The New Normal in Valuations

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Announced transactions cancelled or renegotiated; companies filing for bankruptcy; businesses taking large impairment losses on their books. Each of these situations requires the management, board of directors and stakeholders to make critical decisions on the valuation of businesses, assets and liabilities.

What are some of the challenges and key considerations for valuation amid market dislocation?

Uncertainties and valuation

Unlike past global crises, the impact of Covid-19 is unique in the extent of uncertainty. Subsequent waves of infections, the reimposition of lockdowns, renewed restrictions to movement, and the uncertainty of finding a vaccine, have invoked any number of scenarios. From a “V”- shaped curve, to a “W”-shaped or even a “VL” or “K” shape, what is fairly certain is that recovery will take some time.

These uncertainties have had a severe impact on the transaction and valuation landscape. In Singapore and the region, the markets have reacted with significant volatility in prices and yields. For private businesses, the volatility in valuation can be reduced to some extent, if the fundamentals are still strong.

While businesses have seen an adverse impact on valuations, this varies according to sector focus and business adaptability. For example, some essential services such as healthcare, food and utilities will be less affected, as compared to the airline, hospitality, leisure and entertainment sectors. Industries, such as financial services and education, can reduce the impact if they are able to adapt faster to the new normal. Technology and telecom, on the other hand, may experience higher demand for their services during the pandemic.

Challenges for valuers, board and stakeholders

The most critical challenge around valuations is the unpredictability of the current scenario. Budget forecasts and projections are difficult because the credibility of the information provided is in doubt. Volatility in the market and disruption have led to new business models being created.

A change in the discount factor alone may not help to account for all the risks of such uncertainties. While time-tested approaches can still be utilised, considerable thought needs to be applied. For example, boards need to consider the risk of post-factor analysis or future litigation.

Key Considerations

Commonly used bases of values, such as fair value or market value, do not mean a “fire sale”. They take into account current market conditions, information that is “known and knowable” at the valuation date. Increased uncertainty and risk indicate higher return expectations and therefore, lower asset prices.

Can public companies’ traded share prices be considered as indicative of fair value given the volatility? While prices from orderly transactions cannot be ignored, the weighting applied to that information depends on the purpose of the valuation.

For mark-to-market valuations for financial reporting, such weighting could be significant. For transaction purposes, different approaches can be applied, and scenarios can be considered. For goodwill impairment testing, an incomebased (discounted cashflow) “value-in-use” may be used with market capitalisation as a reasonableness check.

Depending on the purpose, there can be specific valuation adjustments for asymmetric information when comparing to market capitalisation or public company market date. In addition, more thought should be applied to transaction multiples on whether they are still relevant on the measurement date.

Directors should also consider how Prospective Financial Information (PFI) can be used in an uncertain environment. While it is difficult to corroborate the PFI, it is nevertheless a critical input in determining valuation assumptions. Developing scenario-based analysis can be considered, thus reducing reliance on alphas in the discount rate. Care should be taken to avoid a double-dip assumption where the PFI is taken on a pessimistic basis along with an alpha added to the standard discount rate.

The International Valuation Standard as well as several other valuation standards and guidelines stress on the known and knowable assumption. This provides valuers with a much-needed focus and could help reduce the risk of future litigation.

Learnings and takeaways

Business cycles are getting shorter, disruptions will continue, and volatility is a given. It is important to accept that valuations will be dynamic in today’s world, and it is critical to use the best information available as on the valuation date without attaching any consideration for post-facto information. The emphasis should be on best practices, governance and transparency rather than a perfect way to predict the future.

“Fair” valuation is here to stay. “Under” or “over” valuation in the name of being conservative is against the fair valuation principle and creates significant risks for stakeholders. Impairment decisions, while difficult, need to be taken whenever there is a trigger rather than waiting till the financial year-end.

Boards may consider engaging valuation professionals who have the experience of dealing with the impact of these aspects on valuation. Thus, it is important to select the appropriate valuation professionals with the right qualification, certification and affiliation to Valuation Professional Organisations who place significant weight on maintaining the quality of the profession, continuous professional development, and adherence to standards and governance.

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