COVID-19
Private Company Valuation – North American Perspective

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Introduction

The COVID crisis is the largest global economic shock since the Second World War. As a result of the sanitary crisis, billions of people were confined to their homes leading to a sudden halt of the economy. Consequently, global trade came to a standstill, hundreds of millions lost their jobs and indebtedness has greatly increased. As economies begin to restart, it is becoming clear that the impacts of the crisis are not merely transitory. Public equity investors have witnessed the impact of the crisis on valuations first hand, but private equity investors have far less visibility. In order to optimize capital allocation going forward, private company valuations will need to be reassessed. A holistic valuation approach that incorporates macro trends, industry dynamics and company specific factors will yield the best results. This article presents the key considerations we believe private equity investors should make as they evaluate their portfolios and reassess their valuation multiples.

1. Macro Overview: Headwinds may stifle recovery

The COVID crisis has disrupted the global economy and has accelerated certain secular economic and monetary trends. Certain industries – namely travel, leisure and hospitality – have been hit particularly hard by the pandemic, while others have flourished. However, even industries that have benefited from the acceleration of e-commerce and work-from-home trends face potentially severe macro headwinds that threaten to undermine transitory outperformance.

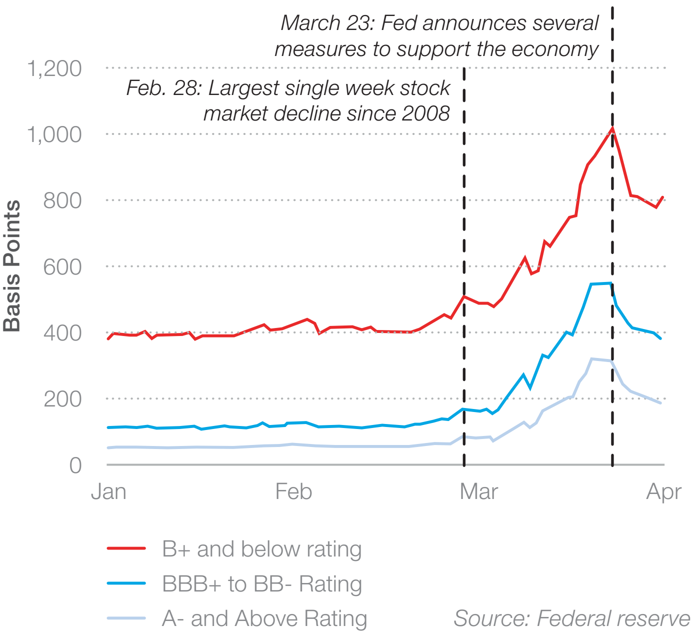
Unemployment and Consumer Confidence

The strong labor market that preceded the onset of the virus was among the first casualties of the COVID induced recession. The US unemployment rate has risen from 3.6% in January to 11.1% in June (with a peak to 14.7% in April) while the unemployment rate in Canada has soared from 5.5% in January to 12.3% in June (with a peak of 13.7% reached in May). As a result of the historic job losses and economic uncertainty, the OECD consumer confidence index fell to its lowest point since the great recession. The confluence of confinement (which reduced consumption), high unemployment and low consumer confidence has driven US personal saving rates among the employed portion of the populous to their all-time high of 33%, while Canadian Household savings doubled from 3% in Q4 2019 to 6.1% in Q1 2020. Although some of the job losses may be temporary, the time it will take to return to pre-COVID employment levels remains uncertain.

Debt, Stimulus and Taxes

Corporate and government debt levels are at all-time highs owing to decades of interest rate suppression and government intervention in the economy, while corporate debt quality is at all-time lows. Median credit spreads increased substantially following the financial market collapse in March, but credit spreads have been temporarily supressed thanks to aggressive and unprecedented central bank interventions.

Median Credit Spreads



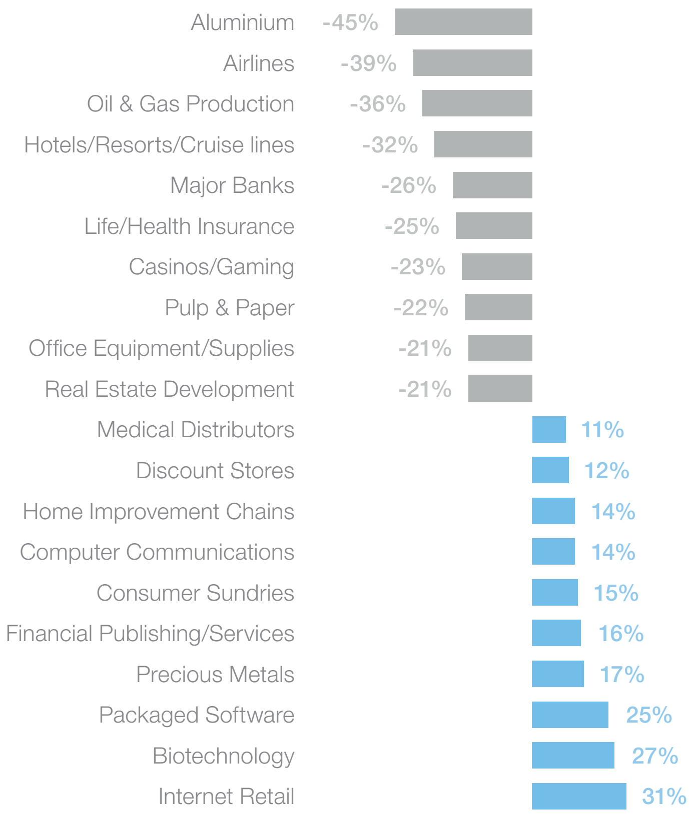
Source: Federal reserve

Despite aggressive fiscal and monetary stimulus, the velocity of money – the number of times the average unit of currency is used to purchase goods and services within a given time frame – is at an all-time low, rendering stimulus efforts less effective. As consumers are confined, lose their jobs, lose confidence and begin increasing their savings, they spend less, contributing to lower money velocity. As debt levels continue to increase, fiscal gaps will emerge that will necessitate either tax cuts, austerity measures, significant currency debasement or some combination of the three. The US federal budget deficit has been growing ever since November of 2017 when President Donald Trump reduced the corporate tax rate from 35% to 21%. The COVID crisis has simply exacerbated the problem, bringing the estimated FY20 federal budget deficit to $3.8 trillion, or just under 20% of GDP.

2. Industry Asymmetry: Permanent Shift or Transitory Shock?

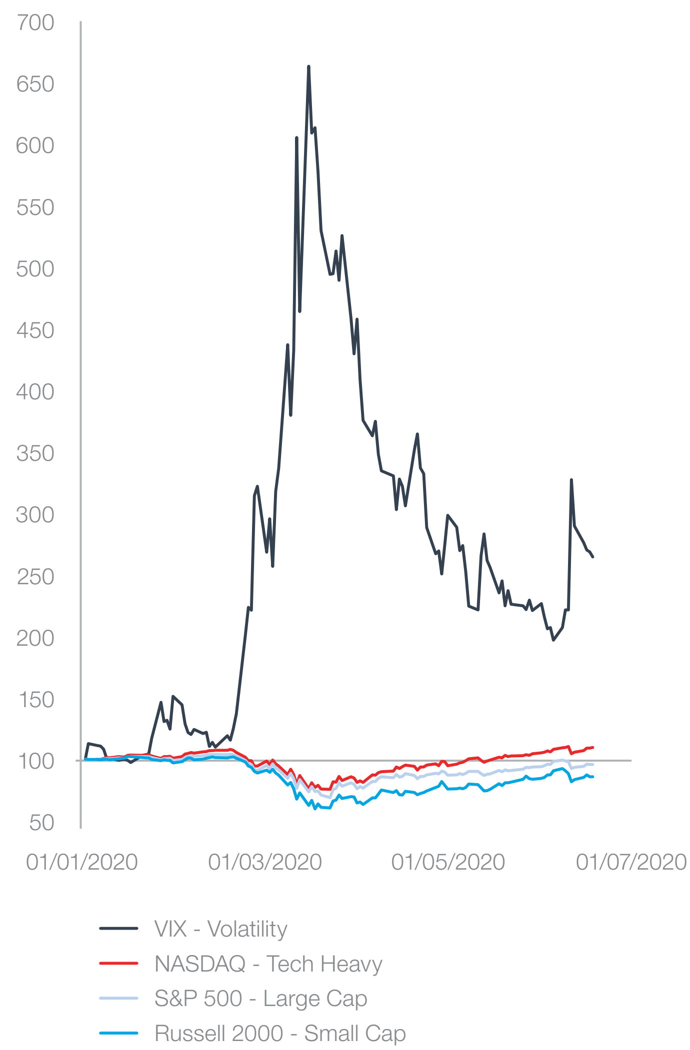
The economic disruption caused by COVID has hit certain industries particularly hard, while others well positioned to capitalize on the stay-at-home economy have benefitted massively. The Great Recession of 2008 largely originated in the financial sector. As a result, financials and real-estate were among the hardest hit sectors. The COVID recession began in the real economy, billions of people were forced into lockdown, effectively bringing the global economic activity to a standstill. Looking forward, investors must determine whether heavily impacted industries are facing a permanent shift or a transitory shock when assessing valuations.

YTD Return %



Source: Trading View, June 4th

2020 Volatility Overview [Indexed to 100 (log scale)]



Source: Capital IQ

Travel

Travel related industries were among the hardest hit by COVID induced lockdowns and travel restrictions. Until a vaccine is developed or an effective medication becomes available, travel demand will likely remain subdued. However, business travelers are amongst the most profitable customers for many in the industry and the growth of teleworking may permanently reduce aggregate demand. In addition, as consumers curtail spending amidst growing uncertainty, demand for leisure travel will likely remain subdued for some time.

Oil & Gas

The global oil & gas industry faced twin shocks in 2020; a global pandemic that brought energy demand to a standstill and a geopolitical spat between Saudi Arabia and Russia that led to the collapse of a planned OPEC+ production cut. The twin shocks may be transitory, but the growth of green energy technology coupled with innovations in electric transportation may create headwinds that could stifle a sustained recovery.

Financial Services

The economic shock caused by the COVID crisis has dramatically weakened bank performance as defaults skyrocket and transactions plummet. The speed at which the financial services sector recovers is largely a function of the speed at which the broader economy recovers. In an L-shaped or U-shaped recovery, high unemployment coupled with ongoing defaults could permanently damage bank balance sheets and impair future performance.

Discount Stores

As unemployment rates soar and disposable incomes plummet, consumers are becoming significantly thriftier. Discount stores have thrived in this environment as consumers opt to conserve cash for a rainy day they view as imminent. The positive impact may prove transient in the event of a V-shaped recovery, but in the case of a slower recovery, the industry will likely benefit from prolonged outperformance.

Precious Metals

High levels of government debt combined with unprecedented fiscal and monetary stimulus have led to a resurgence of precious metals. In many currencies, gold prices have reached all time highs as investors seek ways to store value and hedge inflation risk. Silver prices have largely underperformed gold because silver is used primarily for industrial purposes, meaning demand decreases during periods of low economic activity. However, a majority of silver production comes as a by-product of copper, zinc and lead production, meaning low economic activity also curtails supply, which tends to stabilize prices.

Internet Retail

Growth in the internet retail industry was impressive prior to COVID, but the crisis has acted as an accelerant of secular e-commerce trends. As conventional retail suffered amidst forced store closures and social distancing guidelines, online retail skyrocketed, with orders growing by 146% year-over-year in the US and Canada *[https://bit.ly/3hYrzXC]*. In addition, as older generations began shopping online for the first time during the pandemic, the total addressable market has grown substantially.

On average, global equity valuations are down but certain industries have experienced significant price appreciation amid the downturn. Industry analysis will take on a new significance in the post-COVID world. Applying a discount to all valuations irrespective of the industry is unwarranted; investors should carefully consider industry dynamics, outlook and positioning in the valuation process.

3. Impact on multiples: Decomposing Enterprise Value

Multiples for privately held companies are a simple way to express relative value, but they are derived from market prices and thus do not fully reflect fundamentals. In order to determine the impact of COVID on multiples, it's important to go back to basics. The key drivers of enterprise value include the current cash flows of the firm, the projected growth of those cash flows and the risk-adjusted discount rate used to discount those cash flows.

Current Cash Flows

Current cash flows for companies in most sectors have been materially impacted by the crisis. Using current cash flows as a basis for projecting future cash flows is thus unjustified. Instead, investors should adjust and normalize current cash flows to ensure that they are truly reflective of performance under normal circumstances. However, the new normal may differ materially from the pre-COVID normal, so investors should pay careful attention to the transience or permanence of the impacts when attempting to determine the appropriate adjustments.

Projected Cash Flows

Accurate cash flows projections in the post-COVID world will be difficult to come by. Growth rates are a function of company growth, industry growth and economic growth. Company growth rates are mostly a function of relative competitive positioning within an industry. Industry growth will depend on the degree to which a given industry was impacted by the crisis, as well as the permanence or transience of the impact. Economic growth is the most difficult variable to predict, the depths of the economic destruction are not yet fully understood and may not be for some time. Investors should thus proceed with caution until more data becomes available in the months to come. In addition, many companies will have to deal with customers and suppliers in precaurious financial positions, resulting in increased levels of bad debt and procurement difficulties, respectively.

Given that economic uncertainty and health measures will persist for some time, investors should consider various scenarios to determine projected cash flows, particularly for companies operating in heavily affected sectors. Valuations should incorporate sensitivity analyses to test business plan assumptions that have been or may be affected by the COVID crisis. For example, various scenarios should be considered in the determination of the annual growth rate over the business plan period, or in the determination of the expected ramp-up period needed to return to normal pre-COVID cash flows.

Risk-Adjusted Discount Rate

One of the most common ways to compute the discount rate is the Weighted Average Cost of Capital ("WACC"). The WACC is a function of the cost of debt, the cost of equity and the optimal capital structure. The cost of debt will increase for most companies as credit spreads have increased by more than the decrease in risk-free rates. Additionally, for certain companies, access to debt may become increasingly difficult considering more restrictive credit conditions as many businesses have experienced balance sheet deterioration. Capital structures will then include a higher proportion of equity, resulting in a higher weighted average cost of capital. However, fiscal and monetary stimulus may help larger companies by giving them direct access to low cost loans, provided directly by central banks. The impact of the crisis on the cost of equity is more elusive. The cost of equity reflects the required return on equity given the associated risks. As volatility and uncertainty remain high, investors may demand a higher return on equity after the crisis to compensate them for the additional risks.

It should be noted that fiscal and monetary stimulus efforts have primarily benefited large public companies with investment grade bonds, leading to the creation of what many have called a two-tiered market. Large public companies with strong balance sheets and competitive moats have been able to raise unprecedented levels of debt despite the global crisis, whereas smaller companies are increasingly struggling to stay afloat and access capital. Investors in smaller private companies must therefore be careful not to benchmark their valuations against large public peers with far greater access to low cost capital.

Conclusion: Putting it all together

In order to assess the impact of COVID on private company valuations, investors will need to adjust cash flow projections and reassess discount rates. To do so, investors will need to adopt a holistic valuation approach that places greater weight on both macroeconomic trends and industry specific impacts. In some situations, consideration of a liquidation scenario (in addition to a going-concern scenario) may also be appropriate to reflect the insolvency risks resulting from weakened balance sheets and liquidity shortfalls. In addition, divestitures and write-downs may be necessary for portfolio companies operating in hard hit industries and facing insolvency.

The next few months will be pivotal; much of the financial and economic damage done by the COVID crisis occurred during Q2 2020. The Q2 financial and economic data – released throughout July and August – will help investors gain better visibility over the scope and scale of the COVID related impacts on business performance and the broader economy. We believe that the recent rise in public equity valuations is highly speculative and due mostly to unconventional central bank policies, including the purchase of corporate bonds directly from their issuers and the purchase of high-yield bond ETFs on the secondary market. The long-term impact of these policies remains unclear, but it is having the effect of widening wealth and income inequality, which may fuel sociopolitical unrest in the months and years to come. Until more data becomes available, investors should exercise caution when assessing valuations.

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