COVID-19: How to set values for your infrastructure investments

COVID-19 is first and foremost a public health emergency and managing its impact and seeking to limit the spread of the pandemic is creating unprecedented social, community and business disruption. 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 carrying values for their infrastructure 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 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.

Assessing value impact

COVID-19 is not the only issue impacting values

The equity markets have been on a strong run since 2012, following disruption caused by the global financial crisis (GFC) and European debt crisis. Throughout 2018 and 2019, central banks sought to unwind the monetary stimulus applied during the GFC, as equity markets surpassed record levels. Pressure from political leaders and the business lobby stifled central banks' efforts. By the end of 2019, economic pressures were building. Expectations of continued economic growth through 2020 were tempered.

COVID-19 proved to be the catalyst, amplified by concerns over oil-price tensions between Saudi Arabia and 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.

The profile of the recovery will determine the impact on valuations, more than movements in equity markets

We expect a potential two-to-four month broad "lock down" by the UK government 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.

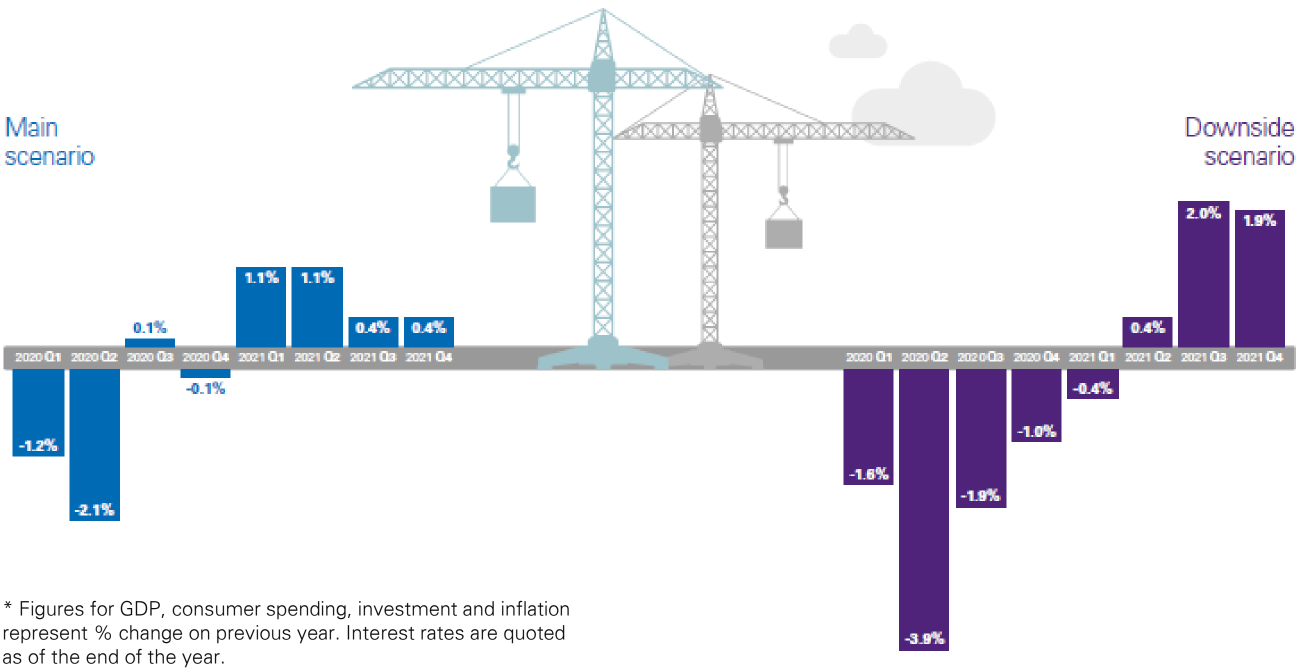
The success of global governments' stimulus measures, designed to support industries and individuals in negotiating the downturn, will contribute to the speed of recovery. However, though these measures may soften the immediate impact, the cost of funding them is likely to create a prolonged and longer-term drag on economic performance.

KPMG's UK Economic Outlook (March 2020) expects the effects of the COVID-19 pandemic to have a material impact on the global economy, at least in the short term. It will be a consequence of both the direct impact of the illness and the measures taken to slow its spread. The COVID-19 outbreak is forecast to slow economic growth sharply until the end of the year, before a recovery begins in 2021. Gross domestic product (GDP) growth in the UK is expected to fall by 2.6% in 2020, then rise by 1.7% in 2021.

An impact on deposit rates and inflation should be considered too. In the UK, inflation is also set to stay low. It will average 1.4% in 2020, as weakness in demand combines with falling global oil prices and changes to household energy tariffs over the year. Interest rates are expected to stay at just above zero, as the Bank of England uses the policy rate to support the economy through the outbreak and subsequent recovery. This translates into lower market rates and easier financial conditions.

GDP growth in our main and downside scenarios

Quarter-on-quarter % change



* Figures for GDP, consumer spending, investment and inflation represent % change on previous year. Interest rates are quoted as of the end of the year.

Source: KPMG's UK Economic Outlook, March 2020

The value impact depends on the characteristics of individual investments

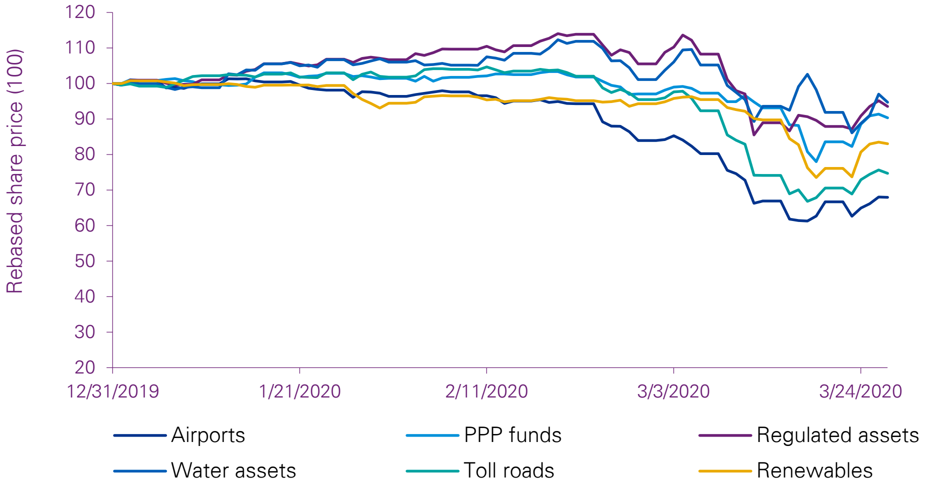
Demand-based assets are most at risk from a downward-value adjustment, particularly those investments exposed to the travel sector (e.g., airports) and those directly correlated with GDP performance (e.g., ports).

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.

Share-price resilience for key infrastructure asset classes in selected UK and European stocks is illustrated below.

European infrastructure companies share price since 1 January 2020



Sector average decline since 1 January 2020

UK water: **– 5.3%**

Regulated assets: **– 6.5%**

PPP/PFI: **– 9.7%**

Renewables: **–17.0%**

Toll roads: **– 25.3%**

Airports: **– 32.1%**

Source: Capital IQ

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.

Equity-return implications

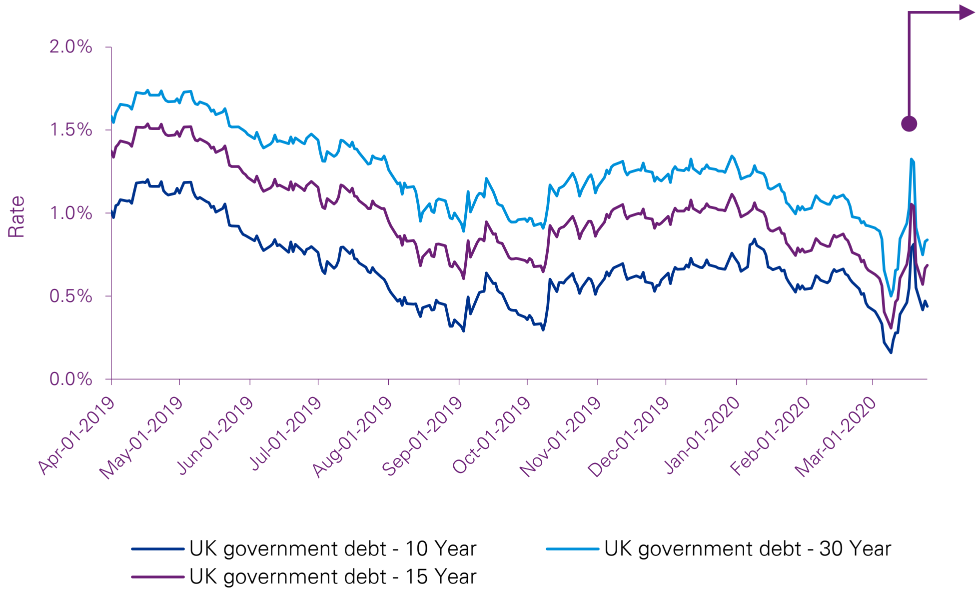
Range of factors influence equity returns

Thirty-year UK government bond yields declined from 1.26% per annum in early January, to a low of 0.50% per annum on 9 March 2020. That is 124 basis points down on the 12-month high of 1.74% per annum in April 2019.

Investors may see equity risk as higher today than one month ago. However, where equity premiums have increased at a lower rate than risk-free rates have declined, then absolute equity returns may still be lower than they were in March 2019 or even December 2019.

The robustness of market indicators complicates matters further. The 30-year yield increased from its low on 9 March 2020 (0.50% p.a.) to 1.33% p.a. on 19 March 2020. This hike was possibly due to further risk aversion driving funds away from bonds and into cash. However, the rates quickly adjusted, bringing the rate for 30-year UK government bonds back down. This same volatility is being seen in the equity markets. The quantification of adjustments, based on market data in an unstable market, can be problematic. Is it the re-pricing of equity-return expectations or short-to-medium-term earnings reductions, or purely market sentiment that is driving market movements?

UK government bond yields



Impact of COVID-19 pandemic in the UK (government stimulus and support packages, restrictions on places of business, restrictions on movement) leads to volatility in the bond markets

Source: Capital IQ

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

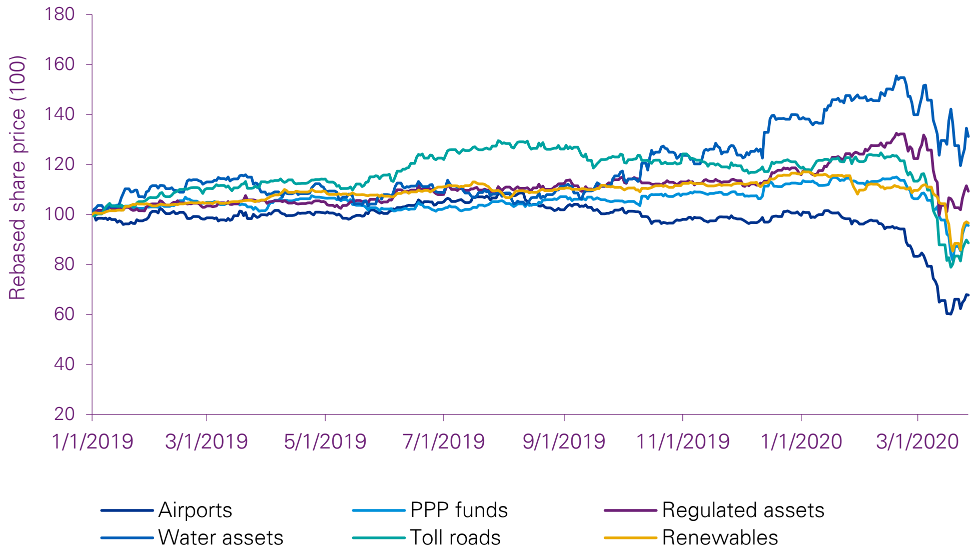
Often, the initial reaction of equity markets in periods of significant dislocation is for a similar re-pricing of all equities. Once the defensive characteristics of certain sectors become evident, equities are re-priced appropriately. Companies, where impacts are not otherwise expected, can be sold to cover liquidity requirements elsewhere in a broader investment portfolio. Valuers of unlisted investments generally seek to separate the emotional response of markets, which tends to drive "price", both on the upside and downside, as opposed to "value". This is especially important during periods of intense market volatility.

The importance of time period when measuring equity-market performance

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 infrastructure 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. Similarly, the FTSE 250 has declined 33% since 1 January 2020. However, as at 25 March 2020, this represents just a 5% decline over 1 January 2019. For this reason, adjustments based on a short period of market volatility, may not be appropriate.

European infrastructure companies share price since 1 January 2019



Sector average decline since 1 January 2019

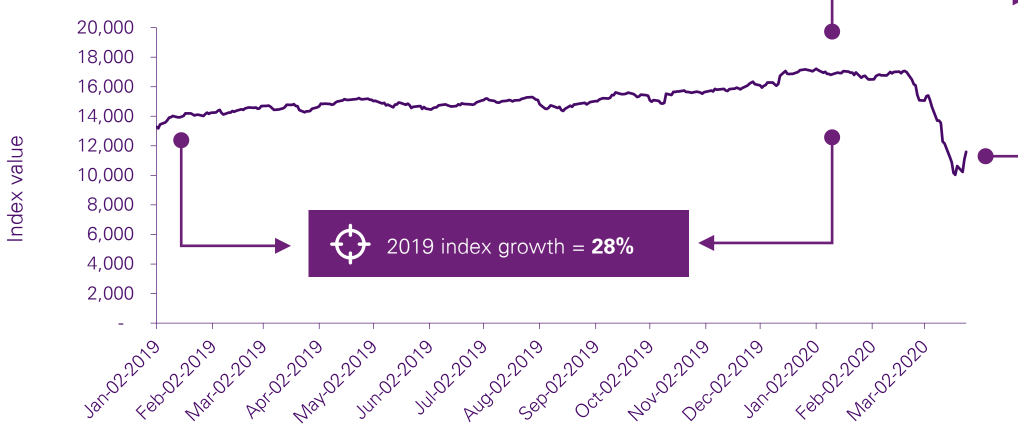
UK water =
31% growth

Regulated assets =
9% growth

Renewables =
4% decline

PPP/PFI funds =
4% decline

FTSE 250 Index (1 Jan 2019 - 25 March 2020)



2 Jan 2020 to
25 March 2020 =
33% decline

Source: Capital IQ

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.

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