

Implications of COVID-19 to Fair Value (Series 1 - Business Valuation)

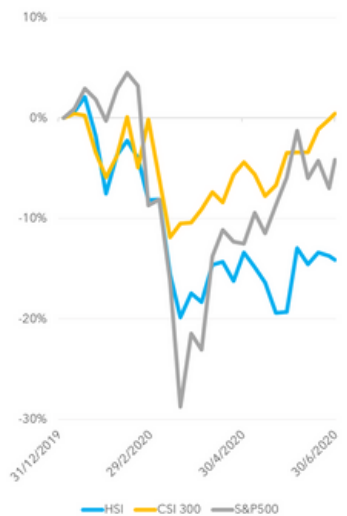
Market Trends - Market cap declined in 1H2020 across sectors

The outbreak of COVID-19 changed the way people live and consume, e.g. work from home, online shopping, city lockdown and local production, etc. Businesses undoubtedly need to adapt to exogenous changes and their underlying values may vary substantially.

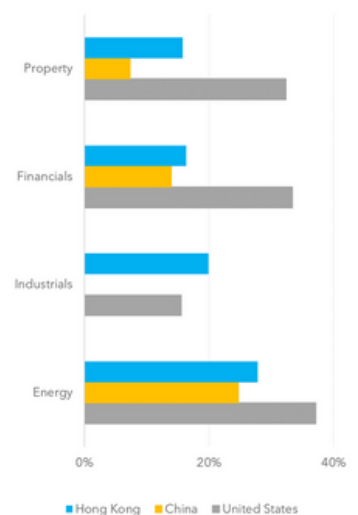
The capital market demonstrates a general downward trend since the start of 2020, the time when impacts of COVID-19 started to unveil. Decreases in Hang Seng Index, CSI 300 Index and S&P 500 Index in the first quarter of 2020 ranged from 10% to 30%. These three indexes have rebounded from troughs in March thanks to economic stimuli announced by governments. Businesses of traditional industries, like energy, financials and property noticeably underperformed. Energy enterprises were hit hard, due to oil price wars and sharp cuts in fuel demands. Dozens of US oil and gas producers have filed bankruptcy protections, shale oil giant Chesapeake Energy is the latest joiner of this painful rally. Banking systems appear to be more fragile than usual, additional stress tests are performed in the US to monitor financial health and resilience. Banks in the UK are banned from paying dividend and cash bonuses to senior executives for the rest of the year to reserve cushions for the recession. Oneworld, Sky team and Star Alliance, representing 60% of the world's largest airlines, called for government aids in March 2020.

Unprecedented governmental interventions and market shocks hint the need for thorough re-assessments of various valuation considerations.

Major Indexes (1/1/2020 - 30/6/2020)



Decline in Market Cap in Selected Sectors (1/1/2020 - 30/6/2020)



Source: S&P Capital IQ

WeValue Advisory Limited is a professional valuation advisory company. We provide valuation and valuation support for a variety of applications to business owners, senior management as well as other professional parties. Our valuation analysis serves different purposes, including financial reporting, corporate development transactions, strategic planning, tax planning, dispute support, etc.

WeValue is more than just a valuation service provider, we are a trusted professional advisor to bring you with knowledge, experience and insights together in every project. We help you optimize the strategic value of your organization and achieve your business goals.



Survivorship Is Not Inevitable

Investors are eager to assess how operations and financials are impacted in this wave of “new normal”, yet not all businesses could survive till the time of recovery. For instance, 36 travel agencies closed down between January and May 2020 in Hong Kong.

If the going concern assumption does not hold for a company, its business value should be assessed based on an exit scenario with a perspective to realize assets and settle liabilities.

It is critical to assess the sustainability of a business in the first place. Mandatory business suspension and/or continuous large cash burn may suggest stopping losses at the time of uncertainty to be more economically sound. Constant cash outflows may pose a problem of liquidity. In the absence of proper capital support, prolonged cash shortfall may invalidate the business model and going concern assumption. Chains of loan call back triggered by deteriorations in loan covenants and unsuccessful refinancing may also lead to liquidity issues.

Potential Implications of the Pandemic to the Income Approach Analysis

The pandemic interrupts the sourcing, production and shipping routines of many enterprises as well as alters the needs and spending appetites of consumers around the world. It is important to re-assess financial budgets to reflect business reality. When conducting an income approach analysis, the following questions should be thought through:

Re-visit Financial Projections

Business reshuffle?

- How do modifications of business models, operating hours and product mixes impact the revenue stream?
- How do market supplies and demands change competitive landscape?
- Does COVID-19 fall in the scope of force majeure clause that may relieve one from performing an onerous or impossible contract?

Production as usual?

- How do governmental controls on factory operations and goods exports affect production?
- Is any consideration given to the latest trend of material and commodity pricing?
- Is historical cost structure still applicable in view of pandemic?

Revamped cash conversion cycle?

- Does it take longer to collect receivables?
- Will more bad debts be expected?
- Will there be any revision in credit terms offered by suppliers?
- Is there any inventory stack up over just-in-time?
- Do city lockdowns lengthen shipment time, and hence lead time?

Re-visit Financial Projections (con't)

Longer to stabilize?

- How long does it take to achieve the state of stabilized cash flows?
- Is there any need to extend the projection period (e.g. beyond 5 years) to reflect a proper recovery pace?
- Do historical financials still provide a good reference when extrapolating financial projections?

Single vs multiple scenarios?

- Would probability-weighted cashflow projections incorporating few possible scenarios (e.g. consider how different scenarios of COVID-19 may impact a business in upcoming years) be preferred over a single most likely scenario?

Any significant restructuring costs?

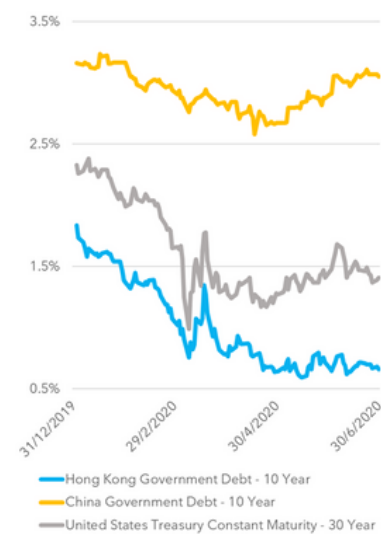
- Are there any significant one-off expenses (e.g. restructuring costs, severance payments) that lead to near-term cash outflows?

As there is great uncertainty as to when the pandemic will end, it makes sense to prepare multiple scenarios analysis, e.g. assuming the pandemic will last for 6, 12 or 18 months or even longer period which will give more insights on the possible range of business value.

Determine Discount Rate

- Given government bond yields show a general downward trend, how does it impact the discount rate under a volatile business environment? Would adopting normalized risk-free rates and equity risk premia be more appropriate?

Government bond yields (1/1/2020 - 30/6/2020)



Source: S&P Capital IQ

- How does the general decline in the market cap of comparable companies recently impact the expected gearing ratio?
- Is there any factor that suggests a higher risk premium (e.g. projection risk, liquidity risk and credit risk, etc.)?
- Is the same risk factor considered repeatedly in the expected cash flows and the discount rate? Any double counting?

Overall, the discount rate should adequately reflect the current risk profile of the enterprise.



Potential Implications of the Pandemic to the Market Approach Analysis

Under the current volatile market, below points should be cautiously examined when applying the market approach analysis.

Historical financial metrics sustainable?

Key financial metrics (e.g. EBITDA, net profit, etc.) in 1H2020 of most enterprises likely differentiate from their comparatives. Mechanically deriving trailing 12-month financials without further adjustments may give misleading "sustainable" metrics. For instance, the adjusted EBITDA of a business that is downsized significantly during the period of pandemic would be much lower than its historical normalized level. In contrast, merely relying on year-to-date financials may penalize the enterprise value without considering any potential recovery. Deriving sustainable financial metrics under changing market landscape and limited relevant track records requires extensive amount of justifications and judgments.

Trading market multiples reflect up-to-date financial metrics?

Current trading market multiples may not fully reflect the impact of the pandemic as the current financial metrics of an enterprise is not known to the public until the time of announcement. Trading market multiples might be distorted during this window period.

The adoption of forward multiples is hindered by the availability of analyst forecasts. Certain analyst forecasts prepared before the outbreak of COVID-19 might no longer be relevant. Fewer earning estimates available may restrict the application of forward multiples.

Precedent transactions - buyers still paying the same now?

Comparable transactions concluded before the pandemic may not necessarily provide a relevant value indicator now as industrial and company specific fundamentals may have changed significantly.

Certain recent transactions may be concluded under a distressed situation. Making reference to these transactions will require additional justifications.



WeValue can support you

Estimating fair value under the current environment becomes increasingly challenging and requires significant amount of analysis and professional judgements. WeValue's valuation specialists are equipped with the technical knowledge and experience to get you through this complex exercise. Please feel free to reach out to our specialists for a discussion at enquiry@wevalue.com.hk or 852 3905 2290.

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