Valuation - Addressing Challenges in Uncertain Economic Times

As businesses come to terms with the Covid-19 pandemic, social and behavioural changes will have a lasting impact on their balance sheets. Furthermore, with the outbreak having varying effects on different industries, there is ongoing uncertainty about how long individual sectors and countries will take to recover from the crisis.

Given these factors, Audit Committees (ACs) must question firms' assumptions, assessments and projections of their financial health more rigorously, said experts from accountancy firm RSM Singapore, at a recent session of the Singapore Institute of Directors' AC Chapter Pit-Stop Series, themed "Valuation – Addressing Challenges in Uncertain Economic Times".

Valuation Tips in Volatile Times

ACs can consider five tips to navigate the new normal, said Mr Terence Ang, CVA, Partner in Corporate Advisory and Head of Valuation Advisory in RSM Singapore.

1. **Recognise that price may not always equal value**

- Some companies may have been forced to sell some of their assets to create liquidity to survive the pandemic. Such fire sale prices may not reflect the fair value of the items. ACs must take this into account when using companies' recent transactions as comparables. Even if the prices are depressed due to the pandemic, the companies may have a higher intrinsic value.

2. **Scrutinise cash flow projections more carefully**

- Projections need to be realistic, supportable and able to withstand challenges. ACs should check whether projections have factored in the pandemic's impact on the firm's industry, supply chain and target markets; how quickly the firm can ramp up during the recovery phase; if the industry is likely to rebound to pre-Covid-19 levels within the specified timeframe; and other considerations.

- Projections should also be examined alongside other line items, including forecasts of sales and marketing expenses and capital expenditure, the contribution of Covid-19-related government support, and bank loan moratoriums. A firm that predicts significant growth without investing in more infrastructure or advertising may be too optimistic about its future.

- There could be instances where some companies may work backwards from a desired outcome to arrive at their cashflow projections or assumptions. ACs should be sceptical over such assumptions, take a granular approach to the numbers, ask questions, and ensure that the projections are in line with the firm's business plan, industry and the economy.

3. **Consider the pandemic's impact on discount rates**

- Discount rates need to be analysed in conjunction with cash flow projections. The less certainty there is in the projections, the higher the discount rate may have to be.

- ACs should also take special care to avoid double counting of risks. Additional risk premiums are not necessary for factors that have been addressed in cash flows or included in market inputs. As the pandemic has affected sectors in different ways, a general Covid-19 risk premium may also lead to excessive risk-loading for some industries. Such premiums should be applied on a case-by-case basis.

- With the increased volatility in the market, ACs may benefit from using the probability-weighted expected return method to evaluate multiple scenarios, including a best-case scenario, normal-case scenario and worst-case scenario, with different discount rates and probabilities assigned to these, rather than just one outcome.

4. **Be cautious with market data**

- When employing the market approach, ACs must review their use of transaction prices and multiples more deeply. Apart from distressed sales, transactions carried out in pre-pandemic, bullish markets may not be appropriate for valuations due to the low likelihood of a return to such markets in the near future.

- Comparisons of companies in different countries also need to account for varying levels of government support in the form of grants, rental rebates or other lifelines. In essence, ACs must verify that they are comparing apples to apples.

5. **Remember that rigour is critical, and expertise is key**

- Scepticism is important. ACs must probe inputs for fair valuation and impairment, study valuation reports for caveats and qualifications, challenge key assumptions, corroborate assumptions in forecasts with supporting evidence, compare the company's past performance against its projection and budget for the same period to gauge its reliability, and undertake many other steps for a robust assessment.

Mr Ang stressed: "Valuation is not an art, it is a craft. There are rules and standards that guide us."

Understanding valuation in an uncertain world

Mr Tay Woon Teck, CVA, Partner and Managing Director of Business Consulting in RSM Singapore, added that more in-depth knowledge of valuation will be useful beyond the Covid-19 crisis and its aftermath.

"We have to deal with many uncertainties in our world. There are issues related to the digitalisation and disruption of business models, geopolitical tensions, including the situation in Myanmar and United States-China tensions, which have resulted in rethinking of supply chains, and environmental, social and corporate governance issues," he said.

"Climate change has created a lot of polluted assets. By 2050, US$1.7 trillion worth of polluted assets may have to be impaired," he continued.

He emphasised: "Valuation cuts across every business, and directors need to understand the inputs that drive the numbers. You need to understand the fundamentals of valuation, and learn how to ask the right questions."