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DOING VALUATIONS AMID AND AFTER COVID-19

INTRODUCTION

Indices swinging, volatilities spiking and increased uncertainty about economic prospects/recovery caused by Covid-19 have put both valuers and users of valuation reports worldwide in a tight spot. Supply chains have been disrupted because of lockdowns, production shutdowns and mandatory quarantine, and majority of retail stores have been closed in many countries. Sovereign yields dropped in early March as investors took flight to safety and base rates were cut, leading to a jump in corporate credit spreads.

In light of this, business and real estate valuation assignments going forward will raise numerous questions. Which methods to employ in the view of the pandemic? Should we increase/modify the elements of discount rates and which ones? How to adjust forecasts? What about company specific risks? To address these questions, let us start with underlying problems and then try to find possible solution(s).

PROBLEMS AND SOLUTIONS

Problem: Uncertain shape of recovery and forecasting cash flows

Even though the pandemic of Covid-19 is a global event, not all countries and industries have been hit equally and hence may exhibit different recovery shapes (e.g., V-shaped, U-shaped, W-shaped or L-shaped). In an attempt to be as reasonable as possible when making cash flow forecasts in these challenging times, one should go back to essentials and start from revised macroeconomic and industry forecasts. Given the circumstances, more thorough analysis will be required than usual. Then move to the subject company and carefully assess its prospects together with the company management. This may also entail a reconsideration of the existing business model. Furthermore, a scenario analysis would be prudent so as to cover possible outcomes of the pandemic and shapes of recovery. This may be just a tool to make up for the lack of reliable historical experience, i.e. consequences of pandemics on the global economy.

Problem: Turmoil in securities markets and impact on cost of capital

With a decline of sovereign yields (i.e. risk-free rates), downfall of stock prices (leading to an increased implied ERP), widened corporate credit spreads (affecting cost of debt) and government stimulus packages supporting borrowings (leading to higher leverage ratios), discount rates as calculated using the CAPM and WACC formulas should be revised. Let us start off with risk free rates - currently in Europe for AAA issuers they are around 0%. Theoretically, a risk-free rate should consist of real rate of return and inflation. I would argue that long-term inflation may even be implicitly contained in the final cost of equity even if we use a 0% risk free rate. Beta coefficients calculated using regression typically cover 3-5 years and may not necessarily need to be changed. Time is yet to tell whether certain industries will be affected in the long run in terms of correlation with relevant market indices. An implied ERP, which is essentially an IRR resulting from current index level and its return forecasts, has probably increased. Duff & Phelps has changed its recommendation of ERP from 5% to 6% (for the US), arguing that pre-Covid-19 cost of capital should not be lower than the one during the pandemic. Also, Damodaran's latest implied ERP (April, TTM with adjusted pay-out) is 6.52% (jump from 5.77% in March), and Covid-19-adjusted ERP is 6.02%. Mind that earnings estimates are yet to be updated in the weeks or months to come, which will probably lead to a downward adjustment of implied ERP. Finally, one should not combine a historical ERP with current (and very low) risk free rates as it does not make sense.

Problem: Covid-19 and company specific risk premium
If Covid-19 happened to affect the subject company more dramatically than its competitors due to specific circumstances (e.g. severe outbreaks and/or lockdowns in locations of manufacturing plants, contingency plans and procedures not put in place, key personnel being in quarantine or caught in a lockdown abroad, etc.), an increase in company specific risk premium may make sense. Still, because this premium is very subjective, it should be considered only if the valuer is not able to assess the duration and intensity of adverse circumstances on cash flows.

Problem: Asset impairments and declined market multiples
From the standpoint of impairment valuations for financial reporting (IAS 36), triggers are already out there by now, for sure. However, it is likely that in most cases Value in Use will be higher than Fair Value Less Costs of Disposal if the latter is calculated using the GPC method (guideline public companies) since market multiples declined significantly. Similarly, transaction multiples may soon take a downward path should distressed M&A activity increase.

Problem: Increased borrowings and leverage ratios
Stimulus packages by governments will likely lead to increased borrowing by companies and consequently lift up leverage ratios, at least in the short-term. Hence, careful (re)consideration of long-term financing needs will be required in each assignment, particularly, if the subject company's business model is expected to be modified.

GUIDANCE FROM VALUATION STANDARD SETTERS

Standard setters and valuation professional organizations have reacted as well, providing guidance related to Covid-19. The IVSC has issued a letter to valuers and users of valuation reports drawing attention to factors of the valuation uncertainty. Valuation uncertainty is not the same as risk, which is inherent in all investments, rather, it relates to market disruption, input availability and choice of methods, all affecting the valuation process. Market disruption relates to lack of transactions or panic transactions. Input availability, i.e. lack of reliable inputs, may be influenced by market disruption but can also be a normal characteristic of some assets. In terms of choice of methods, if there are insufficient factual or observable inputs for a single method to produce a reliable conclusion, another method should be used.

In Serbia, the Expert Board of the Ministry of Finance overseeing the real estate valuation profession has issued a guidance related to Covid-19. Given the lack of real estate transactions caused by the pandemic, which essentially undermines the concept of Market Value, the following recommendations are given:

a) If possible, valuers should consider and quantify the effects of the pandemic without special assumptions.

b) Otherwise, valuers should determine the value effective on a date before the state of emergency was introduced, and comment on possible impacts of the pandemic on value. In addition, the valuation should be reviewed as soon as the state of emergency is lifted and there is enough market data for more adequate valuation.

CONCLUSION

"Cash is king", as the saying goes. Therefore, going back to fundamentals is a recommended starting point in business valuations. Try to understand the changed macro environment and its possible effects at industry and company levels. Furthermore, given the mathematics of DCF technique, it is sensible to put more effort in developing reasonable forecasts of cash flows or scenarios, instead of risking overestimating a discount rate. This is especially the case if V-shaped or U-shaped recovery can reasonably be expected for a subject company, implying quicker recovery. Valuers also need to keep in mind the long-term aspect and avoid undue wariness. Arguably, residual value calculation and assumptions do not need to be changed. This is not the first nor the last crisis - it shall also pass, and recovery will follow. On the other hand, not all industries have been affected dramatically or even adversely - global demand for certain products has increased, many have switched to e-commerce, shifted to remote working, etc. In terms of methods to be employed, depressed multiples due to sell-off will definitely be a conundrum for some time. Possible distressed M&A activity may also distort transaction multiples. Therefore, results obtained from an income approach may be more meaningful than those from market approach. Even more so in the case of impairment valuations, where in many cases *Value in Use* will likely be higher than *Fair Value Less Costs of Disposal* (when calculated using market multiples). Until things start getting back to normal or perhaps some "new" normal, months to come will present a challenge and require additional scrutiny not only for business valuations, but also for valuations of real estate and other asset classes.

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