

# COVID-19: Impact on Valuation of Investments in Sub-Saharan Africa

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**As a result of the outbreak of COVID-19 and ongoing full/partial lockdown in key markets, sub-Saharan Africa (“SSA”) has suffered a general economic slow down characterised by supply chain disruptions, weakening demand for non-essential items and production shut downs.**

Expectedly, governments and businesses in SSA were not prepared for a disruption of this magnitude and are now actively making plans and formulating policies to survive the pandemic. Similarly, investors are reevaluating the increased investment risks to ensure adequate pricing during this period.

In this document, we take a critical look at the impact of COVID-19 on key economies in SSA, primarily Nigeria, South Africa and Kenya, representing economic conditions in West, South and East Africa respectively, including the resulting impact on key parameters considered for investment valuation purposes.

## Assessing the value impact

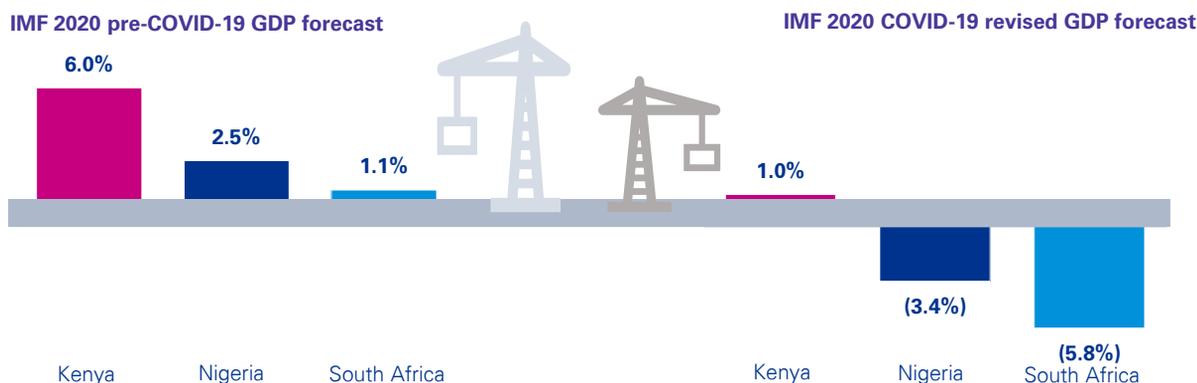
### *Dampening economic outlook*

Previous expectations of continued economic growth through 2020 have been tempered. COVID-19 proved to be the catalyst, amplified by concerns over the

significant decline in oil prices arising from the excess supply of crude oil globally.

Following weeks of lockdown to contain a further spread of the virus, some countries in SSA have gradually lifted restrictions, in order to revive their economies. Should this be successful, the impact of COVID-19 may be short-term. However, where there is a continuous increase in the number of confirmed cases, full lockdown could be reintroduced for extended periods. As such, aggregate demand may continue to suffer as consumers and businesses will be compelled to cut spending through the rest of the year.

The chart below shows the 2020 GDP forecast by IMF released in October 2019 (pre-COVID-19) and revised in April 2020 for the three selected countries. The revised forecast shows that the countries will fall into recession in 2020.



Overall, the IMF economic outlook shows the region’s economy will contract by 1.6% in 2020, a 5.2% downward revision from its October 2019 forecast. The countries in the region will be exposed to varying

degrees of economic contraction depending on the sector(s) driving economic activities. Less diversified economies, particularly oil dependent countries will be hit harder than well-diversified economies.

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

In the coming weeks, we expect more countries in the region to start re-opening factories and other businesses previously shut down. 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. This will also influence the timing of recovery of the equity markets.

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

**Equity return implications**

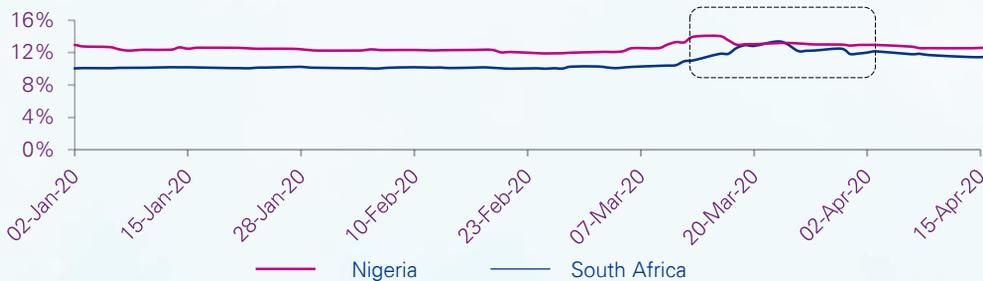
*Range of factors influencing equity returns*

In Nigeria, the 30-year bond yield increased from its low of 11.92% on 25 February 2020 to 14.06% on 16 March 2020. Similarly, in South Africa, the 30-year yield increased from its low on 26 February 2020 (10.07% p.a.) to 52 week high of 13.38% p.a. on 23 March 2020. South Africa was also downgraded by Moody's on 27 March 2020, which also contributed to the movement in bond yields.

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?

Investors may see equity risk as higher today than one month ago. However, where equity premiums have increased at a lower rate compared to the decline in risk-free rates, then absolute equity risk will remain high.

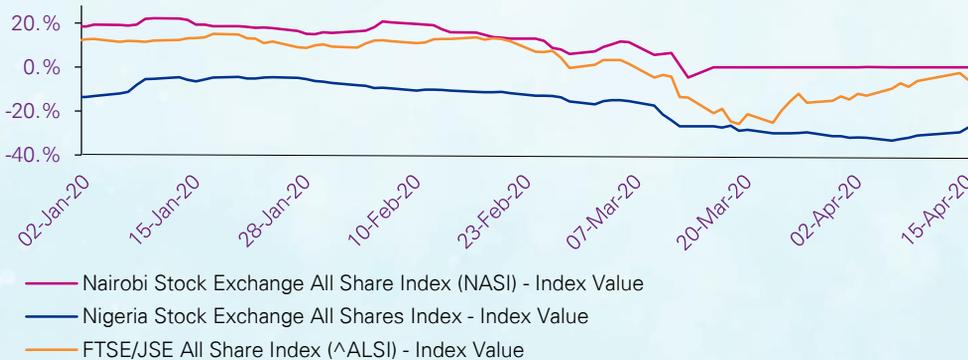
**South Africa and Nigeria 30-year government bond yields**



Source: Capital IQ and Bloomberg

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

**Stock market index**



Source: Capital IQ and Bloomberg

**JSE**  
2 Jan 2020 to 15 April 2020 = **16% decline**

**NSE**  
2 Jan 2020 to 15 April 2020 = **16% decline**

**NASI**  
2 Jan 2020 to 15 April 2020 = **18% decline**

### South Africa - Share performance of select sectors



Source: Bloomberg

**Sector average decline  
1 January 2020 to 15  
April 2020**

Top 15 financial companies:  
**37% decline**

Top 10 resource companies:  
**15% decline**

Top 25 industrial companies:  
**1% decline**

### Nigeria - Share performance of select sectors



Source: Bloomberg

**Sector average decline  
1 January 2020 to 15  
April 2020**

Oil and gas: **20% decline**

Banking: **19% decline**

Industrial: **8% decline**

Consumer goods: **41% decline**

The economic crisis arising from the pandemic has affected key sectors in SSA. There has been a general decline in the performance of sectoral indexes since late February as seen in the charts above. Investors, still uncertain about the magnitude of the impact of the pandemic in the region, have also moved funds out of the region's frontier and emerging markets. IMF regional report on SSA indicates that investors have pulled out a total of \$90 billion from emerging markets since the beginning of the crisis.

However, we see resilience in the performance of some sectors lately, such as industrial companies in Nigeria and South Africa. The intervention funds recently received from agencies such as IMF are expected to drive recovery of other key sectors, particularly consumer goods.

### Key valuation considerations

Key considerations in determining the impact of COVID-19 on valuation of investments:

- Sector specific impact: Is the industry defensive or cyclical?
- Target business specific impact: Among other things, how is the cash flow of the target affected?
- Effects of governmental support and stimulus packages: Is the target or its sector benefiting from any government stimulus package?

The above may be considered in view of the effects in the short term (length and effects of lockdown), in the medium term (pattern of recovery; V, U or L) and in the long term (sustainable change in business models or customer behaviours).

Other valuation considerations include:

#### *Valuation date*

Irrespective of the valuation date, whether it is pre or post-COVID-19, consideration for the impact of COVID-19 will depend on the purpose of the valuation:

- Financial reporting purposes: COVID-19 should be considered for 31 March 2020 but not for 31 December 2019
- Pricing analysis and financing purposes: For practical reasons, COVID-19 should be considered even if the valuation date is set as at 31 December 2019.

#### *Financial reporting and impairment considerations*

The COVID-19 outbreak may give rise to force majeure events or triggers which can be considered a catalyst for the impairment of goodwill and other long-lived assets. As a result, impairment assessments will come under scrutiny in forthcoming reporting periods. Evidence that the underlying financial information is prepared on a reasonable and supportable basis will be critical.

#### *Valuation deals*

High level of uncertainty in the global financial markets has led to lower valuation of privately held equity investments in affected sectors, hence, investors and buyers are reconsidering the timing of their planned deals.

#### *Cash flow projection*

Using the Discounted Cash Flow method will require considering either of the two approaches below;

- Traditional approach: This approach uses a single cash flow projection. The cost of capital will have to reflect the systematic risk (CAPM without alpha), unsystematic risk (alpha factor) and country risk premium. COVID-19 alpha cannot be quantified and will require professional judgement.

- The expected cash flow approach: This uses a multiple, probability weighted cash flow projections. Cost of capital will have to reflect systematic risk (without alphas), country risk premium with no additional alphas.

#### *Country risk premium (CRP)*

The IMF regional economic outlook for SSA shows sovereign spreads have increased by about 700 basis points since February 2020 reaching all-time highs, with the largest rise seen in oil exporters. For countries with a significant exposure to COVID-19 where effects may persist post-crisis, it may be necessary to consider shorter observation periods than the usual 2-year average.

#### *Multiples*

Multiples seem to be less relevant in times of COVID-19. It is important to analyse whether trading multiples of publicly listed companies already reflect metrics adjusted for COVID-19 impacts or not. Consistency is required between COVID-19 adjustments of the valuation subject entity and identified comparable public companies. Transaction multiples observed in pre-crisis times might be of limited reliability.

#### *Risk free rates and equity risk premium*

Risk free rate is expected to decrease as a result of monetary policies. Countries across SSA have taken measures to maintain liquidity in credit markets. Ultimately, decreasing risk free rate will lead to an increase in equity risk premium.

#### *Terminal value*

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. 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.

# Contact us

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**Ijeoma Emezie-Ezigbo**

Partner, Deal Advisory  
KPMG Nigeria  
**M:** +234 909 175 2186  
**E:** [ijeoma.emezie-ezigbo@ng.kpmg.com](mailto:ijeoma.emezie-ezigbo@ng.kpmg.com)



**Carswell Heather**

Partner, Deal Advisory  
KPMG South Africa  
**M:** +278 2718 5635  
**E:** [heather.carswell@kpmg.co.za](mailto:heather.carswell@kpmg.co.za)



**Anuoluwapo Osikomaiya**

Manager, Deal Advisory  
KPMG Nigeria  
**M:** +234 806 051 3417  
**E:** [anuoluwapo.osikomaiya@ng.kpmg.com](mailto:anuoluwapo.osikomaiya@ng.kpmg.com)

## Contributors

Oluwatobi Akeju  
*Senior Associate, KPMG Nigeria*

John Okwute  
*Experienced Analyst, KPMG Nigeria*

[home.kpmg/ng](http://home.kpmg/ng)  
[home.kpmg/socialmedia](http://home.kpmg/socialmedia)



[kpmg.com/app](http://kpmg.com/app)



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