COVID-19: Valuations in the current environment

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1. Introduction

Valuations in the current environment

Global attempts to limit the spread of the COVID-19 novel coronavirus come with unprecedented social and community dislocation. An extended period of economic downturn and profound disruption to established business and financial systems is likely. More immediately, for investors, is the challenge of finalising or revisiting carrying values for their investments as at 31 March 2020.

With little time to assess the impact of the current environment on cash flows, and given inherent risks facing investment companies, it might be tempting to apply an ad-hoc adjustment to equity returns to address potential impacts on valuations.

At KPMG, we believe any adjustment to value should be assessed on an individual investment basis. To help you set or revisit your carrying values as at 31 March 2020, we have identified the top considerations for assessing the extent of the value impact on individual assets, as well as the implications for equity returns.

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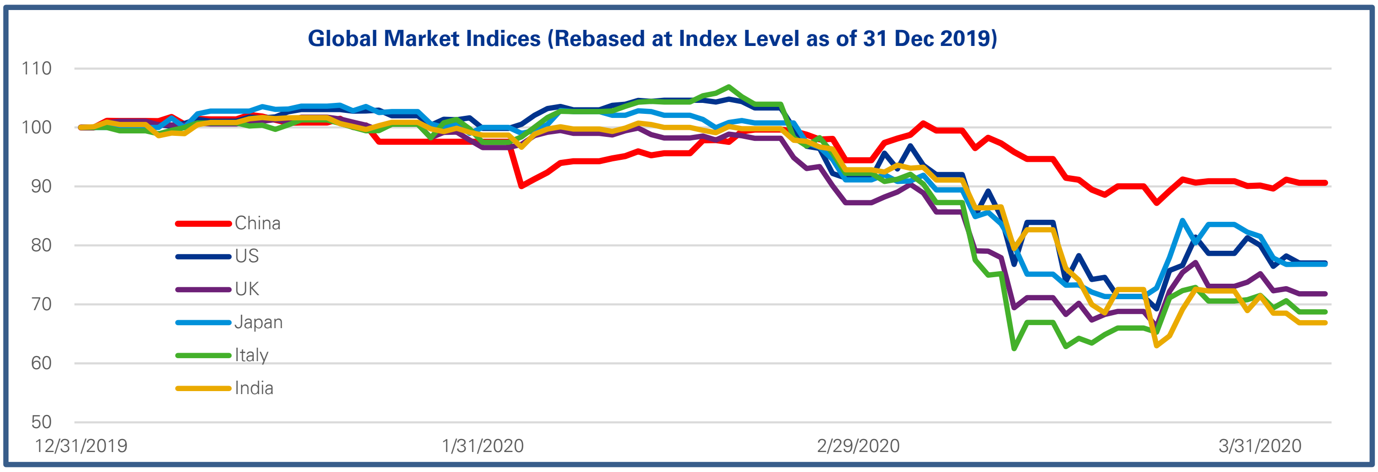
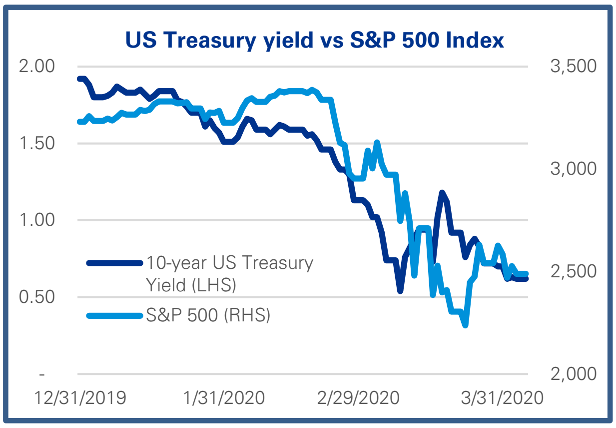
2. Overall impact on the global markets

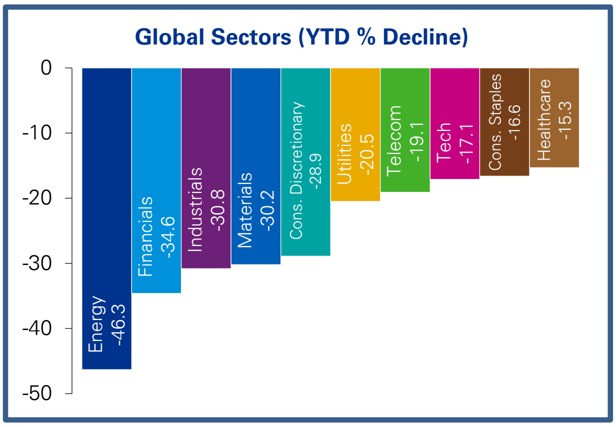
COVID-19 has proved to be the catalyst, amplified by concerns over oil-price tensions between Saudi Arabia and Russia, which have now been resolved for the time being due to agreement reached between the Opec producers and allies including Russia, for the financial markets to finally reflect worries for short-term growth and deeper risks to the economy. These factors were starting to be considered in valuations of unlisted investments, with a dampening of growth expectations, subdued inflation and increased cost-control measures.

Impact on global capital markets

The global markets turned volatile as soon as the news spread out of the COVID 19 shifting focus from China to Europe starting with Italy and Spain. Major indices plunged by an average of 30% from late February to March end.

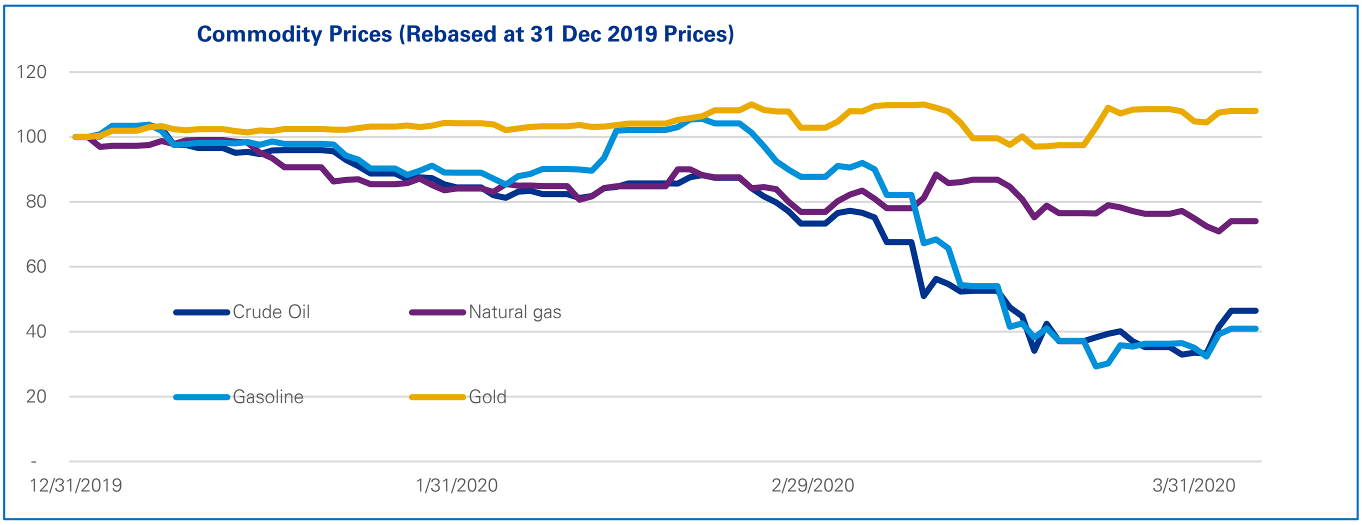






Worldwide aviation, travel and tourism are the hardest hit sectors as most airlines have grounded their entire fleet, business travel is down and global events have been cancelled or postponed including 2020 Tokyo Olympics.

Impact on oil and other commodities



Source: S&P Capital IQ, Thomson One

Saudi Arabia slashed its crude production and threatened record output after Russia chose not to comply with OPEC's proposed production cuts.

As a result Crude oil and gasoline prices fell by 55% and 61%, respectively, from their recent peak in early January. Natural gas prices also fell by 26% from their peak price in January.

Sustained oil prices below $30/barrel will impact U.S. shale producers many of which are heavily leveraged and could face downgrades and increased default rates. However, due to recent agreement reached between Opec+, made up of oil producers and allies including Russia to slash global output by about 10% after a slump in demand caused by coronavirus lockdowns may help to reverse the trend and give some respite to OPEC producers and allies.

Impact on GCC capital markets

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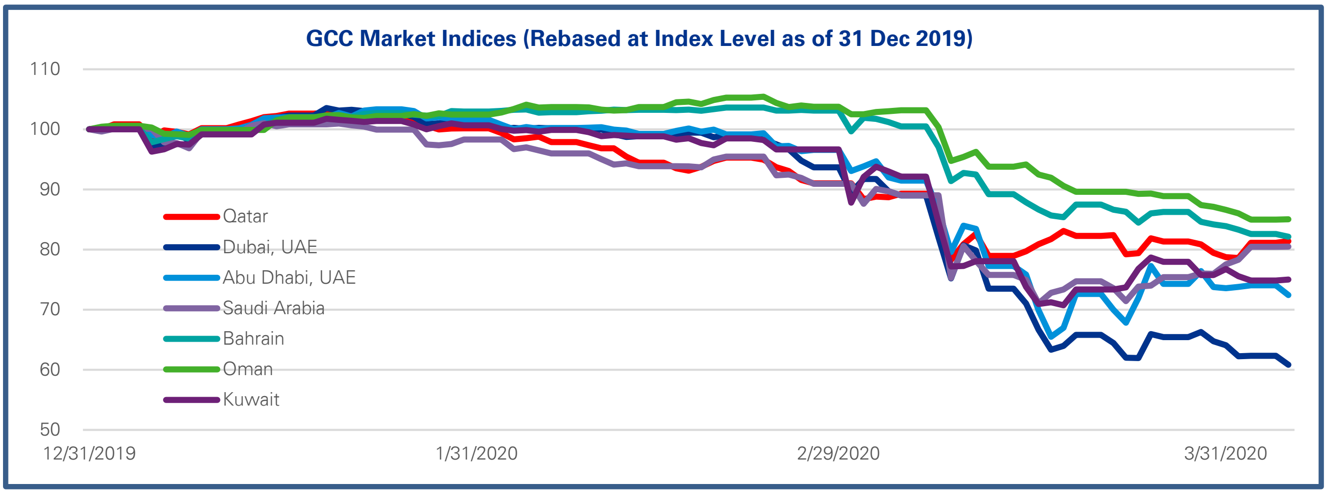
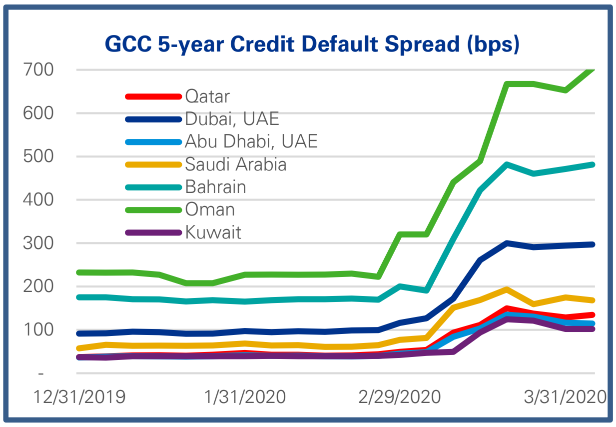
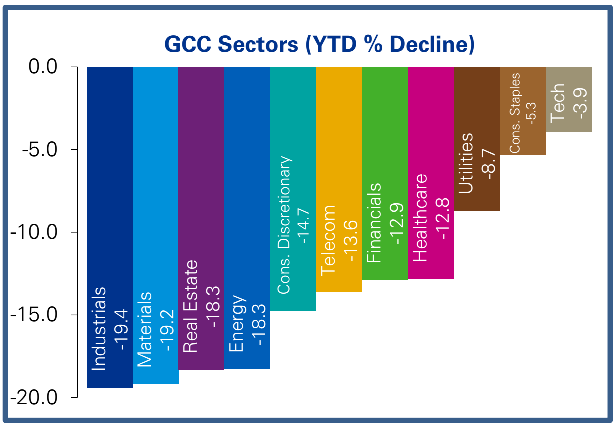






Source: S&P Capital IQ, Thomson One

Impact on GCC capital markets (continued)

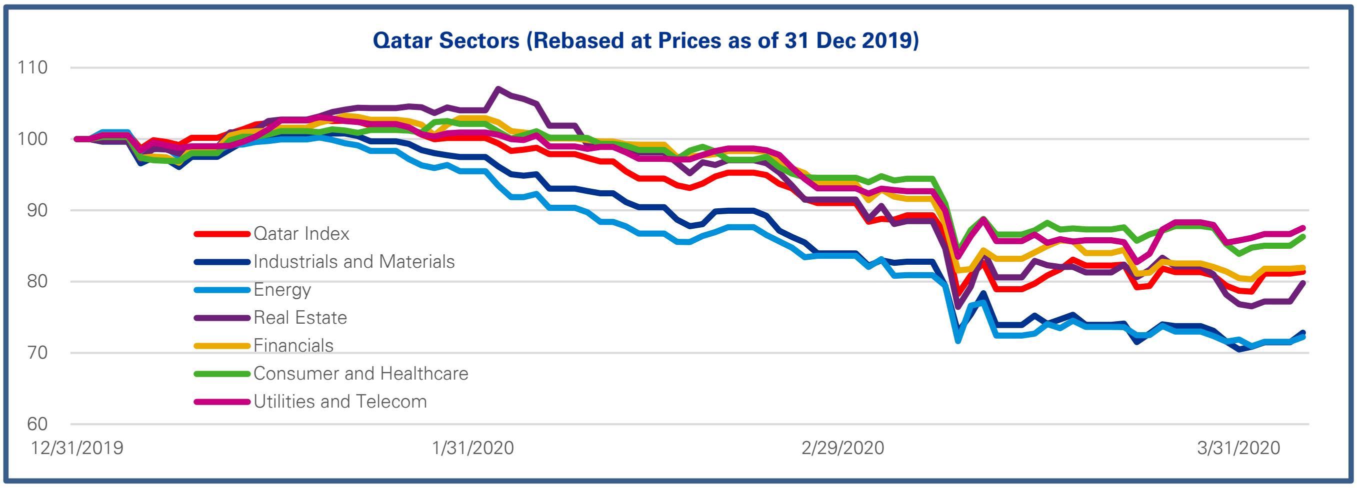
In Qatar, Utilities and Telecom sector is the least effected followed by Consumer and Healthcare sector. Some of the effected sectors include:

Energy: Low oil prices coupled with a prospect of low energy demand

Financials: Impact due to deferring of payments by businesses and individuals which may potentially lead up to NPAs

Industrials: Must deal with global supply chain disruptions along with volatile demand

Consumer: Mixed response as e-commerce picking up but the traditional way of retail shopping getting impacted. Logistics and supply chain issues to be sorted out in the short run.



3. Valuation impact

We expect a potential two-to-four month broad "lock down" by the governments to arrest the spread of COVID-19. We are already seeing China starting to re-engage its factories, two months after its initial lock-down measures. From that point, there will be a period in which to return to previous activity levels or, in some sectors, to establish a new normal. The shape of this return, whether an optimistic "V" shape; a more realistic "U" shape or a more concerning "L" shape, will be a major contributor to the overall value impact on investments. It will also influence the timing of recovery in the equity markets in general.

The success of global governments' stimulus measures, designed to support industries and individuals in negotiating the downturn, will contribute to the speed of recovery. Like in Qatar, the government has announced a QAR 75 billion ($20.5 billion) stimulus package to the private sector. However, though these measures may soften the immediate impact, the cost of funding them is likely to create a prolonged and longer-term drag on economic performance.

4. The value impact depends on the characteristics of individual investments

Demand-based assets are most at risk from a downward-value adjustment, particularly those investments exposed to the travel sector (e.g., airports, hospitality) and those directly correlated with GDP performance (e.g., ports).

Availability based or regulated assets are expected to be more stable at a revenue level, unless broader economic pressures force changes to contractual mechanisms. Demand-based assets, however, are likely to recover more quickly once economic activity returns. They will be potential beneficiaries of initial government stimulus measures too. As a result, it will be important to assess the opportunities available to manage cash flows to mitigate short-term revenue impacts. Scenario modelling of adjustments to capital expenditure profiles, operational expenditure and distribution/financing flows will be important for understanding value impacts.

Capital expenditure profiles may provide flexibility in managing cash flow

Discretionary capital expenditure spend, particularly for expansion programmes, will provide an opportunity for investment companies to manage cash flow by deferring projects in the short to medium term. This may mitigate adverse short-term value impacts, but could affect growth in the medium to long term too. Where assets have high capital expenditure requirements, a reduction in the capital expenditure profile may reduce equity risk to the extent that delivery and execution risk were previously factored into the assessment of the overall equity return.

Gearing positions and timing of refinancing events can increase risk

Governments have taken action to maintain liquidity in credit markets. However, give thought to the funding position of each investment, particularly where there are indications that the credit markets may become constricted. Consider:

- Investments with refinancing events in the short term. Given potential uncertainties over the amount of debt that can be raised and the cost of new debt, these will be most at risk
- Medium-term margin assumptions. These might need to be reassessed if credit spreads widen for lower-rated investments
- Refinancings, assumed in the medium term to provide an equity release, but which might not be available in a dislocated credit environment
- Covenant headroom – those investments with limited headroom will be most at risk

Counterparty risk will be amplified

A broad economic downturn will increase counterparty risk and the potential for default on existing obligations. Investments that are most exposed to counterparty risk (low credit-rated counterparties or those that operate in high-risk industries and/or jurisdictions), will be viewed as higher risk.

The value impact will be greatest for shorter-life assets

Investments with a shorter concession period or asset life, will feel, on an absolute-value basis, any short-term cash-flow impact to a greater extent than longer life or perpetual investments. The shape of the recovery ("V", "U" or "L") is important for all investments, but is especially critical to investments with shorter lives.

The contribution from terminal value may increase

For companies that do not have whole-of-life forecasts, a greater percentage of overall value is likely to be associated with the terminal value period. Inherently, this will require increased focus on the assumptions that drive the terminal value, and the supporting evidence used to establish the long-term growth assumption.

5. Other considerations

Use the valuation range where necessary

Valuations are typically presented as a range. The mid-point of that range is often the stated point-estimate of value. Given current uncertainties and limited information with which to assess the initial impact on valuations, we consider that risk is currently skewed to the downside.

Consider where in the valuation range the point-estimate of value should sit, with the lower end perhaps better reflecting market participants' increased risk aversion.

More frequent valuations

31 March 2020 marks the first quarterly period in which the extent of COVID-19 disruption is known, but where detailed analysis of impacts on cash flow and potential mitigations have not been made.

In subsequent valuations, access to greater information will enable progressively more informed assessment. Views as to the inherent risks in specific sectors may change. Sector participants may adopt different profiles as they return to "normal".

We urge investors who do not participate ordinarily in quarterly valuation cycles to take a more frequent approach to valuations during this period. We also advise all investors to initiate reforecasting and valuation processes earlier than usual.

Financial reporting and impairment considerations

Impairment assessments will come under scrutiny in forthcoming audit processes. Evidence that the underlying financial information is prepared on a reasonable and supportable basis will be critical. Auditors will expect investors to demonstrate an appropriate balance of risk assessment between the discount rate and cash flows.

6. Conclusions

Adjusting the business cash flows or forecasts for March 31, 2020 valuation may not be possible or prudent as the extent of damage is not yet known. At the same time applying an equity premium, based on share-market performance since the emergence of COVID-19, may overstate the potential value impact on certain defensive asset classes. Equity markets have declined substantially from their peaks in early 2020. Notwithstanding that in times of dislocation, we consider a relative assessment of equity-market performance to be flawed, assessments should be done over a consistent time period.

For some asset classes, equity-market performance over the course of 2019 was very strong. This means that year-on-year price movement, even post the recent market declines, was either positive or flat. Between 1 January 2017 and 31 December 2017, Qatar Exchange Index declined by 18.3% due to the geopolitical situation in the region. Subsequently, the Qatar Exchange Index recovered and increased by 20.8% in 2018 and 1.2% in 2019. As at 31 March 2020, Qatar Exchange Index has declined by 21.3% since 1 January 2020. For this reason, the need for adjustments based on a short period of market volatility shall be considered.

Based on above and in the absence or adjusting the cash flows or basing the valuation for private unlisted investments on the equity market performance, we suggest considering an additional alpha factor in the WACC given the inherent uncertainty as an alternative approach to estimate the impact of COVID 19 on equity valuations. The quantification of the additional alpha may vary from company to company and on a case to case basis due to the factors highlighted above. For example, the companies that have enough liquidity to withstand these disruptions in the short run or in the defensive sector should have a lower additional alpha as compared to companies not belonging to this category.

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