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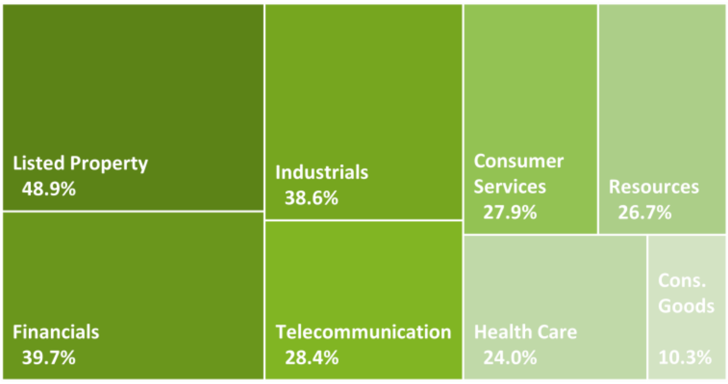
Valuation uncertainty
COVID-19

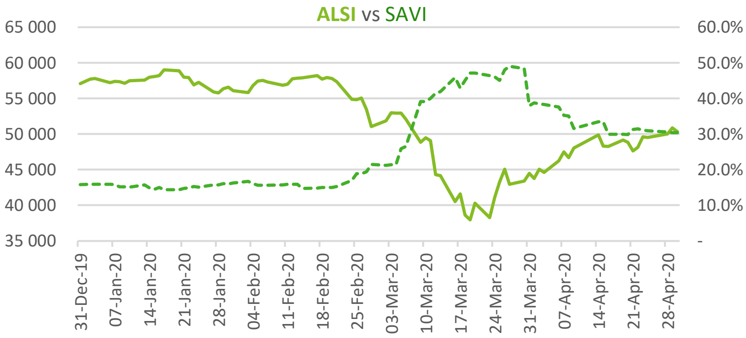
Global and South Africa impact

The unprecedented impact of COVID-19 has resulted in a significant decline across global indices with seismic shifts felt in demand and supply chains across all industry sectors. In South Africa, the JSE All Share Index (ALSI) declined almost 35% year to date at one point in March before recovering to a Q1 2020 loss of 23% with the most impacted sectors being property, financials and industrials.

ALSI decline by sector from December 2019 to March 2020



Tracking the ALSI and South African Volatility Index (SAVI) since December 2019



Source: S&P Capital IQ & IRESS

Business impact

With the economic uncertainty and the practicality of a 'V-shaped' recovery in question, the impact of COVID-19 is expected to be material and potentially further prolonged than what we have seen so far. There are several areas of businesses which will be impacted by COVID-19 which can result in higher required rates of return and challenging business valuations. These include, but are not limited to:

- Site or facility closures
- Loss of customers and significant contracts
- Demand and supply chain interruptions
- Production delays and imposed restrictions
- Human capital management
- Delayed cash conversion cycles impacting working capital
- Ability to bear losses
- Growing indebtedness and increased cost of borrowing
- Increased going concern risk

Valuation implications

Whether for M&A, strategic planning or financial reporting, there are material valuations implications which businesses should consider. In particular, as companies complete their subsequent financial reports, it is critical for businesses to assess impairment of goodwill and tangible assets, as well as consider any potential fair value adjustments where applicable.

16.3x DEC 2019

12.6x MAR 2020

In South Africa, the average **P/E multiples** of all sectors in the ALSI **declined by 23%** (from 16.3x in December 2019 to 12.6x in March 2020). This highlights the potential value impact for Q1 while the future continues to remain uncertain

The impact of the COVID-19 pandemic has resulted in increased market uncertainties and volatility which has added multiple layers of complexities to valuations. This requires valuers to rethink key valuation analyses and inputs as a result of:

- Increased **uncertainty in forecast cash flows** due to assumptions regarding the expected duration and economic impact of the pandemic
- **Volatility of key market inputs** applied in estimating discount rates such as risk free rates, country risk premiums and equity risk premiums
- **Limited reliability of the market approach** (market multiples) due to volatility of share prices and comparability of the earnings bases of peer companies
- Ability to access funding given cash flow constraints and an increase in **going concern risk**

The main areas of financial reporting where we expect there to be valuation implications due to COVID-19 are noted below:

Goodwill, intangible and tangible assets

Non-financial assets such as fixtures, plant & machinery and finite life intangible assets should be tested for impairment based on triggers identified from the impact of COVID-19. While goodwill and indefinite life assets should be tested annually for impairment, in the current circumstances, interim impairment tests should also be considered.

Investment in associates and JV's

Certain investments in associates and joint ventures held by entities are likely to be adversely affected by COVID-19 and there is a need to review their recoverable amounts to support their carrying amounts.

Investments held at Fair Value

Financial reporting of investments held at Fair Value should consider the impact of COVID-19 and the long term outlook for each of those investments at each reporting period date.

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Impairment and fair value

COVID-19

From a financial reporting point of view, the immediate valuation related impact of COVID-19 is expected through impairment assessments on goodwill, intangible and corporate assets (IAS 36) and fair values of financial and non-financial investments (IFRS 9, IFRS 5, IFRS 13 and IAS 28). **Below are key considerations for undertaking assessments:**

Impairment testing considerations

Financial	Operational	Strategic	Geopolitical and regulatory	Extended enterprise
Trends and events related to financial markets or corporate risk	Risks relating to products, services, and operational activities	Emerging issues materially impacting strategy and business direction	Disruptions to trade, global markets, and regulatory change	Emerging risks and opportunities related to third-party ecosystem
Market volatility	Store or facility closures	Competitive shifts	Health pandemic	Supply chain interruptions
Credit risk	Declining customers	Technology innovation	Trade disruptions	Distribution delays
Commodity risk	Reduced human capital	Industry convergence	Sustainability risks	Reliance on third parties

- **Assess impairment triggers carefully**: Consider the triggers above and evaluate their implications as any trigger may necessitate an impairment test
- **Approach:** Ensure consideration of both Value in Use (income approach) and the Fair Value Less Costs of Disposal (either income or market approach)
- **Multiples:** Given depressed market multiples and uncertainty as to the level of maintainable earnings, careful assessment of the appropriateness of forward, normalised and/or through the cycle multiples to reflect for scenarios where estimates are available
- **Share price:** Consider the use of average historical market inputs over a normalised time frame to smoothen the impact of current market volatility
- **Scenario analysis:** Assess and incorporate the probability of the crisis extending for 3, 6, 12, 18-months or longer with robust and flexible scenario based modelling of cash flows and market inputs
- **Discount rate:** Revise discount rates to align with current market volatility, changes in macroeconomic conditions and risk levels. It is recommended however that any increased uncertainty is captured within the cash flow scenarios where possible
- **Stimulus:** Offset the impact on valuations from government subsidies or other forms of financing and stimulus programs
- **Subsequent reversal of an impairment loss**: This is precluded for goodwill impairment but permitted for all other assets under certain criteria, provided that reasonable and supportable projections can be estimated factoring in risk, growth and returns

Fair value considerations

- **Market participant:** Given the market participant premise, greater uncertainty may translate into greater risk and required returns leading to lower asset values. Risk and return metrics must be evaluated in the context of a market participant's perspective while considering any change in discounts for marketability given current economic conditions
- **Selection of metrics and inputs**: Based on last twelve months or next twelve months, metrics should be determined based on market participant expectations and the availability of data, and as at the particular valuation date
- **Operational assessment:** impact of crisis on investee company's revenue/customers, supply chain and operations as well as a stress tested review of performance shortfalls
- **Liquidity and funding:** Assessment of immediate funding needs and liquidity to ensure going concern and existing covenants are met
- **Scenario analysis:** Assess and incorporate the probability of the crisis extending for 3, 6, 12, 18-months or longer with robust and flexible scenario based modelling of cash flows and market inputs
- **Portfolio valuations:** Assessment of any differences between an investor's outlook on the subject business and management's outlook and impact on the operations in the current market scenario
- **Marketability:** Marketability discounts in the context of private company valuations may be higher. As deal flow slows down, there is likely to be a smaller number of potential buyers for assets which may drive transaction prices down
- **Transaction multiples:** We would caution against using transaction multiples as historical data may not be relevant in the current market

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Valuation impact areas
COVID-19

Input change | Value change

Market multiplies

On average, multiples in the ALSI have decreased by more than 20% since December and significant uncertainty still prevails in the market. Comparable multiples are therefore depressed and may not represent a long term view. Furthermore, applying multiples to loss making positions will not be meaningful. Care should be taken when using the market approach and more emphasis should also be placed on using income based approaches, where possible

Risk premia

Global Equity Risk Premiums (ERP) ate expected to increase given higher levels of volatility and default risk. Similarly, we have already observed significant increases in country risk premiums for African countries fuelled by the slow down in the economy, increased government deficits, and lowering of credit ratings

Beta

Further, with increased market volatility relative to stock volatility in various sectors, beta levels are observed higher. When using the Capital Asset Pricing Model, an increase in beta increases the cost of equity and discount rate

Risk free rate

Risk-free rates have increased significantly in South Africa in March 2020 on the back of COVID-19 and the recent ratings downgrade. Conversely, risk free rates in the US have decreased to record low levels. A lower risk-free rate (all else equal) results in a higher valuation outcome, which is counter-intuitive in the current environment and a US-based discount rate may need adjustments

Working capital

Working capital has immediately been impacted by COVID-19. Inefficient or stressed working capital directly impacts enterprise value through reduced free cash flows, and is likely to be more volatile requiring extra consideration when forecasting

Input change | Value change

Gearing

With cash inflow constraints and sustained operating costs, a vast number of entities across several industries are seeking additional debt financing to help fund operations in the short to medium term. While the cost of debt is generally lower than the cost of equity, higher gearing (D/E) levels increases risk and potentially value. The ability to maintain an adequate capital structure, manage debt repayments and adhere to covenants requires consideration

Cash flow

Estimating earnings and free cash flows in the short to medium term carries increased uncertainty with COVID-19. Scenario based forecasting should be considered. Key assumptions for revenue, margin, working capital, impact of government subsidies, and the recovery profile(s) should be modelled to improve the robustness of the valuation

Growth

Discrete period growth rates over 2020 and 2021 are expected to be lower in most industries. Medium and longer term growth rates should also consider any revisions to long term expectations of macroeconomic variables such as inflation, population and GDP

Cost of debt

The cost of debt is likely to warrant adjustment but there are conflicting factors which need to be considered such as the increase in risk-free rates, decrease in the prime lending rate and a potential increase in credit spreads. Lenders will expect higher credit spreads which will increase the cost of financing and debt capital.

Capital spend

Capital rationing in the current environment is paramount and several entities globally have announced measures to cut capex and put projects on hold. While this adds to cash savings in the near term, over the longer term, it may lead to lower incremental earnings generated and impact growth profiles

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How can we help

Our dedicated team of valuation experts in South Africa have deep valuation expertise with the experience of supporting businesses through challenging times, providing clear and timely advice.

- Fair valuations
- Impairment testing
- Intangible asset valuations
- Scenario modeling
- Cash flow forecast testing
- Discount rate estimation
- Real estate valuations
- Tangible asset valuations
- Going concern review
- Purchase Price Allocations

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