, in proportion, as nearly as circumstances admit, to the capital paid up on those shares at that date;"

ing, - (Sixth Edition), - Volume 1, (Indian Reprint by N.M.
Tripathi (Pvt.) Limited Bombay), - p. 448.
15. When a dividend is declared, it becomes a debt to the shareholders in whose favour it is declared.