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Technical Guidance to Valuations during COVID-19

1 EXECUTIVE SUMMARY

This article details our approach to assessing the impact of Coronavirus disease 2019 ("COVID-19") on the valuation of businesses, companies and intangible assets. In summary, we recommend that:

- The discounted cash flow methodology is currently preferable to a capitalisation of earnings approach.
- Projected cash flows should be adjusted to reflect the current best estimate after allowing for the impact of COVID-19 on the business.
- The equity market risk premium should be increased.
- The assessed beta should be based on market trading up to December 2019 (i.e. before the impact of recent share price movements and volatility).

The valuation conclusion may also be expressed as a wider range than would ordinary be applied as a result of the uncertainty in the market

2 BACKGROUND

COVID-19 is an infectious disease that was identified in late 2019 in Wuhan, China. Since then the disease has spread globally.

Governments around the world have imposed significant restrictions on citizens in an effort to slow the spread of COVID-19 to help health systems cope with the expected number of patients. Examples include travel bans, closing hospitality venues and restricting public gatherings. These measures are having dramatic repercussions for businesses and individuals around the world. This in turn has led to significant declines in market valuations of businesses. Between 31 December 2019 and 31 March 2020, the Australian stock market fell 22% as shown in the chart below:

Figure 1: Market movements since December 2019

Source: Capital IQ

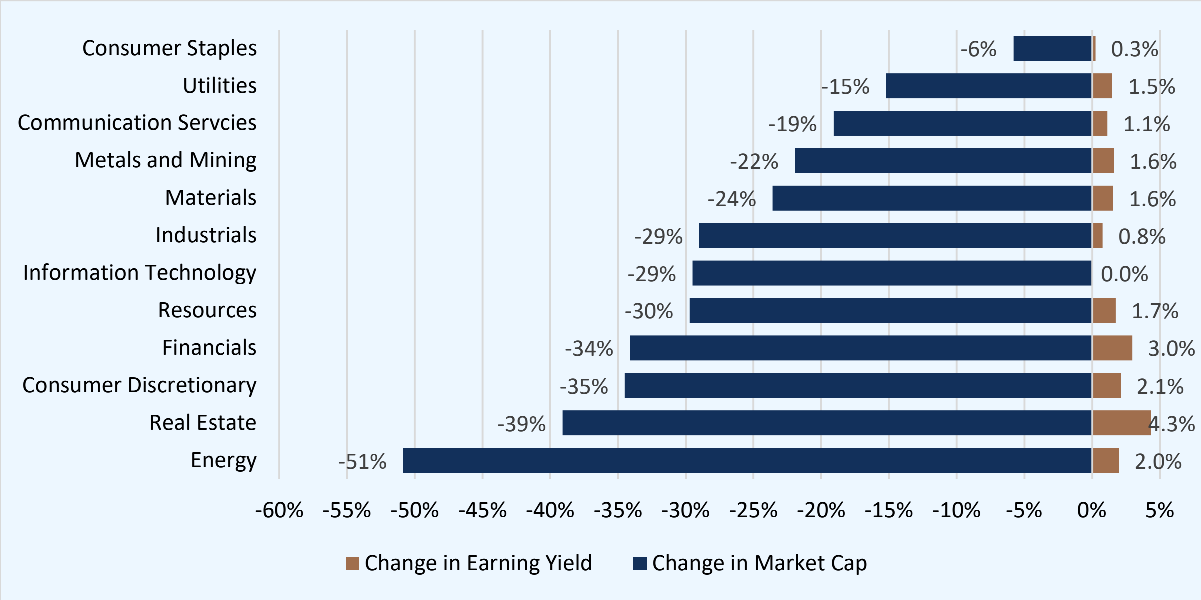
Global share markets are down in part because expected earnings for most business are now significantly lower than they were prior to the onset of COVID-19 for many reasons including the impact of:

- Travel bans
- Consumer caution
- Social distancing policies
- Increasing unemployment
- Supply disruptions

To some extent these issues may be partly mitigated by government stimulus measures. In many cases it is difficult to predict the impact on earnings in the medium to long term. This uncertainty has pushed valuations down further.

The impact across industries is not uniform, as shown in the chart below.

Figure 2: Market movements from December 2019 to March 2020



Source: Capital IQ

This chart shows that energy, real estate and consumer discretionary stocks have fallen the furthest, while consumer staples have fallen very little. It also shows that real estate stocks have fallen the most as a result of risk re-ratings (as measured by the increase in earnings yield), whereas for information technology stocks, the fall appears to be entirely cash flow related (earnings yield is unchanged).

In this situation, valuation is more uncertain than usual. It is therefore reasonable to expect a wider range of opinions on value.

3 POSSIBLE APPROACHES TO VALUATION

3.1 The appropriate valuation methodology

Given the current economic turmoil, the closure of many businesses and the limited availability of capital for many business owners, greater consideration of the asset approach will be required.

Where there is a reasonable expectation of the continuation of the business in the medium term, an income approach may still be the preferred valuation approach. This will normally involve the use of either the capitalisation of future maintainable earnings or a discounted cash flow analysis.

The capitalisation of earnings approach involves the selection of:

- **Future maintainable earnings** - at the best of times it can be controversial to select a relatively small range for maintainable earnings. In the current environment it is highly likely that past earnings will not be indicative of future earnings, at least for the medium term. As it would be extremely difficult to incorporate a period of poor returns and a future turnaround into a single earnings estimate, selection of maintainable earnings is currently problematic.
- **The capitalisation multiple** - when using a multiples-based approach, it is important to ensure consistency between the earnings used to calculate the multiples and the earnings used in the valuation. This means that if the earnings of the subject company are based on post-pandemic cashflows the earnings used to calculate the multiples of comparable companies must also be based on post-pandemic earnings. However, care must be taken when using current market multiples, where earnings forecasts may not have been updated. This can be difficult because many companies have withdrawn their earnings guidance and many brokers have not reissued earnings forecasts since the onset of COVID-19.

  Furthermore, the use of transaction multiples is particularly problematic given the significant change in the market over the past three months.

Due to the problems with the application of a capitalisation of earnings approach at present, a discounted cash flow analysis is the preferred valuation methodology where an asset approach is not used.

3.2 Approach to projected earnings

There are three broad approaches that are possible ways to adapt valuations to the COVID-19 pandemic as set out below:

Table 1: Approaches to incorporating the impact COVID-19 into valuation

Approach	Discussion	Conclusion
Adjust discount rates / multiples	Some practitioners have suggested leaving forecasts at pre-COVID 19 levels and applying a higher discount rate or lower multiple to those earnings projections. In our view, adjusting discount rates or multiples in isolation is problematic given the cash flow impact on each business will be different to other businesses, and for different lengths of time. To get a reasonable outcome using this approach it would be necessary to make specific adjustments to discount rates or multiples for each business based on the extent to which cash flows are impacted. It is therefore simpler and more reliable to adjust the cash flow or earnings projections directly.	Not adopted
Adjust cash flows / earnings	A significant portion of the fall in market prices can be attributed to the expected falls in earnings. Adjusting projected cash flows to reflect current expectations is therefore a plausible approach. This approach is also more consistent with what we are seeing in the market in terms of impact on different industries (refer to figure 2 above.) However, we also believe there is an additional reduction in values arising from the higher level of uncertainty. This is best captured through an increase in discount rates or reduction in multiples.	Not adopted
Adjust both discount rates / multiples and cash flows / earnings	Our conclusion is that the incidence of COVID-19 has not changed the best practice approach of using expected cash flows / earnings as the basis for valuations. These earnings should be coupled with an appropriate COVID-19 adjusted discount rate or multiple reflecting the market on the valuation date.	Selected approach

3.3 Approach to projected earnings

Whilst always important, in the current environment projected cash flows require additional attention. In preparing projected earnings it is useful to consider:

- Reserve Bank, Treasury and OECD commentary indicated as early as March 2020 that COVID-19 will cause a significant downturn in economic activity and that there is likely to be a prolonged recovery.
- ABS data in its mid-March 2020 update indicated the impact on business is likely to be widespread, with approximately half of Australian businesses having experienced an adverse impact associated with COVID-19 and 86% expected to be impacted in future months (prior to social distancing measures).
- The largest impact will be on businesses relying on face to face contact such as airlines, accommodation and food services, tourism, retail and recreation.
- The effect on businesses is expected to not only impact on the demand side but also the cost side through, for example, supply chain effects.
- In the medium to longer term we may see softer labour market and rental markets.
- Several industries including IT and telecommunications, and in the shorter-term consumer staples, and any other business that can bypass the need for physical interaction will be less impacted.

- Many companies will be entitled to receive support via stimulus packages that have been announced, but the impact may not be uniform across all sectors.
- There is likely to be more competition for revenue and this may impact pricing, and a greater focus will be required on collections and bad debts.
- The duration of these impacts remains uncertain with some economists allowing for a six month to 12-month lockdown, and the flow on impacts from a downturn in consumer demand being unknown.

The uncertainty associated with projections will be best dealt with by assessing the impact of a range of potential scenarios which reflect the size of downturn, and the rate and degree of recovery.

3.4 Approach to discount rates

We considered the following approaches to adjusting discount rates:

Table 2: Approaches to estimating discount rates with COVID-19

Approach	Discussion	Conclusion
COVID-19 premium	The idea of applying a COVID-19 premium to unadjusted or partially adjusted cash flows is problematic. COVID-19 does not impact each company equally as shown in figure 2 above. Thus, a uniform adjustment to discount rates would not yield a reasonable outcome. To correct this, a '*COVD-19 beta*' would also be required to increase or decrease the amount of premium applied to a business. This would be particularly difficult to measure.	Not adopted
Adjust EMRP	We believe the EMRP has increased with the incidence of COVID-19 and we have therefore updated our estimates of the EMRP. This will therefore reduce values. There are estimation difficulties with EMRP at present given brokers' earnings forecasts are in many cases still to be downgraded to reflect the current situation. However, we don't believe the estimation difficulties are sufficient to make an alternative approach preferable. Given estimation issues we are now adopting a range for EMRP as discussed in our lasted EMRP update. The problem with adjusting EMRP in isolation is that it does not capture the differing amounts of uncertainty for different industries. The EMRP implied by this analysis as at 31 March is 8.1% to 8.2% and based on our recent analysis, we are currently recommending an EMRP of 7.5% to 8.0%.	Adopted
Adjust β	In our view, COVID-19 is not a beta issue. It has not impacted industries in proportion to their betas. There is presently no reason to expect underlying beta has changed for any specific industry. The incidence of COVID-19 will introduce significant noise into beta estimation. At present we are therefore using pre COVID data for beta estimation.	Not adopted

Approach	Discussion	Conclusion
Adjust α	Alpha can be used to address the issue discussed above regarding the differing degrees of uncertainty in forecasting for different businesses in light of COVID-19. We therefore consider it reasonable to apply an additional alpha to businesses for which it is especially difficult to forecast earnings. This additional alpha will be somewhat subjective. We recommend its estimation by considering the impact on the valuation conclusions of alternative hypothetical cash flow scenarios.	Adopted as relevant
Adjusting Size premium	Leadenhall incorporates a size premium for smaller companies in its assessment of discount rates. It is possible smaller companies, which may not have sufficient capital resources to continue are at greater risk. Alternatively, the focus of government subsidies and greater flexibility to minimise costs may provide smaller companies with a greater chance of recovery. As size adjustments are somewhat subjective and as there is currently no clear evidence of the impact of COVID-19 on different sized companies, we have not adjusted our size premiums at this stage.	Adopted as relevant

3.5 Discounts and premiums

Where minority shareholdings are being valued, additional consideration needs to be given to the shareholder level discounts, specifically the discount for lack of control and discount for lack of marketability (commonly called minority interest discounts).

Intuitively, and based on some evidence, it is likely that both of these discounts increase in times of high economic uncertainty.

We will provide further analysis of this as we complete it.

4 CONCLUSION

Due to the problems with the application of a capitalisation of earnings approach discussed above, a discounted cash flow analysis is the preferred valuation methodology.

Focus on expected cash flows is now important than ever. Along with falling expected cash flows, valuations are also currently being impacted by increased risk aversion, as well as greater uncertainty regarding future cash flows. This has led our assessed EMRP to increase from 6.75% before the COVID-19 pandemic to a range from 7.5% to 8.0% at present.

We also consider that in some cases an additional alpha factor may be required for business that have a particularly high level of uncertainty arising from the COVID-19 pandemic.

It is also likely that minority discounts have increased in the current economic environment.

As a result of these uncertainties, we are generally adopting a wider range for valuations than would normally be the case.

If you have any questions with this or any other valuation issue, please contact the Leadenhall team.

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