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CFA SOCIETY SINGAPORE

By Julie Hammond

On valuations: it's back to basics amid Covid-19

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CORPORATE finance guru Aswath Damodaran had some advice for the audience at the 73rd CFA Institute Annual Virtual Conference: Don't abandon valuation fundamentals during the Covid-19 crisis.

"It is precisely times like these that matter most," he said. "You need to go back to the first principles of valuation. Everything I have learnt about valuation has been in the context of a crisis."

With so much uncertainty around companies' future earnings growth, cash flows, and even their ultimate survival, it's tempting to give up on traditional equity valuation methods. Pre-crisis historical financial data seems useless and there's a wide range of predictions about the economy and individual companies for 2020 and beyond. But to value the S&P 500 Index and individual companies, Mr Damodaran urged investors to stick with traditional valuation tools with adjustments for the pandemic.

"Gone, gone, the damage done"

Mr Damodaran started with a damage assessment of financial markets during the worst part of the crisis, from Feb 14 to March 20, when the United States and Europe realised that novel coronavirus was not confined to Asia.

By dissecting more than 36,000 public companies, nearly all in the world, by region, country, sector, P/E ratio, and dividend yield, Mr Damodaran found that unlike other crises, this one was not a full-scale panic where all stocks were punished indiscriminately. "There was actually a rationality of how markets knocked down stocks," he said.

The best-performing industries ranged from those providing possible solutions to the Covid-19 pandemic, such as health care, pharmaceuticals, and biotech, with the possibility of generating profits, to low capital intensity businesses and those supplying everyday goods like toilet paper and food.

The worst performing sector? Financial services, which fell 26 per cent from Feb 14 to May 1, 2020. "Banks either live in reflected glory or reflected pain," Mr Damodaran said. "When oil companies default or when travel companies and airlines refuse to pay on their loans, guess who's holding the loans?"

The second-worst performing sector was energy, with a global demand shock combined with an Opec supply glut causing Brent and West Texas Intermediate crude prices to decline 53.6 per cent and 62.2 per cent, respectively.

The common denominator for many of the worst affected companies was high up-front investment usually funded with debt. "The cautionary tale coming out of this crisis is companies should be much more careful about pushing the financial leverage button to obtain growth," Mr Damodaran said. "This is the dark side of debt."

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Though they had many naysayers during the crisis, growth and momentum outperformed value, according to Mr Damodaran. Traditional "safe" stocks with low P/E ratios, low momentum, and high dividend yields were actually among the least safe places to hide.

A coronavirus valuation framework

To value the S&P 500 Index in the current environment, Mr Damodaran recommends making adjustments to DCF (discounted cash flow) valuation models by asking a series of questions:

- How will earnings growth be affected in 2020 and how much of this effect will linger for the long term? The current year will be a bad one, but it's just as important to figure out how much earnings will recover by 2025 or 2029.
- How will fears about the future affect what percentage of earnings is returned to shareholders through dividends and buybacks? As companies get nervous about what lies ahead, they return less cash.
- How will the risk-free rate, 10-year US Treasury bonds, be affected by a flight to safety, fears about the economy, and central bank actions? US T-Bonds yields made a major move downward from 1.59 per cent on Feb 14 to 0.64 per cent on May 1, 2020.
- How will investor risk aversion be affected by fear of a market sell-off as reflected in the implied equity risk premium (ERP)?

Because the possible outcomes for the above variables were so divergent, Mr Damodaran used Monte Carlo simulations, rather than point estimates, combined with his base case to produce an overall distribution of possible values for the S&P 500 Index. On March 13, the S&P 500 index was 2400 and Mr Damodaran's median value was 2750, showing the S&P 500 was undervalued according to his assumptions. "This (Covid adjusted) model gives you the tools to try to get your hands around where the index should be," he said.

A post-coronavirus assessment to value individual companies

What firms and sectors are in the eye of the Covid-19 storm? Mr Damodaran singled out those linked to travel, consumer discretionary, and people-intensive businesses, those with high fixed costs, and young startups – and across the board, those with high net debt loads.

As a case study, Mr Damodaran provided his valuation analysis of Boeing – a company whose revenues were already plummeting due to the mishandling of the 737 Max incidents and that was also hit hard during the pandemic because airlines are its primary customer base.

When valuing companies, Mr Damodaran emphasised the importance of creating a story to go with your valuation, about how your sector will play out after the crisis and whether your company will emerge stronger or weaker. He advised investors to think about and adjust for:

- How the crisis will affect revenues and company operations in the near term.
- How the crisis will affect the business the company is in and its standing in that business over the longer term.
- New probabilities for the company's "Failure Risk."
- How the crisis has affected the price of risk and likelihood of default by updating the ERP and default spreads.

In closing, Mr Damodaran offered some reassurance. "It's all going to be okay," he said. "Go back to basics and the fundamentals and be willing to live with uncertainty. If you're wrong, revisit your valuation."

Julia Hammond, CFA, is a director in the Educational Events and Programs group at CFA Institute, where she leads the planning for a number of annual and specialty conferences, including the Fixed-Income Management Conference, the Equity Research and Valuation Conference, the Latin America Investment Conference, the Alpha and Gender Diversity Conference, and the Seminar for Global Investors, formerly known as the Financial Analysts Seminar.