Grant Thornton

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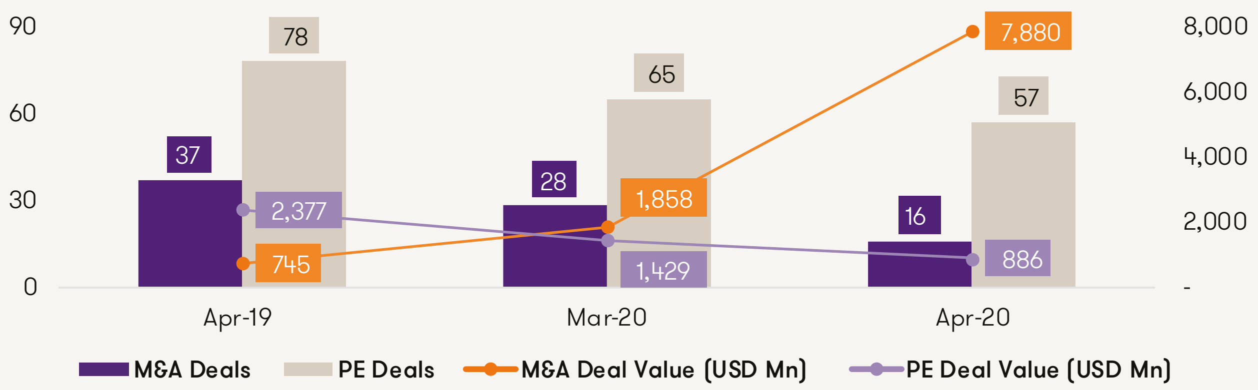
HALT - PLAN - REFRESH

COVID-19: Managing valuation challenges for private equity funds

Impact of COVID-19 has been felt globally across countries, business houses, capital markets, private and public sector entities. India is now on the verge of gradually and cautiously unlocking the economy after industries and business operations were under lockdown for almost three months.

Among other financiers and investors, the fourth wheel of the finance industry, private equity (PE) and venture capital (VC) funds, are also witnessing huge challenges. Given the turmoil in the overall world economy, these funds face an uncertain road to recovery in the coming months.

Number and value of deals



Source: Grant Thornton Monthly Dealtracker April 2020 and March 2020

Impact of COVID-19 on PE and M&A deals

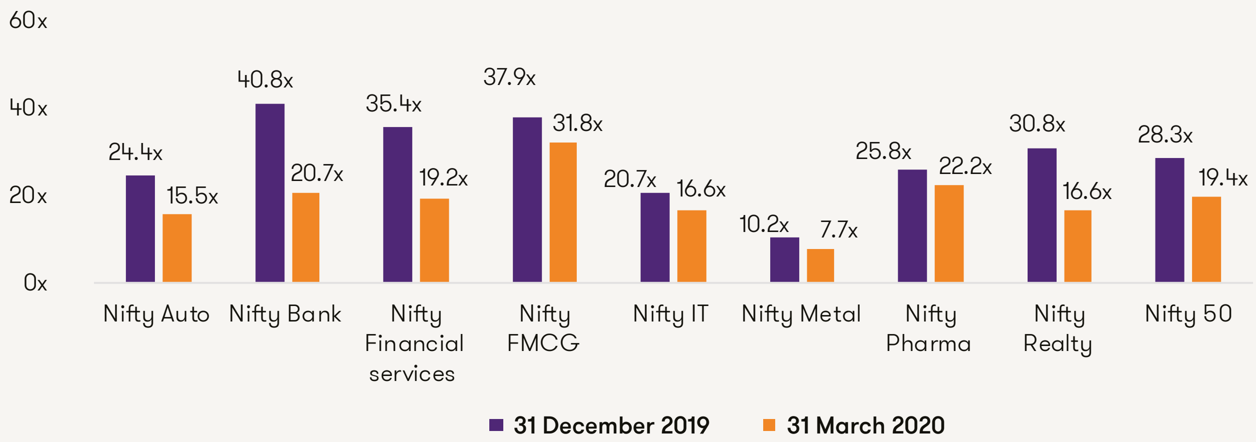
According to Grant Thornton's monthly dealtrackers for March and April, PE deals in April 2020 decreased by 27% year-on-year (y-o-y) and by 17% compared with March 2020. Total PE deal value in April 2020 decreased by 63% y-o-y and by 40% compared with the previous month.

Similarly, the total number of merger and acquisition (M&A) deals in April 2020 decreased by 57% y-o-y and by 24% month-on-month. However, the total M&A deal value in April 2020 increased mainly on account of increased number of high value deals compared with March 2020 and April 2019.

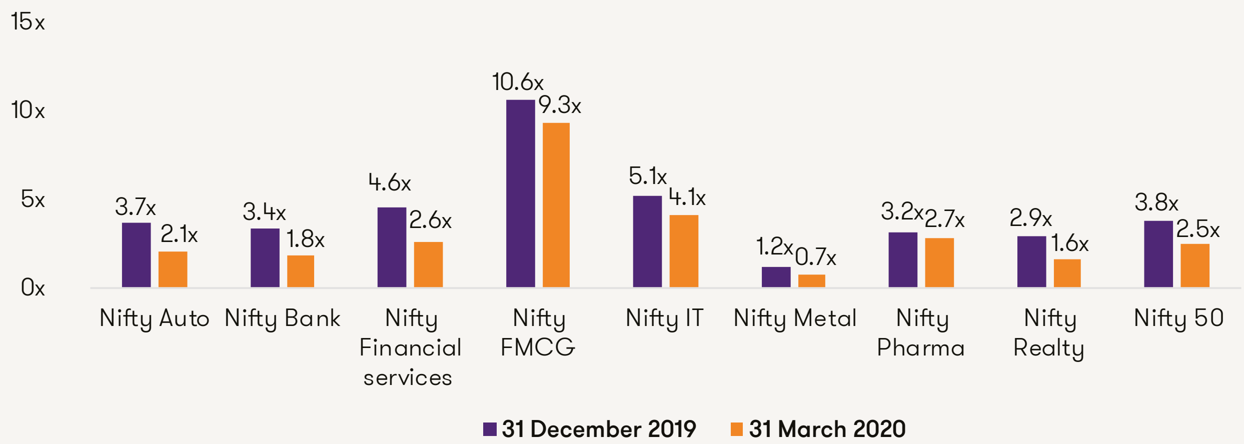
Sharp corrections in stock markets

Stock markets have also shown strong reactions by declining by over 35% during the lockdown period in response to a near closure of economic activities and uncertainties looming over the outlook for industries across the globe. However, markets have been recovering in recent weeks in anticipation of economic unlocking.

Price to earnings multiple



Price to book multiple



As a reaction to the COVID-19 pandemic, valuations of all sectoral Nifty indices have moderated compared with the previous quarter.[1]

- The banking and financial services sectors have been severely affected. P/E and P/B multiples of the Nifty Bank index decreased by 49% and 47% respectively, between December 2019 and March 2020.
- Similarly, P/E and P/B multiple of the Nifty Financial Services index decreased by 46% and 43% respectively, over the same period.
- Overall P/E and P/B multiples of Nifty 50 declined by 32% and 35% respectively, over the same period.

In this situation, one of the challenges faced by PE funds is to determine the right value of their portfolio companies. While listed stocks are valued based on the prices quoted on the bourses, unlisted stocks are valued based on either market approach, income approach or cost approach. However, in the current challenging and uncertain times, each of these approaches need to be followed with caution.

1. NSE India

Here's how PE leaders can PLAN how to manage their valuation challenges and ascertain the appropriate value of unlisted stock

Valuation through transaction price

When there is a recent transaction in the portfolio company, the transaction value may represent fair value. However, if the transaction was concluded prior to COVID-19, the transaction price may not necessarily be considered fair value.

- The pre-COVID-19 transaction price needs calibration with market inputs at the time of investment and on the valuation measurement date.
- The current scenario may demand a write down in the value of the investment if there is significant impact on near-term or long-term financial performance of the portfolio company.
- Holding an investment at cost or a prior period valuation may not be in alignment with their fair value. It is important to check the value using alternative methods.
- Does your investment agreement provide for liquidation preference or other preferential provisions? It may give you downside protection despite falling fair value.

Consider comparable companies' multiples

This is suitable if closely comparable companies with no significant differences in their business and fundamental drivers vis-à-vis the portfolio company are available.

- Comparable company multiple method as on the valuation measurement date uses financial metrics of the last reported quarter. Hence, it does not capture the realistic expected run rate, given the current disruptions in the business cycle.
- Care needs to be taken to use similar financial metrics of the portfolio company and comparable companies.
- Reflecting deep uncertainty, the valuation measurement date multiples may exhibit fire sale value . Therefore, it is generally advisable to use forward multiples based on forward earnings expectations, considering the new economic environment. However, forward estimates may also not be updated by market analysts.
- You may consider applying control premium over and above the market value if the fund holds a significant stake in the portfolio company.

Explore discounted cash flow method under the income approach

This method appears to be more appropriate. However, given the difficulty in accurately estimating time to normalcy, forecasting short to medium term financials of portfolio companies is a challenge.

- The method commands higher risk premium, higher cost of debt and therefore higher discount factors due to uncertainty of future operations. Care should be taken to avoid double dip i.e., increased discount rate for uncertainty and revised lower financial projections adjusted for uncertainties.
- It is advisable to gauge the need for revisiting key inputs and assumptions used in near to medium term financial projections based on assessment of supply and demand position, relevant industry outlook, likely recovery curve of the portfolio company, among other operating parameters.
- One should analyse various scenarios, considering value drivers, such as growth or drop in sales, margins, working capital and other factors that provide additional comfort on valuations.

Given the unprecedented challenges hovering around valuation of portfolio companies, it is advisable to use a combination of methods to get a reasonably clear assessment of value. As the current economic situation is very volatile, a frequent assessment of values is key.

How Grant Thornton can help

Grant Thornton's Private Equity team can help you navigate current business and operational challenges by drawing on years of experience of working with industry leaders. The team provides a wide range of services, such as – fair valuation, impairment analysis, equity and hybrid instrument valuation, deal advisory and due diligence advisory.

Grant Thornton's Transaction Advisory team can help you effectively manage investment valuation challenges, especially during these uncertain times.

Click **here** to access the latest version of the Grant Thornton Monthly Dealtracker, which captures the PE and M&A deal activities for May 2020 in India.

Click **here** to access the Grant Thornton Annual Dealtracker 2020, which captures the PE and M&A deal activities for 2019 in India.

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Click here to download the recently released Grant Thornton Halt-Plan-Refresh Guide on revisiting business priorities and plans

For more insights on the COVID-19 crisis, scan this barcode to see continuous updates on our website