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Private equity

Private Equity valuations shift in COVID-19 era

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COVID-19 has caused private equity firms to evaluate and adjust their valuation practices by postponing valuations to avoid reset triggers, exploring new approaches to valuations, or diversifying existing ones. Firms are relying less on once-stable assumptions and relying more on a robust and nuanced examination of all relevant variables. Today's valuations will be more rigorous, well-thought-out, and supportable.

A profound impact prompts immediate structural response

The COVID-19 crisis is affecting variables ranging from liquidity to supply chain health to the presence of willing buyers and non-distressed sellers and the access to capital; its effect on industries may be substantial.

The situation highlights the importance of robust evaluations

Robust evaluations have become imperative, meaning valuations should employ more than one methodology, reference as much data as possible, scrupulously articulate, and aggressively identify assumptions, and, because new information becomes available daily, build in checkpoints. Moreover, a reconciliation of results between each method is critical.

The crisis promises to affect all valuation methodologies and tools

Discounted cash flow analysis

While blended or supplemental approaches are a good way to go and considered best practices, spending more time in developing a well-thought-out discounted cash flow analysis is also needed to make sure your market-based inputs mirror the risks identified in a meaningful cash flow analysis.

In this market environment, given the overall uncertainties in the general economy, that may require you to consider probability-weighted cash flows. However, FASB ASC 820 requires the use of observable market inputs over unobservable inputs, so it is important to consider the market approach.

In the actual situation, you will want to supplement expected cash flows with probability-weighted cash flow scenarios. This allows you to account for risk in the cash flow analysis itself, as opposed to applying a discount after you have completed the analysis. The probability weighting allows you to make assumptions about when the market will normalize and what normalization means for the company you are valuing.

The uncertainty around the extent and timing of the market return also has implications for terminal value. Conservative expectations seem appropriate here, although you can use weighting to account for more optimistic expected outcomes.

Comparables

Because multiples may be distorted, comparables may serve as an important supplemental/alternative way to look at value. While standard practice is to look at the median of a cluster of comparables, best practices in the current situation suggest you look at, and interrogate, the particular comparable that best matches your profile while still referencing multiple comparables.

Market

If you are employing a transactional methodology, it is especially important to deeply understand the nature of the transaction, the participants, and the market itself. In normal times, active markets are assumed. But do such markets exist now? Is there sufficient activity? Are deals arms-length? Are the buyers and sellers transacting in the same market with the same assumptions and purposes? Do they have access to the same information?

Carrying at cost and calibration

The assumption that recently purchased assets can be carried at cost for any length of time does not appear to hold in the new environment.

The current situation demands dynamic, fact-specific decision-making informed by expert perspectives. It is also an opportunity to evaluate your valuation process and overall conclusions. Anyone wanting a quick evaluation, or a more in-depth analysis should call on valuation professionals.

Source
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