The global COVID-19 pandemic has presented new challenges and opportunities across all industries, none more so than the UK Consumer & Retail sector. As a ‘triggering event’ for impairment, COVID-19 has brought International Accounting Standard (IAS) 36 to the forefront of increasing auditor scrutiny. Whilst the short-term impact on earnings and the divide between winners and losers is now evident, the medium to long term outlook for companies within this sector remains highly speculative.

More than a year on from the start of the global pandemic in March 2020, the sector remains materially impacted by global restrictions and closures, with the latest twelve months’ financials decreased below pre-COVID levels by up to 90 percent. The recovery shape is by no means sector generic, but depends on a number of retailer-specific metrics such as: online vs bricks and mortar exposure; access to prime vs secondary shopping locations; customer experience; reliance on substantial footfall in stores; mix of categories and occasional vs day to day shopping; target audience and their future shopping habits. The impact on annual impairment testing exercises is becoming increasingly complex as a consequence.

Managing such complexities requires robust consideration of technical valuation theory, individual facts and commercial overlay in order to bridge the gap between valuations and IAS 36. KPMG’s Valuation specialists would be happy to discuss and share their experiences to help you navigate through the challenges highlighted below.

Companies have to perform annual testing of their, often significant, amounts of goodwill and assets for potential impairment where a ‘triggering event’ exists. In light of the global COVID-19 pandemic, most companies within the Consumer & Retail sector have witnessed a drastic decline in financial performance, adding pressure to such exercises and increasing auditor scrutiny on sensitivities and conclusions reached.

### 1. Financial forecasts

At the forefront of an impairment testing exercise is undoubtedly the financial forecasts. IAS 36 suggests the use of up to five years financial forecasts unless a longer period can be justified. The five years of explicit forecasts are expected to provide sufficient room to determine "steady state" earnings before applying a Terminal Value assumption, whereby Terminal Value is often representative of more than half of the overall value. In times of increased uncertainty due to the global pandemic, it has become even more important to accurately estimate the “steady state” level of earnings, which may require an extension of the explicit forecast period beyond the company’s regular forecast period. This often brings significant practical challenges associated with building such a forecast.

Whilst management teams are well versed in forecasting exercises, a 1-3 years planning horizon is typically considered for internal strategic reporting purposes. Extending these forecasts plus incorporating assumptions which appropriately capture growth and profitability reflective of a “new normal” in this volatile climate presents a challenge for any seasoned analyst. Indeed an analysis of broker forecasts and consensuses across Financial Times Stock Exchange (FTSE) 350 Consumer and Retail companies doesn’t paint a clear picture (see chart below); with the assumed length of COVID-19 recovery periods, growth expectations and earnings diverging significantly between businesses even within the same sub-sectors.

Due consideration should be given to the impact on forecasts of i) reorganisations, ii) changes to the business model and iii) consumer behaviour (including the rapid switch to online), as well as the impact of these items on the company’s “steady state” earnings and Terminal Value assumptions. Businesses and their auditors need to be comfortable that the impairment results ultimately make sense given longer term expectations of a recovery. This remains particularly important for impairment testing at both the overall goodwill and/or store cash generating unit (CGU) level; where balance sheet assets acquired pre-COVID are effectively tested against volatile earnings projections in a post-COVID-19 era.

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**Re-Based EPS forecast (Consumer & Retail FTSE 350)**

![EPS forecast chart](chart.png)

**Source:** Capital IQ as at 1 June 2021

**Notes:**
1. Earnings per share (EPS) has been Re-Based to Calendar Year 2019 EPS, with estimates derived from Capital IQ broker consensus data.
2. Sub-sector lines represent the Median Re-Based EPS movement from Calendar Year 2019.

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Complicating the position further, is the adoption of International Financial Reporting Standard (IFRS) 16 in a pre-COVID environment, especially for those companies with significant exposure to physical stores. The initial recognition of leases under the IFRS 16 standard, in most cases, would have occurred pre-COVID-19. Lease liabilities and Right of Use (ROU) assets would have been initially recognised by reference to the present value of future lease payments which, amongst other things, considers potential renewals of lease terms in the future. Going forward, lease liabilities cannot be restated or adjusted unless there is a change to the underlying contractual terms affecting future lease payments, whereas the ROU assets are tested for impairment when there is an indication of a potential impairment or presence of a triggering event.

This again presents a challenge in the context of impairment – in particular for traditional store-based enterprises. Cash flow and earnings projections will need to be commensurate with the commercial conditions underpinning the lease renewal assumptions initially considered on adoption of IFRS 16, in order to avoid a mis-match. This is difficult to reconcile with the current economic climate and change in industry direction, which may result in an ROU asset balance being tested against a comparatively suppressed value in use (VIU).

Businesses should seek to understand the materiality of their IFRS 16 lease balances in light of current commercial developments to consider whether an impairment is required on ROU assets. Particular questions in this context may include:

— What is a sustainable leverage for the company or can the company afford current levels of lease payments in the post COVID-19 environment?

— How such assumed leverage may be aligned with those observed from other listed comparable companies and what is the corresponding assumption to consider within the discount rates for IAS 36?

— If lease renewals were reflected in the lease liabilities and the ROU assets, is a re-assessment of assumed lease renewals underpinning lease liabilities under a substantial terms amendment warranted?

— Would a valuation on a pre-IFRS 16 basis lead to a similar conclusion on potential impairment?

2. The Weighted Average Cost of Capital

The Weighted Average Cost of Capital (WACC) is a focal point of auditor scrutiny and remains a difficult input for businesses to justify given the subjectivity around core discount rate assumptions. A key concept to ensure is that the WACC utilised does not represent a company specific WACC, but a WACC derived on a 'Market Participant' basis; determined by reference to comparable benchmark company data.

The impact of COVID-19 on discount rates is twofold; with greater uncertainty, comes greater volatility causing equity values to decrease (and implied cost of equity to increase). Economic uncertainty stemming from the pandemic has simultaneously resulted in risk free rates of almost all countries decreasing in recent months, as governments seek to support the economy with liquidity programmes (decreasing cost of equity). IFRS 16 once again muddies the waters, with benchmark companies recognising differing amounts of lease liabilities, which leads to variations in the equity risk observed in betas.

Although market risk premiums, risk free rates and beta factors are (often) derived from longer term data, the near to medium term volatility as a result of COVID-19 should not be ignored. The combination of COVID-19 induced instability and recent adoption of IFRS 16, has resulted in a larger range of potential market participant WACC inputs to apply to businesses across the Consumer and Retail sector. Thus increasing the likelihood of auditors deriving a materially different WACC for the purpose of impairment testing – the extremities of which may make or break an impairment being recognized. Consequently, WACC assumptions should be carefully studied, justified and documented by management.

The derivation and collation of market based WACC inputs is a well oiled spreadsheet for many valuation practitioners. However in this transitional period, one must not forget to step back from the data to identify and remove the noise impacting key long-term assumptions. Specific examples of which may include:
What is the long-term beta factor for the company, especially taking into account the fact that the recent data will likely be impacted by COVID-19 disruption? For example, beta factors for food companies and supermarkets may have been exceptionally low during the initial months of the COVID-19 pandemic given that the respective share prices would have benefited from the pandemic. Other examples of atypical betas may include stressed or distressed companies or those with exceptionally high leverage.

In times of increased volatility and forecast uncertainty, combined with lower government bond yields, the market risk premium may need an upwards adjustment to accurately reflect the prevailing and longer-term expected equity returns on a diversified assets portfolio.

What is a sensible level of a long-term leverage for my company? In the post-IFRS 16 world, leverage would include lease liabilities and may therefore show a greater spread due to different levels of exposure to stores or in-house manufacturing. Furthermore, the length of leases, including potential lease extensions, will impact the resulting leverage significantly.

As with all key issues highlighted in this paper, the derived WACC and implied level of risk and return should achieve consistency with the underlying cash flows to be discounted, in addition to cross-checks performed. As noted previously, there is a significant divergence in broker estimates for companies within the Consumer & Retail sector. An inherent mismatch therefore arises when deriving a market participant based WACC and comparable multiples from such companies which are intrinsically linked to future estimated performance. Further analysis should be undertaken to compare comparable company cashflow estimates to managements VIU forecasts; identifying underlying differences in risks and COVID-19 recovery reflected in the cashflows to enable an adequate calibration of overall WACC conclusions.

In light of greater judgements being required with respect to volatility of cash flows and discount rates, now more than ever, the ‘Cross-Check’ has become a crucial litmus test for businesses and their auditors to sense check impairment testing results.

In the case of listed companies, a reconciliation of VIU to market capitalisation is often performed, with further sense checks of implied VIU multiples to benchmark company multiples.

Such an exercise has become inherently difficult on the backdrop of differing COVID-19 recovery profiles between benchmark companies and any given company specific forecast reflecting the ‘new normal’. This has driven an increase in the spread of multiples observed on a forward looking basis (see chart below) and more often than not, requires businesses to pay closer attention to the drivers behind such variances to defend to their auditors the veracity of both financial forecasts and WACC assumptions prepared.
Pre Covid vs Post Covid multiples (Consumer & Retail FTSE 350)

Source: Capital IQ as at 1 June 2021.
Notes: (1) Multiples have been calculated on a Calendar Year basis, utilising observed Enterprise Values as at 1 June 2021, multiples presented above represent median multiples, with the size of the circle indicating the spread in multiples observed.

Given the impact of COVID-19, a careful assessment of multiples for cross-check purposes is required, including:

— The calendarisation of traditional financial-year based multiples observed between comparable companies identified, to remove the differentials in COVID-impacted financial performance periods and enable a like for like comparison of profitability and growth.

— Identification and adjustment of net debt, Enterprise Value and earnings before interest tax depreciation and amortisation (EBITDA) in consideration of non-IFRS based or identified overseas comparators with dissimilar lease accounting standards to IFRS 16.

— Enhanced consideration of both forward post-COVID and historical pre-COVID multiples in light of substantial deviations between actual COVID-19 impact on comparable company performance and the estimated shape and length of a post-COVID recovery going forwards.

Takeaways

Estimating fair value requires significant informed judgement at the best of times, with the story behind each valuation being just as important as the accompanying technical analysis. As we transition towards a new normal, further deliberation of both qualitative and quantitative elements will now be required to conclude on a robust valuation position.

Whilst COVID-19 may not necessarily result in an impairment per se, the complexity of issues at hand often leads to unusual results and diverging viewpoints between internal management and external auditors. KPMG has helped multiple players within the Consumer & Retail sector make sense of their impairment testing results; working side by side with both management and audit teams to connect the dots between individual 5 Year Plans, WACC assumptions and audit requirements.

Our Valuation specialists are happy to share latest views and experiences to help you navigate through, and provide further insight into, the current challenges surrounding IAS 36.

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