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Impairment Barometer: Covid-19 and Goodwill Valuation

By Jason Mutarelli

Weathering the storm created by Covid-19 has a different connotation for all businesses, particularly for financial reporting professionals when managing balance sheet requirements, disclosures, and shareholder communications. In volatile times, business valuations and impairment testing require a clear understanding and precise application of valuation principles and methodologies to analyze the market disruption impacts on a company's assets, including potential goodwill impairment.

By relying on facts and fundamental data, we provide our observations through a valuation expert's lens and measure how H1 2020 events have impacted equity market indices, adjustments to EBITDA expectations, and their influence on enterprise values by sector.

Most sectors show a more substantial decrease in the next 12-months (NTM) EBITDA than a decline in enterprise values. We believe this indicates an increase in market multiples, which can be challenging to reconcile in the current environment. A more reasonable conclusion for many companies is to view 2020 as an anomaly, with businesses expected to return to normal levels in 2021. As a result, the impact on enterprise values has not been as significant as near-term expected EBITDA. However, given the uncertainty of the pandemic's future economic effects paired with the timing of vaccine development, there is a material risk to forecasts.

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What Does This Mean for Business Valuations and Impairment Testing?

From a market approach perspective, most sectors indicate that the enterprise values are slightly lower for the Q2 2020 relative to the 2019 calendar year. In the context of the income approach, we anticipate nearterm expected cash flows to be materially lower, and there may be significant risk associated with expected earnings beyond 2020. There are many different subsectors within the 11 sectors we cover here that may have varying results relative to their overall industry.

The SEC is making it a priority to focus on impairments related to Covid-19. In Q1 2020, while many companies may have concluded (and reported) that, despite rapid changes in their stock price and uncertainty about the shape and timing of a recovery, it is unlikely that goodwill is impaired. For many companies, their analysis was a simple comparison of their market capitalization and the book value of equity without more than a cursory review of individual reporting units given the rapid nature of the downturn, and the potential for varying outcomes. The SEC is now asking for a more detailed analysis regarding impairment disclosures.

VRC remains of the opinion that more than likely, Q2 2020 financial evidence will show that many companies will require interim impairment testing, and the effects on accounting and valuation issues may further evolve before coming to a final resolution.

General Market Event Observations

The Covid-19 pandemic has created significant volatility in the U.S. equity markets. In midFebruary 2020, all three major U.S. stock indices—Dow Jones Industrial Average, NASDAQ Composite Index, and the S&P 500—reached alltime highs. However, in late February 2020, stocks began to plunge into correction due to Covid-19 fears. Stocks continued to decline as the World Health Organization declared the virus a pandemic on March 11, 2020, and on March 13, 2020, Covid-19 was declared a U.S. National Emergency. All three major stock indices reached new lows on March 23, 2020.

The turnaround in the U.S. equity markets began on March 23, 2020, when the Fed announced economic support measures. On March 27, 2020, the U.S. signed into law the Coronavirus Aid, Relief, and Economic Security Act (CARES). On April 3, 2020, the Small Business Administration opened its Paycheck Protection Program, which provided loans designed to give small businesses a direct incentive to keep their workers on the payroll. On April 9, 2020, the New York Fed opened registration for the Commercial Paper Funding Facility. On April 24, 2020, the PPP and Health Care Enhancement Act was signed into law, which increased funding to the PPP and provided more funding for hospitals and testing for Covid-19. These government stimulus programs spurred a material rebound in the U.S. equity markets.

Our first chart illustrates the Q1 2020 significant decline from CY 2019 as well as the material rebound since 1Q 2020 for all three major U.S. stock indices. On a yeartodate basis, the DJIA and the S&P 500 are down ~9.6% and ~4.0%, respectively, while the NASDAQ is up 12.1%.

Industry Observations

We reviewed the decrease in NTM EBITDA forecasts from the CY 2019 to Q2 2020 to observe how EBITDA expectations have been adjusted to reflect Covid-related impacts. As expected, the sectors with the most significant decreases to the expected NTM EBITDA are the energy and consumer discretionary sectors. The reduction in the expected NTM EBITDA from CY 2019 to Q2

2020 for the energy and consumer discretionary sectors are materially higher than decreases observed for the change in enterprise values from this same period.

In early 2020, global energy investment was on track for a 2% growth, which would have been the most considerable annual spending rise in six years. But after the Covid-19 crisis brought the world economy to a standstill in a matter of months, global energy investment is now expected to plummet by 20%, or almost $400 billion, compared with last year, according to the International Energy Agency's World Energy Investment 2020 report. This, along with the impact on oil price from the Russia-Saudi Arabia oil price war, are the significant change factors in NTM EBITDA for the energy sector.

Consumer behavior has changed in response to the pandemic, which has materially impacted the consumer discretionary sector. Due to record declining levels of unemployment and incomes, consumers are spending on essential, not discretionary items. As businesses reopen, many are doing so with much less capacity to adhere to social distancing guidelines. Yet many consumers remain reluctant to return to daytoday activities outside their homes without medical endorsement or the development of a vaccine.

The decrease in enterprise values from CY 2019 to Q2 2020 for most sectors is comparable to the declines observed for the DJIA and S&P 500 over the same period. The decrease in enterprise values from CY 2019 to Q2 2020 for the energy sector was materially more significant than observed for the indices and the other areas given the significant drop in oil price as a result of reduced demand and Russia-Saudi Arabia oil price war in March 2020. The healthcare sector was the only one to experience an increase in enterprise values from CY 2019 to Q2 2020.

About the Author

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