IOV RVF the Valuer Bi- Monthly Journal, Vol. 03 , Issue-05 Sep - Oct 2024, PP. 16 - 21

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ENGINEERING APPROACHES IN VALUATION OF STRESSED ASSETS

Introduction

Valuation of an asset is principally an economic decision and hence all parameters which affect this decision have to be thoroughly understood and evaluated by a valuer. Interest rates prevalent in the property/real estate market at the time of relevant date of valuation is one such parameter. Similarly, yield or return expected by an investor on his capital investment in an asset is also an equally important aspect of consideration by a valuer, as value of any asset, yielding monthly or yearly income, depends on the rate of interest on investment expected by an investor. The growing real estate market in India, especially post the advent of the Insolvency and Bankruptcy Code (IBC) and the rise in Non-Performing Assets (NPAs) in the banking sector, valuing stressed properties accurately, has become critical for investors, lenders, and stakeholders.

Understanding Stressed Assets

Stressed Assets are typically associated with defaulted loan accounts. The stress could be due to:

- **Loan defaults:** When property owners fail to repay loans, triggering the possibility of foreclosure or auction by banks/financial institutions.
- **Distressed sales:** Properties sold under duress due to financial instability of the owner.
- **Litigation:** Properties tied up in legal disputes that affect their liquidity.
- **Incomplete projects:** Properties in real estate projects, incomplete due to lack of funding, regulatory issues or any other reason.

Stressed Assets are typically associated with defaulted loan accounts. The stress could be due to:

For example, the failing real estate Projects, exacerbated by demonetization, GST, and RERA implementation, saw many developers in India facing liquidity crises, leaving projects incomplete, and even witnessed several of these properties entering the insolvency process, impacting their market value significantly.

Understanding distressed Assets

a) **CAUSES**

i. **Management**

- Loss of key staff
- Incompetence/ weak governance
- Increasing tension between directors, shareholders, lenders
- Failed merger/acquisition

ii. **Operational**

- Production/ product quality issues
- Unhappy customers/ loss of key customers
  Poor financial control
- Supply chain mismanagement
- Stockpile up/ working capital blockage
- Litigation

iii. **Funding**

- Overleveraging
- Inappropriate financing

iv. External

- Macroeconomic pressures
- Changing markets
- Increasing competition

b) EFFECTS

Financial Symptoms

- Deteriorating financial performance
- Worsening cash flow
- Financial shock
- Default /covenant breach

VALUATION OF DISTRESSED ASSETS

a) Challenges

- Significant Uncertainty
- Non-Availability / Reliability of Data
- No / Limited Comparable
- Compressed Timing Issues

b) Observations

Due to the above-mentioned challenges, following observations were made

- Wide variations in value of Estimates
- Difficult to obtain Financing from such assets
- Higher RISK

What are the stressed assets of Indian banks?

Stressed Assets are similar to Non-Performing Assets (NPA) or Special Mention Accounts (SMA), which include written-off assets and restructured loans. Stressed assets are a strong indicator of the health of the Indian banking system. Predominantly in Indian public sector banks, there has been a massive rise of stressed assets. There are numerous reasons behind this problem, they are, misconduct, mal-intention, governance-related problems, global slow-down, etc.

What is a distressed asset?

We think that an asset is anything of value owned by a person or a business. But, when the person or business needs immediate cash and wants to sell the asset at less than its value, it becomes a distressed asset.

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What is the difference between stressed and distressed assets?

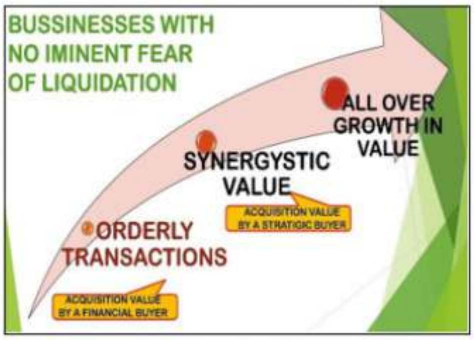
The difference between the two terms lies in the degree of insolvency risk: a company in stress has sufficient liquidity and no imminent insolvency risk, allowing for a more orderly sale process (albeit on a more accelerated timeline than a typical M&A transaction), whereas a company in distress has a greater, more pressing liquidity or insolvency risk that requires a 'fire sale' on an accelerated timetable.

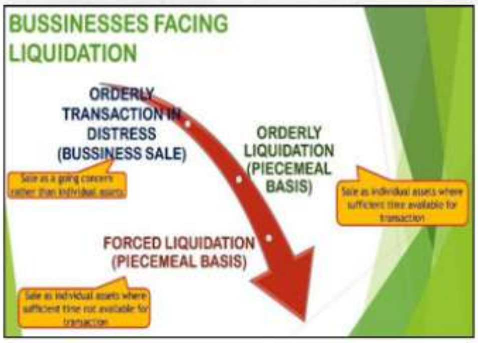
STRESSED	DISTRESSED	INSOLVENCY
Value breaks below the equity	Value breaks below the equity	Company in insolvency process
No immediate default on debt	Actual or imminent debt default	Sale (usually of assets) by office holder
Sufficient liquidity for orderly sale	Uncertain liquidity for orderly sale	

What is the approach of asset valuation?

Asset-based valuation is a form of valuation in business that focuses on the value of a company's assets or the fair market value of its total assets after deducting liabilities. Assets are evaluated, and the fair market value is obtained.

STANDARDS OF VALUE





IVS 104 Bases of Value

In addition to the IVS-defined bases of value listed below, the IVS have also provided a non-exhaustive list of other non-IVS-defined bases of value prescribed by individual jurisdictional law or those recognized and adopted by international agreement:

IVS-defined bases of value:

- Market value (section 30),
- Market rent (section 40),
- Equitable value (section 50),
- Investment value/worth (section 60),
- Synergistic value (section 70), and
- Liquidation value (section 80).

Premise of Value/Assumed Use

A premise of value or assumed use describes the circumstances, stating how an asset or liability is used. Different bases of value may require a particular premise of value or allow the consideration of multiple premises of value. Some common premises of value are:

- highest and best use,
- current use/existing use,
- orderly liquidation, and
- forced sale.

IVS 105 Valuation Approaches and Methods

Consideration must be given to the relevant and appropriate valuation approaches. One or more valuation approaches may be used in order to arrive at the value in accordance with the basis of value. The three approaches described and defined below are the main approaches used in valuation. They are all based on the economic principles of price equilibrium, anticipation of benefits or substitution.

The principal valuation approaches are:

- market approach,
- income approach, and
- cost approach.

Market Approach Methods

- Comparable Transactions Method
- Guideline publicly-traded comparable method

Income Approach Methods

- Discounted Cash Flow (DCF) Method
- Explicit Forecast Period

Cost Approach Methods

Broadly, there are three cost approach methods:

- **Replacement Cost Method:** a method that indicates value by calculating the cost of a similar asset offering equivalent utility,
- **Reproduction Cost Method:** a method under the cost that indicates value by calculating the cost to recreating a replica of an asset, and
- **Summation Method:** a method that calculates the value of an asset by the addition of the separate values of its component parts.

Conclusion

In conclusion, the valuation of stressed and distressed assets presents significant challenges due to uncertainties, limited reliable data, and compressed timelines. Understanding the differences between stressed and distressed assets, as well as the approaches to their valuation, is crucial for making informed economic decisions. The use of methods under the market, income, and cost approaches help assess the value of these assets, though the process is often complicated by factors such as market conditions, governance issues, and the financial stability of the entities involved. Accurate valuation is essential for stakeholders to navigate the complexities of distressed assets and to make strategic decisions that align with their financial objectives.