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COVID-19: Valuation in the time of crisis

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The COVID-19 crisis has left the global stock markets in turmoil and many industries staring at an uncertain future. Most of the listed companies in the Indian stock markets have witnessed a significant downfall.

In these turbulent times, corporations, financial institutions, investors and professionals are grappling with several questions related to the valuation for various purposes.

Some of these issues are discussed below:

How will this situation impact investments of entities that are being accounted at fair value?

The Fair Value or measurements that are based on it would need to consider cash flow expectations and market conditions as on the measurement date.

The auditing standards governing such measurements place importance on the three-level fair value hierarchy based on the inputs to the valuation methodology. The Level 1 inputs relate to the directly observable inputs from the market. While measuring investments in publicly listed entities or marketable investments, it may be appropriate to review the trading volumes, any trades in a principal-to-principal market, etc., and assess the 'orderliness' of the market.

As provided in International Financial Reporting Standards 13, adjustments should not be made to the observed market inputs as on the current date, except for certain circumstances as explained therein.

The use of level 2 or level 3 inputs may require a much more careful consideration.

If the investment has been valued using the transactions multiple method historically, there could be a need to evaluate and consider appropriate discounts if the transactions in our set of comparable list have been announced before the COVID-19 situation aggravated.

Under the market multiple approach, which involves using multiples of comparable listed companies, it becomes even more important to understand and compare the businesses and fundamental drivers of the subject company vis-à-vis the comparable companies. If the businesses are comparable and the shares of comparable companies are frequently traded, it may not be prudent to consider taking an average price over a longer period, only due to the current decline in prices for estimating the valuation multiples of comparable companies.

Under the income-based method, it will be important for the professionals and the management to carefully consider the cash flow projections and update them as on the measurement date. Given the high uncertainty prevailing currently, it may be appropriate to develop scenario-wise sets of projections with probabilities estimated for each set. Near-term projections are likely to be most affected. How would our risk assumptions in the discount rate change? The pandemic poses a 'known-unknown' risk, which is difficult to model in valuation and hence, a certain degree of conservatism may be advised.

In the given circumstances, using capitalisation of earnings method may be less relevant, even for companies that have been generating stable cash flows until now because it will be very difficult to arrive at a single normalised cash flow measure to be capitalised.

Will there be an impairment in the carrying value of my assets like Goodwill, Intangible Assets etc.?

Assessment of impairment in Goodwill and other intangible assets are governed by International Accounting Standards 36 and similar standards across the countries.

It is important to note that the details provided in the standards focus on their recoverability of the asset and hence, they implicitly require us to take a long-term view. This involves a careful reading of the temporary as well as permanent changes in the macroeconomic factors. Any structural changes in these factors caused in the wake of this uncertainty needs to be appropriately factored in the valuation analysis.

For example, in the Value-in-use method, the near-term cash flows may be affected, but the long-term cash flow expectations may remain unaffected, which may not lead to any impairment. To reasonably ascertain our conclusion on the impairment, a robust stress testing analysis of our valuation models needs to be carried out. This will include testing valuation-related assumptions such as long-term growth rate, profit margins and discount rates, etc., along with changing the assumptions behind the projections to understand the results in the worst-case scenarios. The analysis would help professionals understand the valuation 'cushion' over the carrying amount of the investment.

Further, another aspect which the companies can look at while testing goodwill for impairment is the applicability of control premium. Since the unit of account in a goodwill impairment test is at the CGU (cash generating unit) or a reporting unit level, it's fair value is implicitly on a control basis. Hence, in arriving at the CGU/reporting units' fair value, one might take into account an appropriate control premium. This will however require judgement and supporting documentation.

If my fund invested in a company five months ago, do I need to take a write down at the time of reporting fair value as on 31 March 2020?

Investments made in private equity or venture capital funds factor relatively higher degree of volatility in the month-over-month performance of their assets than usually observed in the market. The valuations at which these funds invest generally also factor for near-term underperformance for various reasons such as lower rate of team build up, difference in actual versus projected market traction, etc. It is important to examine the health of balance sheet and the year-to-date performance as at the measurement date.

It is important to assess and discuss any near- or long-term effects in financial performance with the management of these funds and the investee company. Remember, each investment will be different and such impairment conclusions can be different for different cases.

How will the changing macroeconomic factors like reduced interest rates impact the valuations?

The COVID-19 crisis may lead to lowering of interest rates as a result of immediate response by the regulatory authorities across the world and due to decrease in the GDP growth expectations. The valuation models should factor in the implications of changes in the discount rates.

Due to a significantly lowered interest rates, the risk-free rate used in our discount rates may be very low, which may provide us an incorrect picture of the valuation. This is because the cash flows may not be appropriately adjusted to reflect the lower growth rates. If the valuer feels that cash flows are not adjusted for the change in the interest rates, additional risk premiums should be considered in the discount rates to ensure that lowered risk-free rates do not lead to anomalous valuations.

In a negative or a zero-interest rate scenario that may prevail in some economies like the US, Japan or some countries in Europe, alternative measures of a representative rates can be considered instead of point estimates.

How we can help

Grant Thornton's Financial Advisory team can provide you with all the insights to help you in arriving at the valuation of your assets.

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