Markets across the world are collapsing. The COVID pandemic and the resultant shutdowns will affect businesses financially. All earnings estimate for FY21 will have to be thrown out of the window. How much should stocks fall? What price is a good price to buy, if at all? And what do stock prices falling 50%-70% mean? We try to answer these questions through the lens of a financial analyst *(I know you think that stock markets are not based on any theory, especially in a time like this – but bear with me for a moment!)*

Let us take an example to understand the valuation impact on a high-quality business owing to a disruption like this. Imagine you own a mall in a prime locality of Mumbai. This mall houses the best of brands, the best of restaurants, the best of cinema halls and is generally the most preferred hangout place for the mass affluent and above. Given the location advantage and historical cost of construction, it is very difficult for competitors to compete with this mall. How do investors value this Company that owns this mall during normal times?

(I am not pasting the excel sheets in this note to save you from the technicalities. I will try to explain the concept. You will have to trust that my numbers are right. This concept is very fundamental and hence, numbers are not very relevant in any case)

The value of any business is the net present value of all cash flows that the business will generate from now till judgment day. You discount the cash flows using a discount rate that you think compensates you for the risk of investing in the equity shares of the Company *(technically called "cost of equity" or "Ke")*. Two concepts are important here – a. valuation is done based on cash-flows till eternity and b. immediate cash flows are more valuable than cash-flows far in the future – just the way "present value of money" concept works.

Now, let us assume that in a normal environment, the present value of all expected future cash flows from this mall discounted at 14% is INR 100. And then you hit upon the current situation – a pandemic. Malls are shut down – for God knows how long! While the mall owner (our Company) is still allowed to collect rentals, let us assume that such rentals will be lost forever until the mall is shutdown. Let us imagine that no rentals are collected for three months but the fixed costs must be borne. There is negative cash flow for these three months. But, starting fourth month, things get back to normal. How much would the present value of cash flows fall to? The answer is INR 94 (6% lower than the pre-pandemic price). But you may say three months is too short a period. The shutdown will be more, much more. Let us consider a 12-month loss of rentals – where fixed costs still must be borne. How much

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does the present value of cash flows fall to in such a case? It falls to INR 85 (15% lower than the pre-pandemic price).

But then, why do stocks fall 40%-60%-80% during these times. A simple answer is that people panic and start selling, irrespective of the valuation. But what does this mean in financial terms? In case where prices fall far more than the expected loss in present value of cash flows, it's really the "Cost of Equity or Ke" that is rising. People are essentially saying "I need to be compensated more, much more for this risk". If the price falls by 50% for an expected loss of 3 months business which affects present value of cash-flows by only 6%, the new price is implying an increase in Cost of Equity or Ke from 14% to 25%. And similarly, a 50% fall for an expected loss of 12 months business which affects present value of cash-flows by only 15% implies an increase in Cost of Equity or Ke from 14% to 21%. This means – that if you are selling shares at today's price *(50% lower)* – you are allowing the buyer of these shares to earn 25% and 21% under 3 months and 12 months disruption scenarios respectively.

But, that's not all. What happens when the situation starts improving? May be three months or six months from now or twelve months from now. The perception of risk attached to this cash flow stream reduces. The heightened Cost of Equity or Ke starts coming down – people start thinking *"I don't need a 25% return for a solid predictable cash-flow stream – I am happy with 18% – then 16% and then 14%"*. Slowly, as situation normalizes, equity risk premiums narrow and Ke drops. What happens when Ke drops from 25% to 14% – this leads to a 100% and 90% jump in Net Present values under 3 months and 12 months lockdown scenarios.

The point I want to drive is that during periods of panic, equity risk premiums, even for high quality companies that are likely to return to normalcy post crisis, rise sharply. And the Net Present Values *(and the stock prices)* are the most sensitive to this rise in "Cost of Equity". Imagine a 10 year "AAA" rated bond trading at a 9% yield suddenly re-prices to offer a 15% yield – price drops by 30% – but once the yields normalize to pre-pandemic levels – price recovers.

A strong argument against the above reasoning that can be made is as follows – what is the right "Cost of Equity" or "Ke"? What if the pre-pandemic cost of equity was too low – implying too low a compensation for risk accepted by stockholders at their purchase price during pre-pandemic times? And, post normalization, even if "Ke" is revised lower than during-pandemic

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peaks – what if it does not go to the pre-pandemic low levels at all? Cost of Equity is a summation of risk-free rates and equity risk premium. Risk free rates can be understood/ predicted logically but equity risk premiums are sentiment driven and difficult to comprehend *(though complex formulae try to pinpoint it to a number – which I think are incorrect and oversimplification)*. Having said that, equity shareholders cannot be anchored to their purchase price and resultantly the Ke accepted by them at the time of purchase is irrelevant today. They can only think ahead and the prospective returns that are being offered at today's prices. And if they are satisfactory or more than satisfactory, decisions should be based on that.

Another important point is that while a mall in a prime locality was used as an example to illustrate this concept, a portfolio of high-quality companies with moats around them that protect excess returns – on an aggregate – are similar to this mall. Not individually but as a portfolio. Some businesses are so weak that a 6-9-month disruption might lead to bankruptcy or might lead to a very significant drop in net present value *(structurally impact some business models!)* – which will cause what we term as "permanent loss of capital". And the above metrics are meaningless in such situation. If you have created a portfolio of companies wherein you can predict impact on cash-flows due to a lockdown with reasonable confidence and have a fortress of a Balance Sheet to sustain current shock, today's price points generally offer a high return – implying you are handsomely compensated for the risk you are taking of investing in equity shares of such Companies.

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