Assessing your Cost of Capital in a COVID-19 world

Non-executive directors, along with their management teams, are rightly considering the impact of the current economic crisis on the cost of capital. This issue is particularly relevant in relation to impairment tests that companies need to complete as part of their year-end reporting routines.

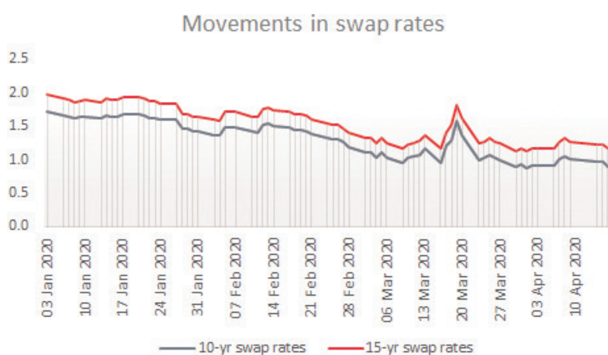
Companies that are currently preparing their financial reports are in a particularly difficult position. The sharp and serious economic downturn is the result of the COVID-19 global public health crisis and there are no precedents that can be used to model impacts on individual companies. The current downturn:

- has been sudden and is likely to be extremely significant (Treasury has estimated that the decline in New Zealand's GDP for the year to March 2021 could be between 13% and 33%); and
- is expected to be long lasting (loss of GDP for New Zealand is estimated to be between 6% and 13% over the next five years).

In six months' time, the impacts of the COVID-19 public health crisis may be clearer, and it may become easier for companies to forecast. At present, we believe that the most appropriate approach is to develop multiple forecasts that are based on the broader macroeconomic environment and expected sector impacts, meaning that a range of scenarios should be considered, rather than just a single forecast. However, even the Treasury acknowledges that it is very difficult, if not impossible, to develop scenarios with any degree of confidence right at the moment. This is the situation for many companies as management seek to understand impacts on customer demand, distribution channels in New Zealand and overseas, supply chain, employees and the availability of capital, both debt and equity.

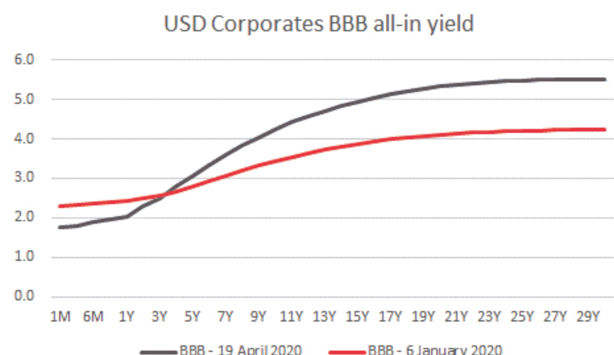
This pervasive uncertainty translates to greater risk and an increase in the required rates of return demanded by investors as they consider a wide range of possible future outcomes for their investments. As a result, we do not believe that the decline in risk free rates[1] will lead to a decline in the cost of capital (see Figure 1). The increased risk premium is evidenced in the approximately 1% increase in yields on BBB rated US long term corporate bonds since the start of the calendar year (see Figure 2).

Figure 1



Data source: Reserve Bank of New Zealand

Figure 2



Data source: S&P Capital IQ

[1] Long term swap rates have declined by approx. 0.6% p.a. between January and April 2020

Betas and estimates of the market risk premium (MRP) are long-term measures and our view is that these estimates do not need to be altered. Betas are measured over periods ranging from two to five years and the current market volatility will have little impact on calculated betas. The MRP is measured over a much longer period[2] that includes several economic cycles and, although the range of the "true" MRP is quite wide, we do not believe that there is sufficient evidence to justify any change to the estimated MRP.

The decline in risk free rates is also partly offset by higher borrowing costs and higher debt-equity ratios resulting from a decline in equity values (i.e. market capitalisations for many listed companies have decreased, the NZX50 is down 9% since mid-January and likewise the ASX200 is down 23%). Higher leverage due to a decline in equity values will, all else equal, result in higher equity betas, increasing the cost of equity. And with our tax imputation regime, debt is not tax advantaged relative to equity, meaning that the overall cost of capital does not change with changes to the debt-equity ratios within a reasonably wide range.

It may be appropriate to add a further risk premium to the cost of equity to take account of the increased uncertainty. However, care will have to be taken to avoid double counting risks, especially if cash flows are adjusted to reflect lower expected earnings. Whether or not an additional risk premium is appropriate depends on the issues facing the sector, the range of outcomes considered and the central estimate (or "base case scenario) put forward by management.

In summary:

- Management should prepare a set of forecasts that reflect a range of plausible scenarios that are based on a broad consideration of macroeconomic and sectoral outcomes.
- The cost of capital has not reduced merely because risk free rates have declined. Investors are facing greater risk and uncertainty.
- Borrowing costs appear to be higher and leverage ratios will increase.
- It is therefore likely that the cost of capital will have increased for many companies.
- It may be necessary to add an additional risk premium, especially in the short term, to take account of the inherent uncertainty in future outcomes.

Adding a specific risk premium rather than adjusting parameters like the MRP is a more transparent approach that allows management and the directors to have a better conversation on the outcomes of impairment tests. It also allows the company to remove the additional risk premium once market conditions settle and forecasting becomes easier.

For advice and to further discuss the impact of the current economic crisis on the cost of capital, particularly in relation to impairment tests to be completed for year-end reporting, please get in touch. In the first instance please contact any of:

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[2] An estimate that is commonly used in New Zealand and has been measured over an 80 year period.

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