COVID-19 and private equity valuations

April 2, 2020

The global spread of the Coronavirus Disease 2019 ("COVID-19") is having a significant impact on the global economy and financial markets. At the same time, geopolitical forces have driven nominal oil prices to lows not seen since 1999.

These market movements present valuation challenges to investors in private equity. As investors look to measure fair value during these volatile times, KPMG is here to help and provide market insights.

Public equities sell off

The spread of COVID-19 has brought businesses, cities, and almost entire countries to a standstill. Public equities reacted aggressively by shedding three years of gains in just a few volatile weeks as investors contemplated recession fears and shutdown-related earnings misses. In mid-February the S&P 500 index peaked at an all-time high of 3,393, with the index falling to as low as 2,192 just over a month later. The CBOE Volatility Index (VIX) index topped at over 82 in mid-March, up from just the mid-teens a month earlier. KPMG’s Chief Economist’s base case forecast suggests a 12 percent drop in Q1 global GDP, a 25 percent earnings drop for the S&P 500, and preliminary analysis suggests a 4.3 percent drop in US GDP in 2020. Despite Congress approving a $2.2 trillion stimulus package, uncertainty over the human and economic toll of COVID-19 remains extremely high.

To illustrate the significant changes, we focus on major indices to highlight the broad market effects in the table below.

<table>
<thead>
<tr>
<th>Index</th>
<th>LQ-MRQ △</th>
<th>Mar-20</th>
<th>Dec-19</th>
<th>Sep-19</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>(20.0%)</td>
<td>$2,585</td>
<td>$3,231</td>
<td>$2,977</td>
</tr>
<tr>
<td>NASDAQ Composite</td>
<td>(14.2%)</td>
<td>7,700</td>
<td>8,973</td>
<td>7,999</td>
</tr>
<tr>
<td>Dow Jones Composite</td>
<td>(23.1%)</td>
<td>7,221</td>
<td>9,386</td>
<td>8,961</td>
</tr>
<tr>
<td>FTSE 100</td>
<td>(24.8%)</td>
<td>5,672</td>
<td>7,542</td>
<td>7,408</td>
</tr>
<tr>
<td>Russell 2000</td>
<td>(30.9%)</td>
<td>1,153</td>
<td>1,668</td>
<td>1,523</td>
</tr>
<tr>
<td>CBOE Volatility S&amp;P 500</td>
<td>288.5%</td>
<td>54</td>
<td>14</td>
<td>16</td>
</tr>
</tbody>
</table>

1 See KPMG’s complete economic impact analysis [here](#)
Trailing enterprise value (EV)/EBITDA multiples have declined, but we expect forward multiples to be flatter once companies and equity analysts release updated forward estimates.

**Private equity correlation to public markets**

Based on U.S. private equity quarterly return data published by Cambridge Associates in its U.S. Private Equity Index, and S&P 500 index data sourced from S&P Capital IQ, the 10-year correlation of private equity to the S&P 500 was approximately 0.77. Other correlation estimates to public equities have been observed in the 0.6 to 0.9 range.

In a March 16th publication, “COVID-19, the Sell-Everything Trade, and the Impact on Private Markets” Morningstar’s Pitchbook research reported that private equity trailed public markets in 24 of the 28 quarters where the S&P 500 was up by more than 5%, and private equity outperformed public markets in all 21 quarters where the S&P total return was negative.

While this information provides broad relational information, there are a number of considerations investors should evaluate when valuing private equity during volatile markets.

**Valuation considerations**

The fair value standard for financial reporting is defined as “[t]he 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.”

Understanding market conditions, market participant assumptions, what constitutes an orderly transaction, and what is known and knowable at the measurement date remain the guiding principles.

Attention must be paid to appropriately adjust inputs and assumptions to reflect changes in the underlying business outlook as well as market-driven assumptions as viewed by market participants.

Changes to assumptions should be well documented with solid logical underpinnings.

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Evaluate the subject business
Consider how the company is positioned and the degree that the business could be impacted by the recent economic developments. Some factors to evaluate include:
— Discretionary nature of service/product offering
— Ability to operate through a shutdown (i.e., is the business considered essential, can employees work remotely, etc.)
— Nature of revenues, contracted, variable, etc.
— Ability to control costs and cash flows
— Creditworthiness of customers
— Inventory levels and exposure to impacted supply chains
— Liquidity, solvency, and/or covenant concerns including access to additional capital.
— Special strengths or weaknesses during a pandemic/recession
— Ability to rebound (recover lost revenues, trajectory) after a pandemic/recession
— Correlation to macroeconomic factors.

Update the forecast
Significant effort should be expended to consider the specific drivers and assumptions to arrive at adjusted forecasted cash flows. Consider if the disruption could result in permanent lost growth and/or the potential shape and tenor of a recovery.

There are undoubtedly more unknowns and thus greater difficulty in forecasting relative to a stable market.

Adjust the discount rate
Discount rates should be adjusted for additional idiosyncratic risk to be commensurate with the company’s expected ability to achieve the updated forecast. Consider the factors above in estimating risk.

As a result of the Federal Reserve’s emergency move to cut rates to near zero, risk free rates could create a downward effect on discount rates under a Capital Asset Pricing Model (CAPM) framework, when market participants are clearly requiring higher returns for risk taking. Consider adjusting other inputs to the CAPM, such as the company specific premium (CSP) and the equity risk premium (ERP) for CAPM-derived discount rates. Effective March 31, 2020, KPMG LLP raised its target ERP 50 basis points to 6.5 percent.

Credit spreads have widened across the credit spectrum, and Standard & Poor’s and Moody’s have announced a wave of anticipated credit rating downgrades in the near term. Consider any potential changes in cost of debt capital.

Consider the investment time horizon
Private equity investing is typically characterized by a time horizon focused on long-term planning and long-term return expectations. Consider how the current market could change the investment horizon, return requirements, exit valuation assumptions, and the pool of market participants.

Consider that investors in the public market are sometimes subject to short-term liquidity needs and other technical factors that are not as present in the private markets, which could mitigate fair value volatility for private equity investments relative to public equities.

Evaluate weighting of valuation indications
Consideration should be given to how market participants consider valuation input data from the various valuation approaches by evaluating the relative merits of each. Consider the quality of inputs, the estimation error, and the depth and liquidity of the market inputs. Reflective questions like: is transaction data outdated, or is there more or less confidence in cash flows than before, should be part of the normal quarterly valuation process.

Use caution with forward multiples
Ensure that both the numerator (e.g., total enterprise value) and the denominator (the performance metric, e.g., EBITDA) of the forward multiple are contained in the same frame of reference. Market data is updated daily, but forward estimates are not. Ensure that the metric has been adjusted for COVID-19 impacts, otherwise forward multiples may be understated in the event of a sudden market drop.

Calibration is still key
In the AICPA’s guide, entitled Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies calibration may help explain fair value. Valuation assumptions may be calibrated from the last observable fair value market indication (i.e., an arm’s length transaction in the company’s securities) to the measurement date. Even in a market dislocation, calibration provides valuable context for relative quarter-over-quarter movements, and a framework for assessing changes in company performance and markets.
In these volatile times, choosing an adviser requires a firm that has the technical skills and practical experience to provide sound and objective advice. KPMG’s professionals provide that experience and knowledge along with a trusted name, and can help market participants meet their valuation needs through this challenging time.

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