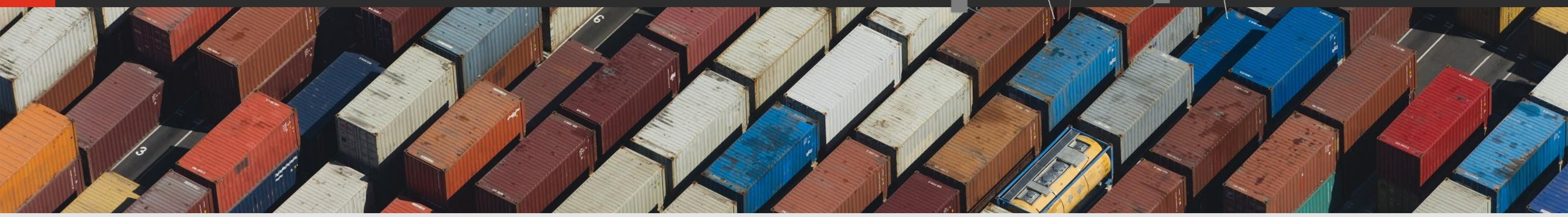
COVID-19: What is fair value in times of uncertainty?



Valuations unlocked: A valuations snippets series

Fair values of businesses and investments are generally expected to decrease due to the significant impact of COVID-19. You can consider the following factors and adjustments to account for uncertainties surrounding fair value measurements: (1) use of a combination of different valuation methods; (2) adjustments for discounts on liquidity and other risks; and (3) analysis of several scenarios reflecting the wide range of COVID-19 impact on future cash flows.

Back to basics

Breaking down fair value

Fair value is the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date.

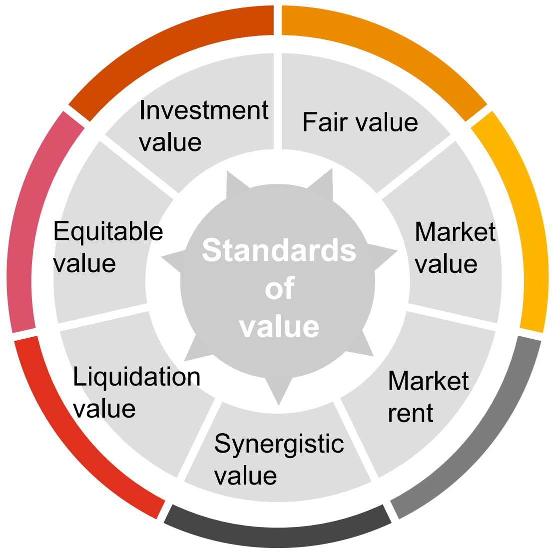
- *Exit price*
  Fair value is based on the exit price and is determined as at the measurement date under current market conditions, considering the specific characteristics of the asset or liability
- *Market*
  Assumed to take place in either the principal market with the greatest volume and level of activity or in its absence, the most advantageous market where best price is available
- *Orderly transaction*
  Assumes a regular transaction among market participants (exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary) and not a forced or distressed sale
- *Market participants*
  Measured using the assumptions that market participants would use when pricing the asset or liability (and not company-specific assumptions or interest)

Sources: IFRS 13 Fair Value Measurement, ASC 820 Fair Value Measurement

Did you know?

Fair value

is just 1 of the 7 standards of value that describe fundamental premises on which reported values will be based.



Source: 2020 International Valuation Standards (IVS) – 104 Bases of Value

Where can fair value be applied to?

- Financial assets and liabilities, including derivatives
- Investments in subsidiaries, associates and joint ventures[1]
- Intangible assets
- Property, plant and equipment
- Investment properties
- Non-controlling interest in an acquiree and other accounts[2]

Notes:
[1] Held by investment entities or mutual funds or for impairment testing
[2] Fair value can also be applied to biological assets, share-based compensation, right-of-use assets, and barter transactions under PFRS 15.

Benefits in using fair value:

- Enables more relevant and up-to-date valuation
- Provides insights into the risks undertaken by Management
- Offers a more acceptable basis for financial reporting
- Reflects the economic realities of market conditions

Can current traded price be disregarded when the volume of transactions for an asset has significantly declined?

- **Yes**, but only upon performance of further analysis to conclude that the quoted price does not represent fair value.
- A decline in volume or activity, on its own, does not necessarily indicate that the quoted price is not fair value (i.e., transactions are not orderly).
- Adjustments to the traded price may also be made, considering:
    - Liquidity and other risk premia reflecting the amount that market participants would demand as compensation given current market conditions
    - Change in valuation technique (e.g., use of relative valuation, dividend discount model or present value techniques)
    - Use of multiple valuation techniques to come up with a reasonable range of fair values (e.g., combination of the recent quoted price, comparable trading and transaction comparables, and dividend discount model).
- Companies can use weights for different indicators of fair value estimated using different valuation techniques.

Can current traded price in an active market (e.g., Philippine Stock Exchange) be disregarded if it has significantly dropped from its previous level?

- **No,** unless the transactions are determined to not be orderly (e.g., inadequate exposure to the market, transactions with a single market participant, seller is in or near bankruptcy or distress, forced sales or outlying transaction price).
- Generally, there is a high bar to conclude that a transaction price is not orderly. Assessments of whether a transaction is not orderly generally needs to be made at the individual transaction level.
- Fair value shall reflect current market conditions, regardless of the expectations and intentions of the reporting entity.
- The current market price cannot be disregarded on the basis of volatility alone.
- There is an implicit rebuttable assumption that transactions between unrelated parties are orderly.
- The fair value of a quoted instrument shall continue to be measured using market price and quantity held, despite significant market volatility.

Is it fair to assume that derivative contracts to hedge market and other financial risks can fully offset potential losses from market volatility?

- **No,** because of credit value adjustments that are required in measuring fair values of derivative instruments.
- Potential gains and losses shall be adjusted for counterparty and the company’s own credit risk, respectively.
- Derivative contracts are valued considering movements in the underlying assets or benchmark and counterparty credit risk for derivative assets and the company's own credit risk for financial liabilities.
- Maximum exposure and probability of defaults shall be considered in estimating credit valuation adjustments for outstanding derivative contracts.

Can I expect the fair values of outstanding options to increase given significant market volatility and decrease in risk-free rates?

- **Not necessarily,** because all inputs to the valuation model shall be updated (i.e., not just volatility and risk-free rates).
- While increases in market volatility and decline in risk-free rates may result in a higher valuation, the expected decrease in stock price given the current environment will have a significant offsetting impact.

Given significant decline in the equities market, can traded prices be disregarded and discounted cash flows (DCF) be used instead in testing investments in listed entities for impairment?

- **No,** particularly if the operations of the investee are significantly impacted by COVID-19.
- The recoverable amount of the investments in subsidiaries (at cost) and associates and joint ventures (at equity method) shall be the higher between value in use (based on DCF) and fair value less cost to sell (generally based on quoted price).
- While a company can argue that quoted prices may not be reflective of the intrinsic value of the investment given significant decline in traded price, it doesn't follow that the value in use will be higher than the fair value less cost to sell, particularly due to the potential impact of COVID-19 on the operations and expected cash flows of the subsidiary.

What factors should be considered in estimating the value in use for investments in subsidiaries, associates and joint ventures?

- If dividend discount model (DDM) is used:
    - Expected dividends and growth shall be adjusted to reflect the potential impact of COVID-19 on the amount, timing and ability of the investee to declare dividends in the future.
    - Since the risk-free rate is generally low, adjustments to the cost of equity for size, liquidity (if appropriate), volatility and other company- or investment-specific risks shall be added in estimating required return.
- If the DCF approach is used:
    - The forecasts should consider the wide range of potential impact of COVID-19 on the business, including changes in consumer demand, competition, working capital and financing requirements, and medium- to long-term growth of the business.
    - Scenario analysis for the worst, base and best cases should be considered to estimate the range of potential impact of the outbreak on the company's expected cash flows, value chain and medium to long term growth rates.
    - The weighted average cost of capital shall also be adjusted to consider any change in the credit rating or borrowing cost, and other risk premia specific to the investee (see required return for DDM).

I have a significant influence or control over a listed entity. Can that potentially increase the recoverable amount of my investment?

- **Yes** for estimating fair value less cost to sell using the quoted price, since traded price is based on minority holding without significant influence or control over the operations of the investee.
- **No** for the DCF approach. The control premium is assumed to have been imputed in estimating the future cash flows of the investee given the influence of the investor in business recovery plan, operations, and distribution of cash.
- Discount for illiquidity, however, shall also be considered because buyers appear to be less interested in buying any significant stake at the moment given market volatility and uncertainty.

Should government support be considered in measuring value in use?

- **Yes,** if the extent of the government support or fiscal stimulus is known or can be reasonably estimated as at the valuation date.
- Though fiscal stimulus may help mitigate the magnitude of the impact of COVID-19 on the economy, industry or subject company, it should not be expected to completely offset the potentially significant adverse impact of the pandemic.

How can PwC help?

Given our solid experience in performing valuations of listed and private companies, our valuation professionals can help you in:

- Performing several valuation methodologies to estimate the range of fair value of investments in entities
- Estimating projected cash flows to consider the wide range of impact of COVID-19 on operations and cash flows
- Estimating the appropriate level of return or discount rate given market and company specific risks amidst current circumstances
- Estimating the appropriate premia or discounts in measuring fair value less cost to sell

Mary Jade T. Roxas - Divinagracia, CFA®, CVA
Managing Partner
Deals and Corporate Finance
jade.roxas@pwc.com

Darwin B. Saribay, CFA®
Senior Manager
Deals and Corporate Finance
darwin.saribay@pwc.com