TCSP Webinars

Session 3: Valuation of investments in a COVID-19 climate

9 July 2020

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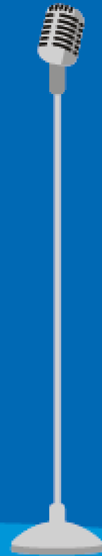
Introduction

Format of the webinar

Asking questions

Reference to materials / webinar playback



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IFRS 13 Fair Value Measurement

“the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under the current market conditions”

Based on the “principal market” for the asset or liability, or the “most advantageous market” in the absence of a principal market.

When a price for an identical asset or liability is not observable, an entity measures fair value using another valuation technique that **maximizes the use of relevant observable inputs.**

Consideration should be given to the market participants that would enter into a transaction in that market, but does not need to identify specific market participants.

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IPEV guidelines

Some basic concepts under the IPEV guidelines:

- For actively traded (quoted) investments, available market prices will be the exclusive basis for measurement of fair value for identical instruments;

- Consistent valuation techniques should be used from measurement date to measurement date unless there is a change in market conditions or investment specific factors. This should also apply to comparable investments being valued on a comparable basis.

- Undertaken at the Unit of Account level, this would be at the level that a market would be expected to transact. Not likely to be at the individual share level.

- In estimating Fair Value for an investment, the Valuer should apply a technique or techniques that is/are appropriate in light of the nature, facts and circumstances of the investment and should use reasonable current market data and inputs combined with market participant assumptions.

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IPEV special valuation guidance

- Continued need for consistency
- Robust processes and documentation of valuation bases
- Focus on what was known and knowable at the measurement date
- Don’t rush to “fire-sale” approach

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Economic environment

Covid-19 has had a number of significant economic consequences that may affect the valuation of your clients' investments:

- Global economic downturn may depress demand
- Specific changes in business or consumer behavior may have a disproportionate impact or benefit for any particular business;
- Changing priorities may adversely delay, accelerate or divert spending;
- Shifting morality may change the economics of a particular sector.

Market observable data may not sufficiently reflect the specifics of your investment closely enough, resulting in unexpected or inappropriate outcomes.

This is where you will need to spend time assessing the market data and justifying your reasons for deviating from it where you feel that is most appropriate.

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Asset valuation considerations

Impairment indicators – non-financial assets (Goodwill, Intangibles assets, PPE)

- Value in use and fair value less costs to sell likely to be reduced
  - **Income approach:** Value in use forecast financial information to be adjusted for current/forecast trading conditions and increased risk environment
  - **Market approach:** External market inputs, comparable performance
  - Volatility

Loans and receivables

- Increased counter party risk due to wider economic deterioration – revisit provisioning assumptions:
  - Credit risk
  - Interest rate environment
  - Default / timing of receipts

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Property value considerations

Investment property valuation

- Consider the impact of rental concessions on revenue recognition
- Increased counter party risk in respect of receivables due to wider economic deterioration – revisit provisioning assumptions / cashflow impacts

RICS guidance

- Material valuation uncertainty clauses: disclosure considerations and reporting
- RICS guidance - Regarding the difference between the market value of a property and the worth of it to a particular owner or occupier. An unwillingness to transact at a certain level based on own needs should not influence the assessment of Market Value

Development property

- Revisit project plans and consider whether the development will satisfy changing consumer or industry demands
- Have developments experienced delays due to changed working practices or supplier constraints
- Will sales hold up as planned – volume and pricing – consider net realisable value and forecasts / budgets

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Debt considerations

Leverage

- It is important to understand the impact of changing environment and activities on loan covenants, for example:
  - Loan to value: Has the value of your property declined? How does this interact with existing covenants? How much headroom remains – consider sensitivity scenarios?
  - Debt service: Have rent concessions to tenants impacted operating income, with the consequence of reduced interest cover or debt service cover? Will reduced cash inflows in the short term impact on the ability to meet loan repayment instalments.

- Engage with lenders early so that they understand your position and outlook. Consider whether a covenant waiver may be needed.

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Net assets valuation

In estimating fair value based on net assets, a valuer should consider the perspective of a market participant when valuing the component assets and liabilities at fair value themselves.

When valuing fund interests:

- the NAV may require adjustment for incentive payments that would be due in the event of realization of the investments of the fund;
- the valuer must have evidence that the NAV is based on the fair value of the underlying investments;
- The NAV may need to be adjusted if significant time has elapsed between the measurement date of the investment and the fund NAV
- If the fund is actively traded then the fair value would be the actively traded price.

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Market approach to valuation

- **Available market prices** – instruments quoted on active markets should be valued at the most appropriate price within the bid/ask spread at the measurement date, bid being the price that a market maker might offer and investor and ask being the price an investor would expect to pay. A mid-market price may be considered where available.
- **Multiples** – revenue or earnings, appropriate given the size, risk profile and earnings growth prospects of the company. Impact of accounting policies on comparability of multiples
- **Industry valuation benchmarks** – best used as a sanity check. Likely to only be applicable in a limited number of situations where market participants are willing to pay for revenue or market share as the profitability of businesses does not vary much.

In the current market, a key risk is that when you are looking at revenue or EBITDA multiples of listed companies, the enterprise value may have adjusted to reflect current conditions but revenue or EBITDA that you are using to derive the multiple may be based on 2019 results, suppressing the apparent multiple. It may be that forward multiples are more appropriate so long as re-forecast trading figures have been disclosed.

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Discounted cash flow

Estimates fair value based on the net present value of estimated future cash flow generation.

Significant considerations:

- Reliability of forecast information
- Ability to estimate the appropriate discount rate
- Appropriate time horizon for terminal value calculation

The reliability of forecast cash flows may be of greater concern currently than in more stable trading conditions and so:

- It is important that forecasts are updated regularly
- Different potential trading scenarios should be considered

Discount rates may well require some adjustment to allow for the additional forecasting risk created by uncertainty over forecast performance.

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Valuing seed, start up and early stage investments

A Milestone approach is often adopted or a scenario analysis because there may be no current or short term future earnings or positive cash flows.

These qualitative measures should be industry-specific benchmarks customarily used in the specific industry of the investee company. The milestones should be agreed at the time of making the investment and might include:

- Financial measures, revenue growth, profitability, cash burn rate, covenant compliance
- Technical measures, phases of development, regulatory approvals, testing cycles, patents
- Marketing and sales measures, customer surveys, market share, market introduction, testing phases

Whilst the milestone approach is still valid, the macro-economic factors cannot be ignored and you should be considering whether customer demand is likely to have fundamentally shifted or whether there is likely to be delay in the development of the business if the availability of development capital has been temporarily restricted.

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Calibration and peer company analysis

Calibration helps you to understand the adjustments that might be required to market data at future measurement dates in order to better estimate the fair value of your specific investment – this is particularly important to capture at your entry point.

When using a multiples approach, care should be taken to identify appropriate "peer companies" whose multiples you will apply to your investment.

You may feel that certain peer companies have experienced specific benefits or adverse impacts in the Covid-19 climate and so they should be excluded from your analysis and new peer companies added. Clear documentation of the rationale will assist in demonstrating consistency in your approach despite a change in the peer group.

Comparable company considerations

- Size and diversity of the entities and so their ability to withstand adverse economic conditions
- Rate of growth of earnings
- Reliance on a small number of employees
- Diversity and quality of customers
- Level of borrowing

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Recent transactions

Under "normal circumstances, IPEV suggests that, on its own, data from recent transactions is only an indicator of fair value to be considered.

- IPEV highlights that the following should also be considered:
- Changes in market conditions since the date of the transaction
- Different rights attaching to the investments
- Disproportionate dilution of existing investors arising from a new investor
- Strategic motivations of the new investor
- Transaction may be "forced" or a "rescue package"

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Common challenges

The most common challenges encountered are:

- Clear documentation & evaluation
- Lack of explanation for the initial investment rationale and/or basis for valuation
- Lack of rigour in the preparation of valuations at the latest measurement date
- Reticence to move away from cost of investment
- No evidence of consideration of whether entity specific, market or economic factors have changed and would influence valuation
- Over-reliance on recent transactions by third parties in the equity of the same entity without consideration of whether this was an “orderly transaction” or of matters that may have ocurred subsequently up to the latest measurement date
- No assessment of performance against financial or operational milestones
- Calibration and back testing are rarely undertaken.

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So what does good look like?

Documented investment rationale

- Attraction of entity and market
- Alignment with stated investment policy of the investor
- Identification of risk factors that may impact future value
- Expected development profile of the investee company (financial and operational)

Calculation of value at point of investment

- Consideration of appropriate method
- Maximum use of observable inputs
- Identification of appropriate comparable companies and transactions for Market approach
- Calibration of price paid for investment to observable market metrics

Investment committee control / approval

- Additional rigour to the process for approving investments, ensuring that internal processes or policies have been adhered to

Consistent re-assessment

- Basis of valuation consistently applied unless strong justification for change
- Observable inputs consistent with those considered at the time of investment
- Consideration of company specific, market or general economic factors
- Viewed through the positon of a market participant

Learn from back testing

- Continual refinement of the valuation process at the time of investment and at subsequent measurement dates

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Summary

- The fundamentals in terms of the frameworks governing how to approach a valuation have not changed;
- There is greater focus on judgements in relation to fair values and impairments regardless of volatility or uncertainty caused by Covid-19;
- Inputs to your valuation may require more consideration at the moment in order to ensure they are consistent with each other;
- You may need to consider multiple valuation scenarios and be able to justify which you consider to be the most appropriate and why;
- Documentation may be more important than ever in order to capture the justification for changes to your valuation approach or indeed for not changing your approach.

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Thank you

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