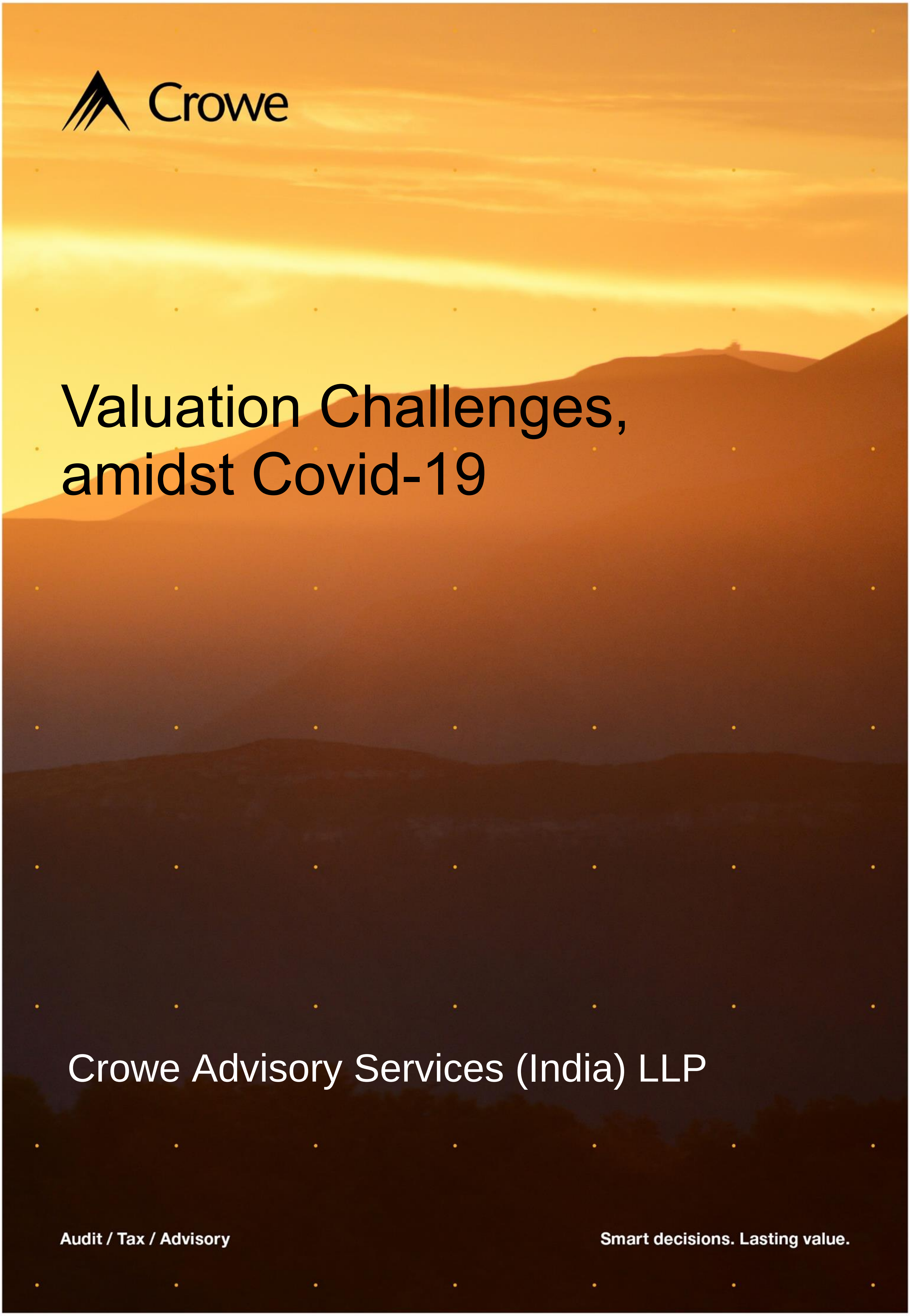

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Valuation Challenges, amidst Covid-19

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Key Questions

COVID-19 is a severe health crisis affecting human-kind globally. It is also impacting financial and economic health of businesses globally, with only a few exceptions.

Valuation aspects draw sharp focus at this time, particularly as corporate India goes about its annual reporting for year ending 31 March 2020 (FY20). The actual impact for FY20 may be somewhat diluted by the fact that the shutdown occurred mainly in the second fortnight of March, although several businesses with cross-border components saw some business dilution from late January.

Valuation needs will relate to several matters including (a) portfolio valuations, relevant to year-end financial accounting; (b) investments and intangibles (mainly goodwill and brand) relating to impairment testing; (c) earn-out related entitlements; (d) valuations of put-options sought to be exercised by joint venture partners; (e) for M&A purposes, including purchase of stressed assets; (f) business valuation needs under IBC restructuring processes.

In each case the biggest questions are two-fold. Firstly, to what extent are normative numbers to be considered over the unusually impacted actuals. Secondly, to what extent can external parameters be considered reliable in supporting the assumptions under the valuation.

It is at times such as these that deep professional judgment and balance is needed, rather than merely applying mathematical formulae. The formulae are undoubtedly a key tool for the valuation, but the depth of assumptions and analysis – and a sense of balanced realism – must be the professional hallmark.

When business is shut – every business and not just the business being valued - and the country is in lockdown, is there a case to be made that actuals must be replaced by normative numbers? Particularly so when eleven months or more of the financial year have yielded a certain trend of results. Further, the recovery from lockdown can and will only be gradual, no doubt compounded by a fundamentally challenged economic cycle due to slowing demand, lack of buying power and supply chain disruption.

Should one seek to separate the impact of economic reality from the inevitable factors of inertia that will constrain the restart cycle. This certainly merits a consideration, particularly where one recognises the need to separate normal and unusual business circumstances. However, a normative adjustment may appear more plausible for valuations which rely upon FY20 results (e.g. earn-out based transactions); normative adjustments towards future estimates of earnings and cash flows would be difficult to justify.

Intangibles –shining through, or fading

Business valuations, particularly for on-going entities, rely materially on forecasts of future profits and cash flows – these forecasts are the substratum for valuation of intangibles such as goodwill and brands. In a materially impacted business environment, future projections and resultant valuations will be lower than previous numbers indicating an impairment of intangible valuations. On the other hand, the very fact that the business is able to hold its share (maybe even gain share) – and survive through tough times should mean that the brand and goodwill are a strong asset. Are these impaired merely because medium term operating levels will be moderate? Or are these intangibles the critical assets that have helped the business survive – and are therefore more valuable?

Going Concern

Comfort, or the lack of it, in the ability of an entity or business to remain a Going Concern is a key element guiding the Valuer's approach to the task on hand. It will also guide the choice of valuation method, except where there is a regulatory prescription – even in the latter case, the Valuer may need to address specific concerns surrounding the very continuity of the business.

Earnings Valuation – the three legs

An earnings valuation is dependent on

- Estimates of earnings and cash flows from business
- Discount rate
- Capitalisation rate

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Earnings and cash flow estimates

Estimation of earnings is the toughest challenge in times of uncertainty. Particularly so when the timing and related extent of impact cannot be presently determined with any certainty.

Management assumptions underlying future projections will need a deeper review to understand the degree of realism underlying the numbers. The word realism is deliberately chosen over 'optimism' or 'pessimism' because neither of those seem appropriate.

Discount Rates

Lets look at key market indicators:

Secondary equity market

Parameter	Returns* as on March 31, 2019	Returns* as on March 31, 2020
BSE Sensex	12%	9%
BSE 500	14%	9%
NSE	13%	9%

** Long term (20 year) compounded annual growth rate*

10 Year Bond Yields

Yield on March 31	2019	2020
10 year bonds	~ 7.34%	~ 6.20%

On one hand, indicators for cost of equity and debt are reflecting reduced costs. However, reduced cost expectations for the valuation seem contrary to the increased risks associated with varied uncertainties – of business, national and global economy, market volatility, currencies, survival even. Just for reference, some market participants in USA have already increased baseline equity risk premiums by 100 basis points indicating cost of capital may actually increase rather than decrease.

Reduced interest rate of central banks may not effectively change the cost of debt for specific asset or business classes with lenders closely assessing default and counterparty risk. As per a global rating agency, credit costs in India are likely to increase by 2.8% in FY21, before declining in FY22. Lenders will also closely watch and factor in costs around the potential increase in non-performing assets, impacting overall liquidity and risk assessments of institutions.

Some industry data-points from capital markets

S&P BSE Index	52 Week High	52 Week Low	Variation %
Healthcare	14,663.7	10,947.9	34%
IT	16,586.5	10,937.4	52%
Consumer discretionary goods/services	3,871.0	2,348.8	65%
Finance	7,079.7	3,696.7	92%
Realty	2,564.8	1,275.2	101%
Auto	20,411.9	10,141.5	101%
Bankex	37,193.3	18,430.3	102%
Capital goods	20,386.8	9,499.2	115%
Metal	11,859.4	5,336.0	122%

The above table indicates very significant variation in the trading range and change in investor outlook within a 52 week period. It also demonstrates level of fluctuations and potential valuation adjustments that market participants are factoring in. Such short-term sectoral trends could be analysed further while evaluating the projected performance and price fluctuations of the asset under valuation.

Capitalisation Rates

- Does the past remain an indicator?
- Is a change to be made, merely for the sake of reflecting recognition of the challenges?
- Is earnings conservatism sufficiently dealing with the need for adjustment?
- Will the sector gain investment preference, or be considered too risky?
- Will the future potentially be better?
- Are external comparables reliable? What is the reliability of sectoral estimates of 'Maintainable Earnings'? Do these provide an indicator of brand value gain or decline?

Public company managements are yet to revise their forecasts and margin guidance. It will be interesting to see the consequent changes in market capitalisation (and multiples) of comparable public companies, once these numbers emerge.

There are several factors to juggle with, and a mature view is needed. One view is that all three parameters – earnings, discount rate and cap rate - will undergo changes; they well might. However balance is also important, and a change in all three factors is not inevitable if, say, the earnings estimates adequately address potential risks. It would also not be appropriate to apply macro parameters or adjustments to the asset being valued, as a matter of habit or conventional necessity.

Potential impact factors

Among the many factors are:

- Depth of impact and speed of recovery of national economy (recent estimates from global agencies place FY 21 GDP growth forecast for India at 2%).
- Short-medium term cash flows and debt service due to uncertain shape and timing of recovery with less consumer spending.
- Related assessment on the very survival (or impact on long term operating capability) of the business; in other words, the risk of the entity or business segment not remaining a Going Concern.
- Value of the brand, as distinguished from a cash-flow stress related declining business value.
- Impact of business continuity and scale, at key customers and vendors.
- Business concentration - domestic or export - could be a benefit or a constraint.
- Changes to the competitive scenario, with some competitors forced to scale down or even shutdown.
- Permanent changes in business models due to changes in customer preferences, health standards, and customer / vendor base. This is critical as terminal year cash flow assumptions often comprise a significant or predominant element of the business or entity value.
- Certain sectors could even gain positively (e.g. pharma, healthcare, food, logistics, on-line education).
- Impact of government support.

Guidance available in India

An audit related advisory issued deals with following aspects:

- Reference made to Ind AS 113 - Fair Value Measurement, which lays down certain fundamental principles in respect of Fair Value, its definition and how to determine it.
- Fair value measurement – Reference is made to Ind AS 113
- It further gives guidance on the need for adequate management consideration and professional judgment to determine whether quoted prices are based on transactions in an 'orderly market'. Application guidance in Ind AS 113 indicates circumstances in which the transaction is not considered an orderly transaction. It seems somewhat implausible that anybody will take this call.

Guidance available internationally

- Fair value is based on what is known and knowable at the 'measurement date'.
- Care should be taken not to "double dip" with respect to valuation inputs.
- One-time impacts would be excluded from the metric to which the multiple is applied.
- For clarity, expected adverse performance in Q1 and Q2 2020 and beyond should not be considered as one-time, except possibly in specific circumstances such as Earn-out valuations which are based on historical rather than forward looking results.
- Scenario analysis will likely be necessary to assess and incorporate the probability of the crisis extending for 3-, 6-, 12-, 18-months or longer.

An interesting question would be the positive impact of a cure or vaccine being developed in the next 4 to 6 months, with a consequent positive reaction in public markets. An impairment provision, or audit qualification, at the time of accounts approval by the Board of Directors may be rendered unnecessary when the accounts are placed for shareholder approval at an annual general meeting in late August or September. Well, from a valuer's perspective, one renders an opinion based on what is known and knowable at the measurement date. The changed scenario, described above, is for the management to address.

Conclusion

Quality of Earnings estimates and Cash flow projections will be key factors in determining confidence in the numbers and the associated assumptions for discount and cap rates.

Company specific approach based on its unique / independent parameters, and cash flow abilities, would take precedence over routine application of historical / sectoral benchmarks.

About Crowe India:

Crowe Advisory Services (India) LLP, a member of Crowe Global provides Risk Advisory, Corporate Finance, Taxation, Business Advisory, Digital Security Consulting, Data Sciences and Business Process Outsourcing services.

We have offices in eight cities in India. With our global network of 765 offices across 146 countries we render seamless professional services to local and multinational clients.

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