COVID-19

Impairment testing during the global pandemic
The fallout from COVID-19 has had a severe impact on the global economy. On 14 April 2020 the International Monetary Fund (IMF) indicated that the global economy would contract by 3.0% in 2020. Just three weeks later, the IMF Chief Economist said that the global outlook had already worsened since their mid-April forecast. Extensive lockdowns across the globe are expected to cause the greatest global recession since the Great Depression of 1929.

As a result of this, the downgrade of South Africa’s sovereign debt, and various other factors, the South African economy is facing unprecedented challenges and the outlook has been significantly reshaped.

Our previous publications; *Valuation impact of COVID-19* and *Navigating valuations in the world of COVID-19* evaluated the impact of COVID-19 on the South African equity market, government bonds, trading multiples and whether an adjustment to the equity market risk premium is required. They also compared the affected trends in South Africa to those noted in developed markets and highlighted some of the other challenges that preparers of valuations are likely to face. This document sets out to highlight potential challenges that preparers of impairment assessments are likely to face in the current environment.

For 31 March 2020 reporting dates and thereafter, companies may be faced with triggering events and be compelled to assess recoverable amounts of assets and/ or cash generating units (CGUs) in terms of International Accounting Standard 36 ‘Impairment of Assets’ (‘IAS 36’). These valuations will require significant professional judgement.
The effects of the global COVID-19 pandemic has already left clear traces on the JSE All-Share Index (ALSI).

The economic implications of COVID-19 on top of the challenges posed by South Africa’s ongoing domestic economic problems and the downgrade of the country’s sovereign debt to junk status in March 2020 have resulted in financial market volatility and erosion, deteriorating credit, liquidity concerns, increasing unemployment, declines in consumer discretionary spending and reductions in production.

The ALSI lost almost 35% over the period 21 February 2020 to 23 March 2020 and the level of volatility in the market, measured by the SAVI Index, doubled. Despite the ALSI making a recovery along with the level of volatility stabilising, the ALSI still remains lower than at the beginning of the year.

Fig 1. ALSI vs SAVI Index (rebased to 31 December 2019)

Source: IRESS
Q: Which industries are more likely to be vulnerable to COVID-19?

Industries have been affected in varying degrees by Covid-19. Between 31 December 2019 and 31 March 2020, certain sectors on the JSE experienced large declines. Listed property fell 48.9% and the industrials sector fell 37.7%, while the technology sector experienced increased closing prices driven by Naspers and Prosus, which were buoyed by a weaker rand and higher demand for online food deliveries, gaming and retail.

Recovery in the various sectors is expected to vary significantly and a rigorous analysis of the effects of the pandemic in relation to specific CGUs or groups of CGUs is therefore essential.

Source: Capital IQ and IRESS
Q: Is the global COVID-19 pandemic classified as a triggering event?

The short answer is that it depends on the extent of the impact of the global pandemic on the affected assets, CGUs or groups of CGUs.

With the exception of goodwill and long-lived intangible assets, for which an annual impairment test is required, IAS 36 requires reporting entities to assess at the end of each reporting period whether there is any indication of impairment for all assets (within the scope).

According to IAS 36.12, impairment tests should be performed whenever an indicator of impairment has been identified. Both external and internal indicators should be considered. Indicators include, but are not limited to:

- Significant declines in market capitalisation below book value (net asset value);
- Disruption in the supply chain, i.e. lockdown restrictions on travel and transport;
- Decrease in the expected growth of the economy in which the CGU operates; and/or
- Increased credit risk due to declines in the ability of customers to meet obligations.
The graph on the right illustrates how significantly share prices of JSE-listed companies decreased from 31 December 2019 to 31 March 2020. For some entities, the market capitalisations decreased below the carrying amounts of the net assets.

Figure 3 shows that several sectors have experienced a significant decrease in their market capitalisation, most notably Travel & Leisure, Property, and Automobile & Parts.

As indicated in the graph on the right, as at 31 December 2019, the market capitalisations of 175 companies (42.4% of all JSE-listed companies) were below their book values, with a slight increase to 183 companies (44.3%) by 31 March 2020. The key reason for this high percentage is the weakened South African economy, which was already in a technical recession at the end of 2019.

In contrast, the number of companies on the STOXX Europe 600, for which respective book values exceed their market capitalisation, increased significantly from 120 at 31 December 2019 to 198 by 31 March 2020.

Source: Capital IQ

**Fig 4. Number of companies with potential triggering event (market capitalisation < net asset value)**

Source: Capital IQ; Sample: Companies listed on JSE
COVID-19 as a triggering event for impairment testing

In the context of the far-reaching economic consequences of COVID-19, a significant number of entities face indicators of impairment. In our view, the cash flows (at least in the near term) of most companies will be affected by COVID-19. Besides goodwill and long-lived intangible assets, this may trigger the requirement for impairment tests for property, plant and equipment (PPE), inventory, financial assets, real estate and investments (including investments in associates and joint ventures). Although not all of these impairment tests are performed in accordance with IAS 36, the principle that the carrying value cannot exceed the recoverable amount is typically applied.

Evaluation of whether COVID-19 is a triggering event is company-specific and should be evaluated holistically.

Recognising goodwill

Did you know:
The total amount of goodwill recognised by all companies listed on the JSE as at 31 December 2019 was R3.28 trillion

Source: Capital IQ
Q: Where do we expect to see the effects of COVID-19 in impairment tests?

Regardless of the economic effects of COVID-19, the concepts and objectives of IAS 36 remain unchanged: to ensure that assets are carried at no more than their recoverable amount.

### Determining recoverable amount

<table>
<thead>
<tr>
<th>Carrying amount</th>
<th>Recoverable amount</th>
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<tbody>
<tr>
<td>compared with</td>
<td>higher of</td>
</tr>
<tr>
<td>Fair value</td>
<td>and</td>
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<tr>
<td>less cost of</td>
<td>Value</td>
</tr>
<tr>
<td>disposal</td>
<td>in use</td>
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The *carrying amount* is the amount at which an asset is recognised on the balance sheet after deducting accumulated depreciation and impairment losses.

The *recoverable amount* is defined as the higher of an asset’s fair value less costs of disposal (FVLCD) and its value in use (VIU).

### Differences between FVLCD and VIU

<table>
<thead>
<tr>
<th>FVLCD</th>
<th>VIU</th>
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<tbody>
<tr>
<td>FVLCD is “the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date” less costs of disposal.</td>
<td>VIU requires management to estimate the present value of the future cash flows that are expected to be derived from the asset in its current condition.</td>
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<td>Guidance on fair value is given in IFRS 13, ‘Fair value measurement’.</td>
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<tr>
<td>“External or market value” – IAS 36.25</td>
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<td>Incremental costs directly attributable to the disposal of an asset/ CGU.</td>
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FVLCD is a market participant approach, which is almost always based on a cash flow model. VIU is a cash flow model with specific requirements and limitations defined by the Standard. The cash flows to be used in a discounted cash flow (DCF) model prepared to determine FVLCD may differ from those used in a VIU calculation.

Key inputs to valuation models, such as cash flow forecasts and/or inputs into the discount rates, are likely to change, especially in industries where, for example, a shift in demand is anticipated, or disruptions in the supply chain have occurred.

Developing models is likely to be an iterative process as management works to reflect the risk and uncertainty in its cash flow forecasts and its determination of an appropriate discount rate, given new facts and circumstances in the wake of COVID-19.
Q: What is the effect on the cash flow forecast?

DCF valuations rely heavily on reasonable financial projections. Given the current environment, with significantly increased uncertainties coupled with some companies facing elevated liquidity risks, a single set of financial projections reflecting management’s best estimate might not adequately reflect the expected cash flows.

We would expect that revised financial projections include several scenarios to reflect current uncertainty caused by the pandemic and address likely increased credit and liquidity risks, casting doubt over the going concern assumption for many businesses.

Although not explicitly required by IAS 36, the recoverable amount calculation should account for possible variations in the amount or timing of future cash flows.

The biggest challenge for preparers of financial projections is assessing when an entity will reflect the full impact of COVID-19 in its performance as well as the rate at which it will return to ‘business as usual’.
The shape of this return, whether an optimistic ‘V’ shape (high); a more realistic ‘U’ shape (base) or a more concerning ‘L’ shape (low), will be a major contributor to the overall value impact on investments.

**Value considerations**

**Fig 5. Probability-weighted free cash flow projections**

<table>
<thead>
<tr>
<th>Year</th>
<th>Weighted FCF</th>
<th>High</th>
<th>Base</th>
<th>Low</th>
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<tr>
<td>FY19</td>
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<td>TV</td>
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Source: Strategy&

**Critical components of multi scenario analysis**

While the concept of a multi-scenario analysis is a simple one, it has three critical components:

1. Determine the factors on which scenarios will be built:
   - Consider the key drivers of revenue and its various components (demand, contracts, supply chain, etc.); and
   - Forecasting of government stimulus if the company qualifies.

2. Determine the number of scenarios to analyse each factor:
   - Scenario analysis is not restricted to low, base and high. It will depend on the number of assumptions made for each factor identified.
   - Assign probabilities to each scenario’s estimated cash flows.
The quantification of the impact that COVID-19 will have on companies in the long term remains uncertain. The implication for the terminal value will depend on the extent and timing of the market recovery.

For companies with indefinite useful life forecasts, it is likely that a greater percentage of overall value will be reflected in the terminal value. Having considered this, increased focus on the assumptions in deriving the terminal value is required along with supporting evidence from macroeconomic and industry research in order to establish the long-term outlook for the company.

Unlike in developed markets, for valuations in South Africa, we do not see any immediate cause to apply adjustments to the capital asset pricing model. For a detailed discussion, refer to our publication: Impact of COVID-19 on valuation inputs.

In March 2020, South Africa witnessed a spike in government bond yields, which was largely attributable to the Moody’s downgrade and risk aversion brought about by COVID-19. This increase in the risk-free rate captured the increased market uncertainty and risk, corresponding with a rise in both implied equity market risk premiums and earning yields at that time.

Given these high levels of volatility, there was a strong argument to place less reliance on a spot government bond yield and use an average risk-free rate for March. However, since April, it appears that the yields on South African Treasury Notes have been normalising and that, as volatility subsides, the risk-free rate may stabilise at lower levels than those seen in March. Additionally, the South African Volatility Index came down in April and May.

Fig 6. South African Government debt: 10-Year Bond (rebased to 31 December 2019)

Source: Capital IQ
Q: Should a COVID-19 risk premium be applied?

Overall, we have seen an increase in the cost of equity, which is not unexpected given the downgrade, higher levels of volatility, uncertainty and risk. However, we do not see any immediate cause to apply a COVID-19 specific risk premium.

Nevertheless, in exceptional situations, it may be that companies are unable to prepare reasonable financial projection scenarios, in particular for the reporting period ended 31 March 2020. In these cases, the addition of a specific risk premium to the discount rate may be considered, but is by no means an alternative to making the necessary adjustments to the cash flow projections.

It is important to note that compensating for forecast risk through an alpha adjustment is a highly judgemental exercise. Quantifiable and measurable support for any discount rate adjustments is therefore recommended. Corroborative analysis, instead of arbitrary discount rate adjustments can help avoid overconfidence in the resulting conclusion.

Q: What are the effects on the cost of debt and the level of gearing?

The South African Reserve Bank (SARB) responded to Covid-19 by cutting benchmark interest rates in an attempt to promote liquidity. Since 31 December 2019, the repo rate has effectively been decreased by over 40%. With the latest cut announced on 21 May 2020, the repo rate is at a 50-year low of 3.75% and the prime lending rate of commercial banks at 7.25%.

Fig 7. Decrease in cost of debt, 31 December 2019 to 15 May 2020

Source: Capital IQ
However, on the back of deteriorating liquidity positions and poor financial performance, company credit ratings are likely to deteriorate as well, and the cost of debt for many companies is expected to increase anyway.

We assessed the probability of default scores for companies listed on the JSE, which explicitly includes country and industry risk, and noted that most industries have seen an increased default score from 31 December 2019 to 31 March 2020.

![Fig. 8 Probability of default movement for listed company debt, 31 December 2019 to 31 March 2020](source: Capital IQ)

The Consumer Discretionary sector has been severely impacted by COVID-19. This is primarily due to companies such as Tsogo Sun Gaming, Sun International and City Lodge Hotels being in this sector. These entities have not been allowed to operate since the announcement of the national lockdown on 27 March 2020.
It may be challenging to prepare reasonable and supportable financial projections given the current high levels of uncertainty and general market volatility, however, adjustments for available information at the valuation date should be reflected in the cash flows. These include, but are not limited to the following:

- Use of multiple sources of data, industry and macroeconomic projections about the duration and severity of the impact of COVID-19.
- Probability weighted scenarios and cash flow projections that reflect the uncertainty of the company’s supply chain and demand for its products or services, and its ability to operate given the impact of restrictions on transport and travel.

**Conclusion**

- Consider whether the discount rates used appropriately reflect the risk within the environment, noting that the increase of the discount rate using a specific risk premium should be a last resort.
- Regardless of whether a triggering event has occurred, valuers should consider enhancing sensitivity analysis and disclosures about the key assumptions and major sources of estimation uncertainty in the interim and annual reports.