Valuations in the time of COVID

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Synopsis

The extensive economic changes provoked by the COVID-19-crisis have led to some urgent concerns regarding the business valuation and valuation of various asset classes has become challenging for asset managers given the current state of market uncertainty. As the world continues to grapple with the health and economic crises brought about by the Covid-19 pandemic, professional valuers are playing a key role in helping to stabilise, and bring confidence to business and financial markets by using some innovative valuation approaches. This article provides an insight into the strategic and practical considerations in valuation in time of Covid

The Perspective

The global spread of COVID-19 is having a significant impact on the global economy and financial markets, with increased volatility and business disruption worldwide. These unprecedented times do not only bring serious threats to the world's health, but also a number of economic challenges. As it stands today, the true impact of the crisis is impossible to measure: current market conditions may only be temporary, and it is difficult to estimate the time required for economic recovery. While some of the risks may be temporary and muted, other risks would be more heightened reflecting expectations of severe/permanent disruptions in these businesses and the sectors in which they operate.

The most relevant factors and risks to be referred to when valuing a company

Volatility in Global Markets: We have observed significant market convulsions and increased volatility over the past couple of months, and this will impact valuations in the form of higher discount rates. These rates will likely rise along with debt margins and betas as investors become more risk averse.

Uncertainty of Business specific Cash Flows: On a company level, the uncertainty surrounding the true economic impact of Covid-19 has resulted in corresponding difficulties with business plan forecasting. Forecast estimates would usually take the impact of the crisis into account. However, without reliable economic forecasts available, companies will need to look to other company-specific risks so as to produce a reasonable business forecast.

Financial Risk Factors: The ongoing operational and economic uncertainties will likely lead to an increase in counterparty risk, and we may see a number of companies defaulting on their outstanding obligations. This will further increase the risk of investing through counterparties that either operate in high-risk industries or have low credit ratings. Many companies are reporting a rise in liquidity risk as they find themselves unable to deliver on short term obligations. Due to these heightened risk factors, we will likely see a rise in debt covenant breaches, insolvencies and asset impairments in the short- and medium-term

Other Factors: How the crisis will affect revenues and company operations in the near term. How the crisis will affect the business the company is in and its standing in that business over the longer term. New probabilities for the company's "Failure Risk." How the crisis has affected the price of risk and likelihood of default by updating the ERP and default spreads.

General Valuation Considerations

The short-, medium- and long-term impacts of the crisis, whether they be macro-economic or business-specific, will need to be taken into consideration. The market disruption observed today may be temporary, and the adjustments we make could potentially overstate or understate the crisis' impact on the company's valuation.

- Fair value is based on what is known and knowable at the measurement date. The assumptions taken into consideration today may no longer be applicable tomorrow, which means that the procedures and rationale for any valuations you perform should be documented in full.
- Assessing the going concern status of companies' company based on what is known and knowable at the valuation date. will also be key, so valuations should focus on companies' short-term cash flows and liquidity needs
- Consider company specific premiums and liquidity risks in your discount rates. Greater market volatility and high levels of uncertainty in the recent past may mean higher betas and debt margins
- Consider scenarios adjusted based on market evidence in your business plans and financial metrics by integrating what is known and knowable at the valuation date.
- Widen the range of your valuations and monitor your assumptions regularly. The ranges themselves may be subject to volatility as the regular valuations you are performing will rely on projections that are subject to constant change. Robust documentation procedures are required as valuations may be performed based on assumptions that that may no longer be valid in the future.

How should valuation adjustments be applied

The value of an asset is intimately linked to its ability to generate future probable gains: however, in times of crisis, the future is much more uncertain and the field of possibilities much wider. Similarly, in times of crisis, common value approaches present their own set of difficulties. Despite these difficulties, not all valuation exercises can be postponed in the expectation that a business will soon gain visibility of when a crisis will end

Income Approach

- fair value is based on what is known and knowable at the measurement date. As such, it is recommended that companies estimate potential performance shortfalls for Q1, Q2 and beyond in so far as is possible.
- It may be judicious to consider adjusting your business to cater for performance shortfalls that result from supply chain disruption, volatility in commodity prices, workforce restrictions, temporary curtailment of operations or delays in payments by your customers.
- Financial projections and metrics should consider any government incentives and short-term measures applicable.

- As investors become more risk averse, adjustments to discount rates in the form of additional risk premiums may become necessary. The income from these risk premiums may set off the financial impact of any other company risk factors which aren't covered in forecast cash flows or market indicators. Care should be taken to avoid any double counting of risks, for example additional risk premiums aren't required for factors that have already been addressed in cash flows or included in market inputs.

Market Approach

- When applying market approach, ongoing metrics and earnings should be looked at on a market participant basis and therefore one-off impacts can be excluded.
- However, expected adverse performance in Q1 and Q2 2020 and beyond, if deemed one-time, would still impact cash balances and would be reflected as a deduction from enterprise value in estimating fair value.
- An appropriate multiple should be congruent with the metric to which it is applied. The percentage change in Market Capitalization of comparable companies may provide a good proxy for the magnitude of the change to be expected in the multiple.
- It may no longer be appropriate to consider application of recent transaction prices, especially those from before the expansion of the pandemic.
- Care should be taken to avoid any double counting with respect to downward adjustments (i.e. penalizing the metric as well as multiples considered)

Other Adjustments

- Investors and companies may need to reassess liquidity needs (i.e., likelihood of a debt covenant breaches, impact of the extended reduced cash flow, funding of working capital required).
- A re-assessment of credit quality and repayment risk needs to be considered for debt investments.
- Emphasis needs to be placed on scenario analysis

Multi Criteria Approach

The various valuation approaches are all affected by a global and pan -sectoral crisis. It is customary, in normal times, to recommend a "multi -criteria" approach to perform a valuation, a term used to designate a methodology consisting of:

- Consider all valuation approaches,
- Analyze them individually, dismiss them or retain them according to the adequacy of the approach considered in the particular context of the asset to be evaluated,
- Implement the selected approaches,
- Compare the different results obtained, gauge the advantages and disadvantages of each method,
- Finally exercise expert judgment in order to arbitrate a range of reasonable values. The underlying premise for such an approach is that no valuation method alone, is able to provide in all circumstances "the correct and accurate result". Thus, the implementation of several approaches is useful as it diversifies the pros and cons of each approach, it helps the valuation practitioner to identify the effects of each strength and weakness in the particular case that is being studied, so that they shall eventually better neutralize any flaws.

Parameters emulating the effects of the crisis

All valuations should match performance expectations, taking into account the risk-reward balance that may be associated to these expectations. Thus, reversely, market capitalizations may be rationalized as a series of flows (and their risk reward couple) in a DCF-like approach. The impact of the crisis may be calibrated through considering pre-crisis forecasts (that would then emulate crisis forecasts), so that, under identical risk reward couple, these new forecasts would match the post-crisis market capitalisation15. As to the transformations leading from pre-crisis forecasts to emulated crisis-forecasts, a compromise must be found between accuracy, practicalities, ability to reasonably calibrate the parameters of the said transformation. For illustrative purpose, the following may be contemplated:

- The initial magnitude (intensity) of the drop of performance: this intensity may differ from one company to the other, depending of the nature of the crisis and the business model etc.
- The duration of the crisis: such a parameter is more likely to be common to a whole sector, it is certainly a very sensitive parameter
- The possibility (or not) of a catch-up: the pre-crisis plan may be considered as indefinitely delayed (the delay would thus match the duration of the crisis); but in certain few sectors, it may be considered that a catch-up is possible (the parameter being then the required duration for actually catching-up)
- The possibility of an everlasting shift in the level of demand: such a situation should concern certain few sectors; some could on the contrary experience an upside thanks for example to demonstrated shortages in certain equipment that the crisis would have revealed.

Conclusion

For valuers, the uncertainty which permeates all markets will inevitably lead to challenges, not just in terms of carrying out valuations and determining value, but also in the reporting of those values in a way that is both helpful and informative to users. Don't abandon valuation fundamentals during the COVID-19 crisis. It is precisely times like these that they matter most, with so much uncertainty around companies' future earnings growth, cash flows, and even their ultimate survival, Pre-crisis historical financial data seem useless and there's a wide range of predictions about the economy and individual companies for 2020 and beyond. It's all going to be okay,Go back to basics and the fundamentals and be willing to live with uncertainty. If you're wrong, revisit your valuation.

If you value companies in a period like this, you are facing exactly the same kinds of uncertainties you face during any other period. The only thing is, you are more likely to be wrong—and guess what, everybody is facing the same scenario. You are just as uncertain as everybody else and you have to make your best judgment.

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