March 5, 2020

SPOTLIGHT ON **COVID-19**

HOULIHAN LOKEY

Valuation Alert: **Spotlight on Coronavirus**

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Over the course of a week, global debt and equity markets caught the financial equivalent of the coronavirus. The magnitude and speed of these declines have posed a number of challenges for many fund managers tasked with valuing their funds' illiquid holdings. In this alert—the first in a series of alerts—we discuss some valuation and reporting considerations.

Valuation Considerations

COVID-19, better known as coronavirus, will likely increase the complexity of valuations of Level 2 and Level 3 assets. Here are some items that may need to be considered in today's valuations:

- In a perfect world, fund managers will have revised projections reflecting the anticipated impact of coronavirus for their underlying portfolio companies. The reality is that revised forecasts may not yet exist or be available to the fund manager. This places an additional burden on the fund managers to have their own views on the potential impact of coronavirus on the portfolio company. This could be a quantitative assessment—leading to revised expectations of revenues, margins, and other financial metrics—or a qualitative assessment, such as whether the impact on the portfolio company is likely similar to, greater than, or less than the impact on the guideline public companies.

- Fund managers should be careful not to mix and match implied forward valuation multiples. For example, if half of the guideline public companies have revised earnings forecasts and half did not, the resulting implied forward multiples are mismatched. If a portfolio company has revised its earnings forecast but the guideline public companies have not, there is another mismatch. Ideally, the portfolio company and guideline public companies will all have forecasts under the same macro environment (i.e., with coronavirus impact).

- Current trailing multiples (e.g., EV/LTM EBITDA) may be more appropriate than forward multiples (e.g., EV/NFY EBITDA) if there is a mismatch in the availability of projected earnings. Fund managers should be cognizant that there may be a mismatch in future trailing multiples if the underlying portfolio company's financials reflect a time period different from that of the guideline public companies. For example, a portfolio company's trailing EBITDA reflects one quarter of coronavirus impact, while the public companies have not yet reported their results for the most recent quarter.

- Borrowing costs may have changed. When deriving a WACC, the use of stated cost of debt may understate the current actual cost of debt.

- Similarly, commonly used models that estimate the cost of equity, such as the capital asset pricing model (CAPM), may understate an enterprise's cost of equity. Beta is one of the biggest drivers in CAPM; however, beta is often calculated using 60 months of historical data. As a result, a one- or two-month spike in observed data is not likely to have a significant impact in the calculation of cost of equity. Additional risk premiums may be appropriate.

- Debt valuations may also require additional analyses. Merely looking at changes in yields of guideline company debt and debt indices tells only part of the story. The portfolio company's outlook vis-à-vis that of the guideline companies may warrant a higher or lower spread adjustment to capture the relative risk of default.
- Financially stressed companies (pre-coronavirus) may now be at a higher risk of bankruptcy or need for restructuring. Caution is strongly recommended when using these companies as guideline companies.

Level 1 Assets, Level 2 Assets, and Broker Quotes

Periods of high uncertainty can often have a negative effect on the liquidity of certain asset classes. Funds typically have systems or processes that automatically obtain Level 1 prices. Fund managers should ensure that the observed public prices still reflect prices in an "active market." If a security is no longer trading in an active market, additional analyses may be needed to determine a security's fair value. The valuation of Level 2 assets relies upon observable inputs. These inputs should be reviewed to ensure their reliability; if they are not reliable, Level 2 assets may need to be treated as Level 3 assets.

Even before coronavirus, the use of broker quotes as reliable measures of fair value was debated. Fund managers should have heightened sensitivity to broker quotes to ensure that they are not stale and reflect meaningful depth and liquidity scores. If a broker quote does not reflect a change in value commensurate with changes observed for similar, liquid securities, there is a reasonable chance that the broker quote is not currently reflective of fair value.

The valuation of illiquid investments is even more complex today due to the uncertainty caused by coronavirus. In the upcoming weeks, Houlihan Lokey will examine in detail some of the impacts of coronavirus on certain securities and sectors. Houlihan Lokey has assisted its clients through times of extreme volatility and exogenous events and is ready to assist you today. Please reach out to one of the team members below for more information.

CONTACTS

Cindy Ma
Managing Director
Global Head of Portfolio
Valuation and Fund
Advisory Services
CMa@HL.com
212.497.7970

Terence Tchen
Managing Director
TTchen@HL.com
310.788.5235

HOULIHAN LOKEY