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Valuations in the time of COVID-19

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Introduction

The COVID-19 crisis continues to heavily affect the global economic, social, and political perspectives. An immediate and visible-tangible impact has been the significant, though varying, decline in capital markets across the world (which have been extremely volatile in recent times). Such volatility—in addition to market related technical factors—may be related to significant uncertainty experienced by investors as regards the perceived higher risk attached to future cash flows of businesses as also their tempered expectations as regards the quantum of such flows. 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 uncertainty due to the impact of COVID-19 is expected to affect valuations of businesses, securities, tangible, and intangible assets carried out for various purposes such as:

- Impairment of assets
- Fair valuation
- Portfolio/fund reporting valuations
- Transactions/deal related valuation
- Tax and regulatory valuations
- Valuation for securitisation/hypothecation of shares/businesses

Due to the uncertainty caused by the crisis, the valuation of businesses has become more complex with the need to evaluate greater degree of variables and scenarios due to business related considerations resulting in a more nuanced application of valuation approaches and methodologies. This document outlines some of the considerations.

Given the imperatives of financial reporting, the most immediate and pervasive impact of the uncertainty due to COVID-19 is expected to occur on valuation exercises of businesses, securities, tangible, and intangible assets carried out for various accounting purposes, such as impairment of assets and other fair value measurement.

Valuations in the time of COVID-19

Key Business Considerations

01

Sector impact

While for some sectors, disruption could be temporary in nature, for others disruption may result in permanent / behavioral shift for products / services / transformation of business model.

02

Supply chain

- Supply chain disruption, impact on production / manufacturing activity / capacity utilisation levels.
- Simplicity of the supply chain and the extent to which it is online / digitised.

03

Working capital management

- Active collection of receivables.
- Negotiation for extended terms with suppliers.
- Negotiations / discussions with landlords for lease rental holidays or otherwise.

04

Liquidity

- Status of current cash / debt levels and evaluation of the company's liquidity needs and position.
- Liquidity issues / pressures and understanding how these are being funded temporarily?
- Sources of working capital required to "restart" the business impacted by the pandemic.

05

Leverage

Leverage and servicing of debt – Are the various terms / costs of debt / scheduled repayments being re-negotiated with the lenders?

06

Covenant breach / claims / disputes

Impact of actual / likely debt covenant breach, related claims/ disputes (including enforcement of force majeure clauses by all stakeholders).

07

Government incentives

Impact of various government stimulus programmes/relief packages covering fiscal and monetary measures.

08

Impact on staff

Rationalisation of staff, salary hike/freeze, etc. and also, availability of employees and the leadership team to work remotely.

09

Revival measures

Any discretionary cost reduction / efficiency improvement plans being planned by the management.

10

Scenario analysis

Various scenario cases to be evaluated - best, realistic, worse, especially where the impact of COVID-19 on the business is difficult to ascertain due to high uncertainty.

All the above aspects need to be factored in the projected earnings / cash flows of businesses and / or in the valuation parameters, while valuing the business in the time of COVID-19.

Valuations in the time of COVID-19

Key Valuation Considerations

Market approach - Comparable companies and comparable transactions methodology

- With depressed current multiples, should forward multiples be used to reflect updated market earnings measures? Are revised analyst estimates (incorporating impact of COVID-19) for the go-forward period available?
- Are comparable companies and the subject company being compared on a like-to-like basis, whether on historical or on forward looking basis?
- Does the current decline in comparable companies' share price due to market volatility on account of COVID-19 warrant an adjustment as regards the period over which prices are considered?
- How does one compute maintainable levels of earning in the current uncertain scenario?
- Are any one-time adjustments warranted?
- Should multiple of comparable transactions, which have happened prior to COVID-19 crisis, be considered with appropriate calibration?

Income approach - Discounted cash flow methodology

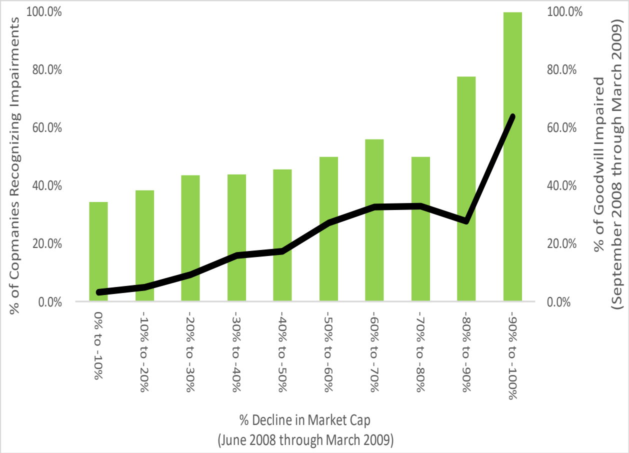
- Is intrinsic value as measured by the Discounted Cash Flow (DCF) given greater weight over the market approach in current conditions?
- How to model alternative scenarios in such times of unprecedented uncertainty?
- How to choose assumptions for projections in such extraordinary and unprecedented circumstances?
- Having regard to the uncertainty of the period over which the business/industry is expected to recover, what should be the period of projections?
- Is there a need to normalise the risk-free rate, considering inter-alia sovereign financing and stimulus programmes?
- Is the estimate of long-term equity risk premium in the discount rate aligned with current market volatility? If the impact on forecasts is uncertain, how should this be reflected in the discount rate?
- What should be the period for which beta of industry should be considered to appropriately capture systematic risk?

COVID-19 can impact multiple valuation parameters (such as discount rate, growth rates, multiples) and performance metrics/future cash flows. Care must be taken to avoid double counting the impact while undertaking valuations.

Impairment of assets

- Historically, declines in the stock market (on account of external events) can trigger testing of assets, goodwill, and other intangible assets for impairment.
- The Financial Crisis of 2008–2009 provides a guidepost to how companies viewed impairment testing during periods of market volatility. Our analysis shows that the impairments recognised by companies in our sample tracked closely with decreases in their stock price.

Greater market cap declines correlate with greater impairments



Market cap declines correlate with goodwill impairment

Source: S&P Capital IQ.; Population: Current S&P 500 companies publicly—traded as of January 2008.

Fair value measurement

- Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
- Fair value measurements (such as those involved in measuring, for example, impairment of assets and certain financial instruments) should reflect market participant views and market data at the measurement date under current market conditions.
- Estimating fair value generally involves judgment. The current uncertain environment requires extensive consideration of various facts and circumstances particularly in the rapidly changing macro economic factors/environment.
- Some of the key questions that one would need to answer include the following:
  - How to factor in the market participant's consideration of the increased uncertainty in the macro environment?
  - How would market participants transact (especially in times of such increased uncertainty)?
  - Should the decline in market prices triggered by the COVID-19 event be used as a benchmark for the increased uncertainty?
- Answering these questions—in terms of the impact of various business considerations in evaluating the potential earnings of businesses and the application of various valuation methodologies and parameters—has become more challenging due to the uncertainty of the economic impact of COVID-19 across different businesses and sectors.

As the discernible impact of COVID-19 will be first seen in the results leading up to the quarter ending 30 June, aspects of possible impairments and fair value adjustments for accounting purposes, will come under greater scrutiny.

Contact Us

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