Valuation of MNCs' Captive units in India

Captive units have been a popular operating model among large global organizations, given their cost-effectiveness. About 1600 international firms have started their captive units in India, driven by superior talent availability, coupled with cost advantages and a well-established ecosystem in Indian cities. These captive units provide various services such as Software Development and Testing Services, Design, Engineering and R&D, Technology Support, Accounting, Payroll Processing, Insurance, Data Management, Legal, and collections and payments services to their parent entities. Overall employment by these captives is in excess of 1 million and accounts for over 25% of the total IT and Business Process Management (BPM) sector employment in India.

Evolution of Captives in India	
Pre 1990 to 1998	Pioneered by hi-tech engineering and research firms
1998 to 2005	By IT and BPO industry and BFSI vertical
Since 2006	Verticals like manufacturing, retail, and consumer products led the adoption

Source: Business-standard

While over 100 new international firms aim to open their captive units in India in 2021, many of the existing international firms are looking to divest their captive units. Every time a global firm starts a captive unit in India, many of its contracts with Indian BPM majors are transferred to the captive gradually. This allows the captive to benefit from economies of scale and simultaneously helps the global firm save on higher fees paid to BPMs. Over time, the captive units mature enough to function as a Centre of Excellence, thereby adding greater value to their parent entities. Mature captive units often turn into lucrative non-core assets which can be divested by their parent entities during economic downturns. Various other reasons that drive divestment of captives include corporate-level demands such as freeing up capital for growth projects or maintaining lean firms.

Shifting of more contracts from BPMs to captives, on the other hand, may be aimed at having each of the support functions in-house to address confidentiality/strategic priorities. For example, in 2009, UBS divested its Hyderabad captive unit of 2000 employees for a consideration of USD 75 million to Cognizant. However, between 2018 and 2020, UBS in-sourced hundreds of roles back into its Hyderabad captive from Cognizant.

Indicative List of Divestments

BPM	Captive acquired	Valuation
TCS	Citi Global Services	USD 505 mn
WNS	Aviva captive unit	USD 228 mn
Wipro	Citi Technology Services	USD 127 mn
Capita	AXA's Sun Life	NA
Mphasis	AIG captive unit	NA
Cognizant	UBS	USD 75 mn
Wipro	Alight Solutions	USD 117 mn
TCS	Deutsche Bank AG unit	NA
TechM	FIS Captive	USD 9 mn
Wipro	Metro AG	USD 50 mn

Source: Business-standard and Nexdigm Analysis

It is a common practice that global majors sign procurement contracts as per existing prices for a period of 5 years from the time of divestment of the captive unit to Indian BPM majors. However, this may not happen all the time. It is possible that the global major may promise to transfer business from its other vendors to the Indian BPM major acquiring its captive unit. The purchase consideration paid by BPMs to MNCs is mainly driven by the cash flows associated with procurement contracts and associated synergies.

Deal valuations (at the time of divestment) are largely driven by the Transfer Pricing (TP) arrangements in existence between the global majors and their captives. Usually, the divestment deals are valued at 1 to 1.2x of revenues, which translates to around 10x the Private Equity multiple at an assumed TP rate of 18% on costs. Valuation of these deals is also essential for regulatory compliances such as Foreign Exchange laws (i.e. FEMA) and Income Tax laws addressing Capital Gains Tax.

Regulatory compliance-related valuations are triggered not only at the time of divestments but are required for various other purposes, including any restructuring of the captive unit such as the issue of new shares, share buyback, and change of ownership within group entities among others. Valuation of the captive units in these instances becomes very tricky as each of these captives can, at best, be valued at their assembled workforce value in the absence of any perpetual procurement contract from the parent entity. Hence, it is essential to review the captive operations in detail to decide whether a discounted cash flow approach rightly captures the firm value or a net asset value adjusted for the assembled workforce.

In our experience of captive valuations, the approach largely depends on the ability of the unit to operate individually. Over the years, we valued tiny captives with just two employees to very large captives with hundreds of thousands of employees. While their pricing terms with parent entities are always on a cost plus mark-up basis, we observed that perpetual procurement contracts are largely absent. If the captive has over 100 employees who are all well-trained and delivering services independently to the parent entity on a requirement basis, the discounted cash flow approach based on expected growth, pricing, and costs can still be an appropriate mechanism to reflect the value of the captive unit. In the case of smaller captives that largely function as extended teams to onshore delivery and cannot be carved out as standalone businesses, the net asset approach-based valuation is deemed appropriate with an adjustment to the assembled workforce value. Some of the other value drivers include intangible assets generated/held by captives, office space lease agreements, and numerous other types of equipment owned. Various licensing agreements held by the captive for the usage of technology or other intellectual properties of the parent entity also drives up valuation estimates. While fair value may not be impacted, commercial valuation of the captive is impacted by the structuring of the transaction that details whether it is a transfer of shares, assets, or business.

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We provide integrated, digitally driven solutions encompassing Business Consulting, Business Services, and Professional Services, that help businesses navigate challenges across all stages of their life-cycle. Through our direct operations in the USA, India, and UAE, we serve a diverse range of clients, spanning multinationals, listed companies, privately-owned companies, and family-owned businesses from over 50 countries.

Our multidisciplinary teams serve a wide range of industries, with a specific focus on healthcare, food processing, and banking and financial services. Over the last decade, we have built and leveraged capabilities across key global markets to provide transnational support to numerous clients.

From inception, our founders have propagated a culture that values professional standards and personalized service. An emphasis on collaboration and ethical conduct drives us to serve our clients with integrity while delivering high quality, innovative results. We act as partners to our clients, and take a proactive stance in understanding their needs and constraints, to provide integrated solutions. Quality at Nexdigm (SKP) is of utmost importance, and we are ISO/ISE 27001 certified for information security and ISO 9001 certified for quality management.

We have been recognized over the years by global organizations, like the International Accounting Bulletin and Euro Money Publications.

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USA Canada India UAE Japan Hong Kong

Reach out to us at *ThinkNext@nexdigm.com*