Valuing Intangible Assets in a Tangible World

Intangible assets are becoming increasingly important to businesses and companies, with their contribution to the market value of S&P 500 firms rising from 17 per cent in 1975 to 84 per cent in 2015. As the COVID-19 pandemic continues to cause economic uncertainties, valuers must exercise heightened diligence and consider adjustments to their valuations for both intangible assets and traditional tangible assets, said experts from accountancy firm KPMG in Singapore. They were speaking at a recent session of the Singapore Institute of Directors' AC Chapter Pit-Stop Series, themed "Intangible Assets In A Tangible World".

Improving valuation inputs

While the income approach is the one most commonly used to value intangible assets, it relies on two key inputs, namely discount rates and projected cash flows. Both inputs are challenging to select and determine respectively, especially in the wake of current business uncertainties, said Mr Jamesy Laya, a Partner in Valuation Services at KPMG in Singapore. He made the following suggestions:

1. In selecting the discount rate for an intangible asset, valuers should evaluate the risks associated with that asset and consider observable discount rate benchmarks. Mr Laya acknowledged that this may be difficult: "Observable market evidence of discount rates for specific intangible assets is rare, so the selection of a discount rate for an intangible asset requires careful consideration and professional judgement." Also, higher discount rates should be used if there are significant uncertainties in the future of the related business. Ultimately, there is an inherent link between the risks associated with an intangible asset and the business or industry in which it resides.

2. When evaluating the riskiness of cash flows, valuers should at least consider the risks in four main categories:
    1. Currency risks, including currency-differentiated inflation;
    2. Market and industry risks, such as risks posed by developments in equity markets and systemic risks in the business's sector;

3. Country-specific risks, spanning the likelihoods of expropriation, nationalisation or changes in political leadership; and

4. Asset-specific risks, which should take into account liquidity, market position, size and dependency, and potential substitutes for its products, among others.

Clarifying cash flow projections

Valuers should also scrutinise four factors that could affect cash flow projections themselves, highlighted Mr Loh Yee Chuan, Director of Valuations, Corporate Finance at KPMG in Singapore. He explained:

1. "Due to COVID-19, many firms have revamped their supply chain, cultivated new customers and made other changes to their business model. All of these shifts will have an impact on the cash flow projections."

2. "The repercussion of the pandemic on firms' revenue is another crucial consideration. How has the crisis altered companies' sales quantities, and are customers still willing to pay the prices that they paid in the past?"

3. “On the cost side, many governments have introduced support schemes that are now helping firms to mitigate their costs. What will happen to these firms’ costs when the schemes taper off?”

4. “Finally, has the pandemic had any effect on companies’ cost of financing? Given the current economic uncertainties and higher business risks, will the credit spreads that firms have to pay when they borrow capital increase in the future?”

Adjusting valuation approaches

If valuers foresee considerable variability in a business’s future cash flow, they should prepare multiple cash flow scenarios for their valuation, said Mr Loh. “You could build a base case scenario, an optimistic scenario and a pessimistic one, and take a probability weighted scenario approach when you do your valuation,” he recommended.

On the other hand, valuers taking the market approach should base their valuations on trailing multiples rather than forward multiples.

“Trailing market multiples continue to be applicable since the numerator is calculated based on stock prices that would have incorporated the impact of COVID-19 and the current economic environment, and the denominator is on the same basis across comparable firms and the entity being valued,” he explained.

“Forward multiples are calculated using a current numerator and a forward denominator, and are trickier to use now because of the difficulty in forecasting the future metric.”

Keeping an eye on developments

Mr Vishal Sharma, a Partner in KPMG in Singapore, added that valuers should have a firm grasp of developments in equity markets and sectors around the world, since these will influence many valuation inputs, such as the discount rates that should be used. He observed that:

- Globally, equity market indices have had similar trajectories, with a steep fall from February to March 2020 due to COVID-19, followed by a more gradual recovery that has brought some of them close to pre-pandemic levels.

- Some industries, however, have been affected by the outbreak differently depending on geography. “If you look at Asia Pacific in Q3 2020, the sectors that have recovered from the consequences of the pandemic and charged ahead the most are the healthcare and communications services sectors, whereas globally it is the information technology sector that has rebounded the most.”

- “It is also not only COVID-19 that has had an impact. Crude oil and coal prices plunged to new lows in April 2020, even though they have since seen gradual recoveries. During this year, we also saw for the first time, oil producers paying buyers to take oil off them that they could not store.”

Not business as usual

“What all of this means is that it is not business as usual when it comes to valuations,” said Mr Loh. “With the current outlook, greater care is needed when applying generally-accepted approaches. We cannot just continue to apply what we have done previously. Valuers need to

look into the situation right now and critically assess their valuation inputs given the economic uncertainties.”