

# Take it case by case: Valuing businesses in volatile times

May 2020

## What do we know?

- ▶ The scale of the impact of COVID-19 on global economies and markets is still largely unknown.
- ▶ Measures taken to limit the spread of the virus are unprecedented. The duration of these measures is uncertain and further measures may be taken.
- ▶ The level of government economic support announced is also unprecedented, but these measurements are not sustainable in the long run and, therefore, a recession and mass unemployment may still ensue.
- ▶ The ECB has implemented a €750 billion Pandemic Emergency Purchase Programme (PEPP) until the end of 2020 to absorb the shock of the current crisis. The ECB aims to lower borrowing costs and increase lending in the euro area.
- ▶ Lockdowns to control the pandemic have triggered a debt and equity market response which has seen significant declines in listed company share prices. For highly levered firms this drop is even more pronounced.
- ▶ A short term return to normal economic activity ('V-shaped' recovery) no longer seems plausible and a prolonged return ('U-shaped'), or even financial depression with no recovery for several years ("L-shaped") could occur.

## It's a challenging time to be valuing businesses

There are significant uncertainties impacting valuations in the current market environment. In the Netherlands, this stems from various factors including the developments of COVID-19 and the general economic weakness in Eurozone.

Many commentators are expressing views on the potential economic impacts of the current crisis. However, in reality the scale and duration of the impact is largely unknown at this point in time. The market reaction is widely reported, but what does this mean for valuations of unlisted businesses or separate CGUs within a public company?

This paper explores some observations relevant for business valuers as we navigate this challenging time.

The key messages in this paper include:

- ▶ There is not a 'one-size-fits-all' approach. Some businesses now have zero revenue, others are barely affected. Each business is different and needs to be assessed on its specifics.
- ▶ Analyzing cash flows is key. Valuers need to understand the potential impacts on businesses through scenario analysis.
- ▶ Market reactions to the economic crisis need to be considered, but short term movements in the equity markets are not directly transferrable to unlisted asset valuations.

This paper is current as of May 2020. The situation is rapidly changing, meaning these observations may evolve.

## Key impacts on business

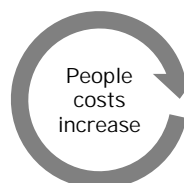
In addition to the general market uncertainty, the values of Dutch businesses is impacted by measures taken to minimise the spread of COVID-19:



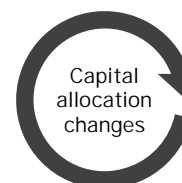
- Cessation of many activities has created 'zero revenue' businesses
- Government intervention in some industries will impact prices
- Increased credit risk of customers
- Reduced inflation forecasts
- Long-term behaviour changes



- Closure of borders (domestic & international)
- Increased counterparty risk
- Change in FX rates may increase costs



- Workforce displacement through adherence to isolation guidelines
- Impact if employees become sick



- Re-evaluation of capital allocation
- Potential limited availability of capital (debt and equity)

# Access to capital and liquidity is harder

The PEPP program implemented by the ECB may help some companies lower borrowing costs. However, in our view the overall risk in companies has not declined. In fact, the risk for most companies has increased given impacts on operations and potential flow-on effects to funding ability and equity values.

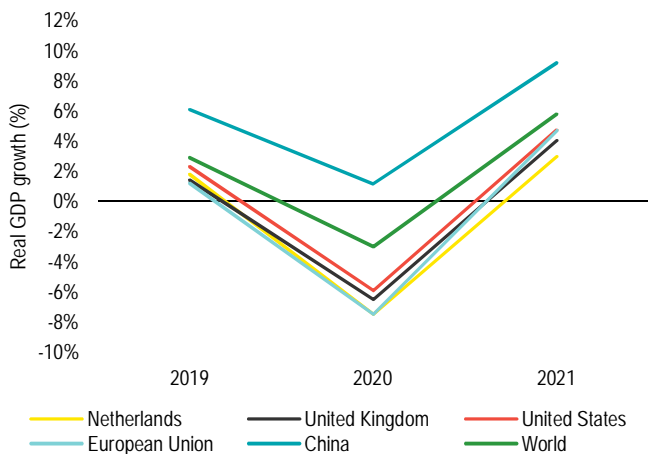
Some companies are now attempting to bolster balance sheets by increasing debt and issuing equity. In many cases these actions will be precautionary.

In this type of market, capital raising transactions may be at a significant discount to valuations, simply to secure funding in a difficult market. On the flipside, we expect that buyers will need to pay higher bid premia for control transactions involving listed companies (relative to listed share prices).

In addition, some institutional investors may need to adjust their asset allocations given significant declines in listed markets. This may affect the market for unlisted assets, where competition has traditionally been strong.

## Where might this go?

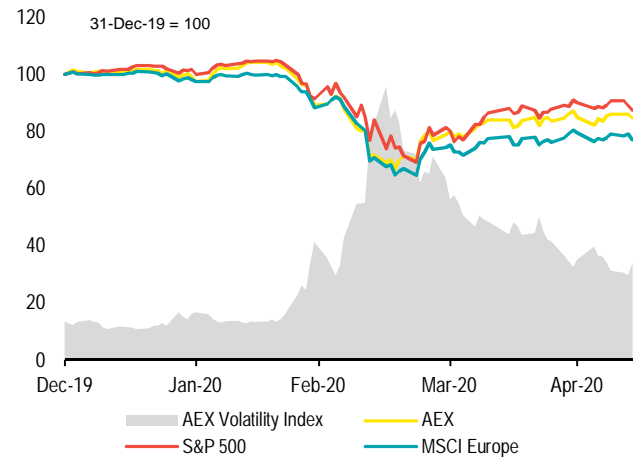
IMF indicates that GDP in the Netherlands and Eurozone is likely to improve in 2021 after a severe shock in real GDP growth in 2020.



The market analysts do not expect that more extreme and prolonged measures are required to effectively limit the spread of the virus. However, if the economy does not improve on longer term, this would mean greater disruptions to productivity and longer term implications. Varied and uneven national recoveries may also result in new trade arrangements and enduring alterations to pre-pandemic global trade flows.

## What has happened to company values?

Decreases in equity market indices<sup>1</sup> indicate that the market likely perceives value declines in Dutch businesses, despite lower bond yields.



Market volatility has also increased, with share price movements impacted both by value considerations and other factors such as investors liquidity decisions.

Given the uncertainty, many businesses are unable to reliably assess the potential earnings impact or provide meaningful guidance. This makes comparisons to market multiples very difficult.

# Impacts on values are company specific

The extent of the impact will differ by company and sector. Sectors which are reliant on discretionary spend will be more impacted, and the longer the crisis lasts, the more sectors will be heavily impacted.



Note: These sector impacts are indicative only. Specific value impacts will differ for each company.

For businesses with significant exposure to demand drivers and to lockdown restrictions and with high operational leverage, as well as those with significant borrowings, the value impact will be greater. A number of sectors are also unlikely to return to 'normal' in the short to medium term. On the other hand, some sectors saw improvements in value through increased demand for their services.

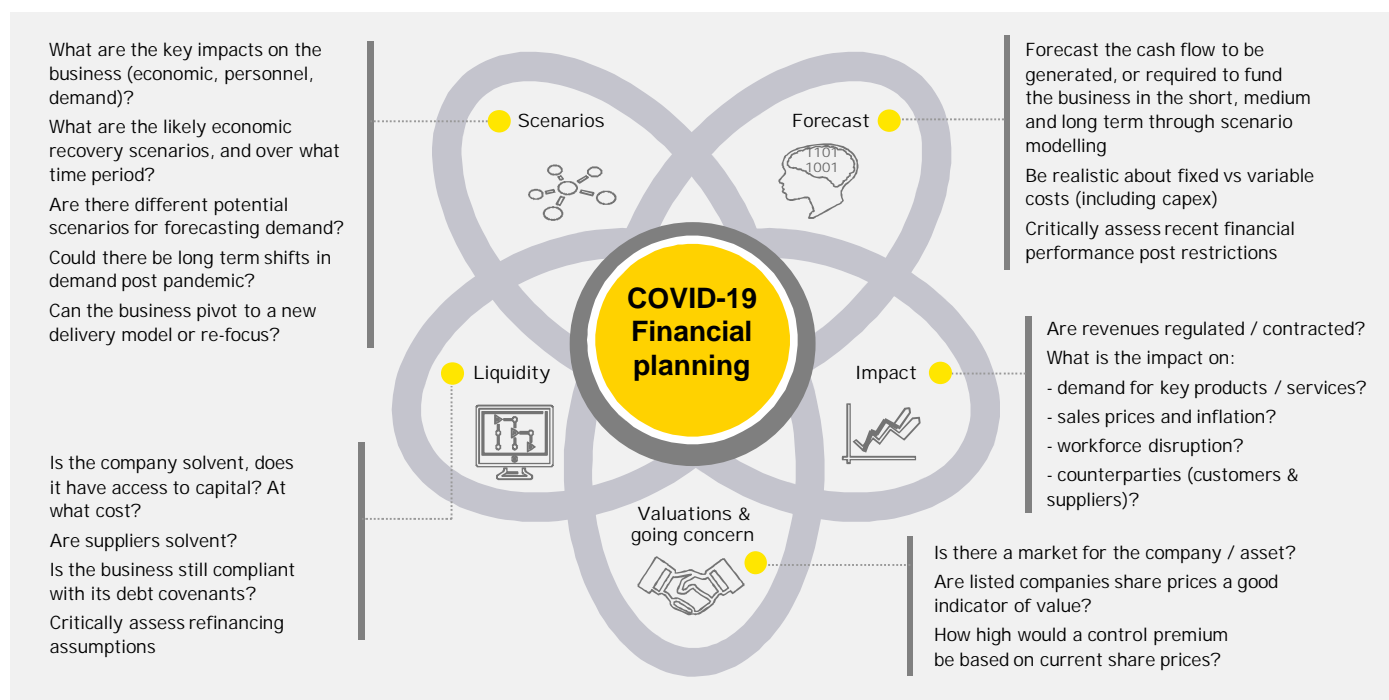
Rebased GDP, permanently changed consumer behaviours, reduced household wealth and other factors will mean that permanent reductions will likely occur. This is critical to assess on an asset by asset basis and would lead to higher asset value deterioration.

# Valuing unlisted assets in the current market is particularly difficult, but necessary

Many funds have requested re-valuations of certain unlisted assets be undertaken in order to ascertain their appropriate fair values. Upon restructuring, e.g. when the WHOA is applied, valuations will be the basis to divide value between equity holders and creditors. Further, it is likely that, for many companies, the COVID-19 pandemic will result in a triggering event for impairment testing in Q2 2020.

The current market environment is rapidly evolving and unprecedented. As values of most businesses will be impacted, companies and funds should be seriously considering revaluation. In some cases, companies have no choice and will need to consider valuations for regulatory, tax or reporting purposes.

## So, what is our valuation approach?



First, we are considering rigorous, company-specific scenario analysis

Given the uncertainty and differing impacts on businesses, in our view the most appropriate means to assess value is through rigorous analysis of cash flows and scenario modelling. Once the potential consequences for cash flow forecasts have been estimated, we can consider potential value impacts, which then inform the extent to which discount rates, multiples, or cash flows might be impacted. The key questions we are considering in these uncertain times are set out in the graphic above.

Whilst forecasts clearly have limitations, they can be powerful tools in uncertain times to try to understand the range of potential paths ahead. The path will be different for every company, and therefore the impact on value will be different.

We are also looking at discount rate adjustments ...

Lower government bond yields may mean a lower risk free rate, but that decrease has not translated into higher company values. Even resilient businesses, such as regulated utilities or those with long term contracted cash flows, will be impacted by lower growth and higher

uncertainty. If cash flows are not adjusted, then the discount rate may need to be (in addition to any change in the risk free rate). Even assuming lower CPI and risk free rate in the short term, this may translate to a 25bps to 100bps increase to the discount rate, all else being equal. The specific risks need to be considered for each company individually.

... and thinking about liquidity risk

At times like this the liquidity risk is almost always to the downside. That is, if a business was to be sold, there is a high risk that the price received would be lower than the 'true' value. This may reflect uncertainty, fewer buyers and potentially limited ability to undertake due diligence. Since most valuations need to consider an arms' length transaction, this needs to be taken into account.

### Bottom line:

Asset values will be impacted, but the impact will differ by company and sector. There is no one-size-fits-all approach.

## Contacts

Our valuations and business modelling partners in the Netherlands are here to help



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