The global spread of the Coronavirus Disease 2019 ("COVID-19") is having a significant impact on the global economy and financial markets. At the same time, geopolitical forces have driven nominal oil prices to lows not seen since 1999.

These market movements present valuation challenges for infrastructure fund managers. As investors look to measure fair value during these volatile times, KPMG is here to help and provide market insights.

**Public equities sell off**

The spread of COVID-19 has brought businesses, cities, and almost entire countries to a standstill. Public equities reacted aggressively by shedding three years of gains in just a few volatile weeks as investors contemplated recession fears and shutdown-related earnings misses. In mid-February the S&P 500 index peaked at an all-time high of 3,393, with the index falling to as low as 2,192 just over a month later. The CBOE Volatility Index (VIX) topped at over 82 in mid-March, up from just the mid-teens a month earlier.

In the infrastructure space, public regulated water utilities have been modestly adversely impacted as of March 31st, 2020 whereas public independent power producers have been hit hard. The following charts illustrate the quarter-over-quarter change in the broader public equity market as well as certain sectors of the infrastructure market.

KPMG’s Chief Economist’s base case forecast suggests a 12 percent drop in Q1 global GDP, a 25 percent earnings drop for the S&P 500, and preliminary analysis suggests a 4.3 percent drop in US GDP in 2020.¹ Despite Congress approving a $2.2 trillion stimulus package, uncertainty over the human and economic toll of COVID-19 remains extremely high.

¹ See KPMG’s complete economic impact analysis here: https://www.kpmg.us/content/dam/kpmg/pdf/2020/covid-19-impact.pdf
COVID-19 and infrastructure private equity valuations

April 9, 2020

Sector Average % Change in Q1 2020

<table>
<thead>
<tr>
<th>Sector</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulated Water Utilities</td>
<td>-3.2%</td>
</tr>
<tr>
<td>Renewables</td>
<td>-8.7%</td>
</tr>
<tr>
<td>Regulated Power Utilities</td>
<td>-12.5%</td>
</tr>
<tr>
<td>Rail</td>
<td>-22.7%</td>
</tr>
<tr>
<td>Infrastructure Funds</td>
<td>-23.7%</td>
</tr>
<tr>
<td>IPPS</td>
<td>-31.2%</td>
</tr>
</tbody>
</table>

Private equity correlation to public markets

Based on U.S. private equity quarterly return data published by Cambridge Associates in its U.S. Private Equity Index, and S&P 500 index data sourced from S&P Capital IQ, the 10-year correlation of private equity to the S&P 500 was approximately 0.77. Other correlation estimates to public equities have been observed in the 0.6 to 0.9 range.

In a March 16th publication, “COVID-19, the Sell-Everything Trade, and the Impact on Private Markets” Morningstar’s Pitchbook research reported that private equity trailed public markets in 24 of the 28 quarters where the S&P 500 was up by more than 5%, and private equity outperformed public markets in all 21 quarters where the S&P total return was negative.

While this information provides broad directional information, there are a number of considerations market participants should evaluate when valuing private equity during volatile markets.

Valuation considerations

The fair value standard for financial reporting is defined as “[t]he price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

Understanding market conditions, market participant assumptions, what constitutes an orderly transaction, and what is known and knowable at the measurement date remain the guiding principles.

Attention must be paid to appropriately adjust inputs and assumptions to reflect changes in the underlying business outlook as well as market-driven assumptions as viewed by market participants.

Changes to assumptions should be well documented with solid logical underpinnings.

Evaluate the subject business or asset

Consider how the company or asset is positioned and the degree that it could be impacted by the recent economic developments. Some factors to evaluate in the infrastructure sector include:

Nature of revenues. It is important to consider whether revenue is variable or contracted in nature. Infrastructure assets that have contracted revenue may not expect to experience a reduction in cash inflows in the short-term whereas assets that have variable revenue sources may. Public-private partnership investors with exposure to toll road investments that have a demand-based revenue structure, for example, may be negatively impacted in the short-term by reduced travel.

Assets that have contracted revenue may fair better than their variable revenue counterparts but may not be completely insulated from increased risk. Infrastructure investors with renewable energy assets in their portfolio could have offtake agreements in place, such as power purchase agreements, which provide for a stable revenue source through the contract period. However, it is important to evaluate whether the credit profile of the offtaker has declined, which could increase the risk of defaulting on the contract.

https://www.cambridgeassociates.com/private-investment-benchmarks/


Stage of the company/asset. Infrastructure assets that are in development or construction phase may face the prospect of delays to completion as a result of the current environment. Ordinarily these projects, such as airports, toll roads, power plants, etc. “de-risk” as certain development/construction milestones are achieved, resulting in a lowering of the development/construction premium in a discounted cash flow analysis. Facing greater uncertainty on timing for completion as a result of the current market environment could push out the timing for achieving revenue as well as result in higher construction/development risk premium, or slower rate of decline in such premium. Both of these factors could result in depressed asset value.

Exposure to macroeconomic and geopolitical factors. Companies that face adverse macroeconomic factors, such as those that have revenues that are exposed to the price of oil, may face the prospect of substantially lower revenues for the foreseeable future. Infrastructure assets can be exposed to geopolitical factors as well. Consider a port company which may suffer revenue declines associated with lower GDP and government-driven bans on accepting imports by countries especially hard hit by the COVID-19 virus.

Update the forecast
Significant effort should be expended to consider the specific drivers and assumptions to arrive at adjusted forecasted cash flows. Consider if the disruption could result in permanent loss in growth and/or the potential shape and tenor of a recovery.

There are undoubtedly more unknowns and thus greater difficulty in forecasting relative to a stable market.

Adjust the discount rate
Discount rates should be adjusted for additional idiosyncratic risk to be commensurate with the company’s or assets’ expected ability to achieve the updated forecast. Consider the factors above in estimating risk.

As a result of the Federal Reserve’s emergency move to cut rates to near zero, risk free rates are lower which could create a downward effect on discount rates under a CAPM framework, when market participants are clearly requiring higher returns for risk taking. Consider adjusting other inputs to the CAPM, such as the asset/company specific premium and the equity risk premium for CAPM-derived discount rates.

Credit spreads have widened across the credit spectrum, and Standard & Poor’s and Moody’s have announced a wave of anticipated credit rating downgrades in the near term. Consider any potential changes in cost of debt capital.

Consider the investment time horizon
Private equity investing is typically characterized by a time horizon focused on long-term planning and long-term return expectations. Consider how the current market could change the investment horizon, return requirements, exit valuation assumptions, and the pool of market participants.

Consider that investors in the public market are sometimes subject to short-term liquidity needs and other technical factors that are not as present in the private markets, which could mitigate fair value volatility for private equity investments relative to public equities.

Evaluate weighting of valuation indications
Consideration should be given to how market participants consider valuation input data from the various valuation approaches by evaluating the relative merits of each. Consider the quality of inputs, the estimation error, and the depth and liquidity of the market inputs. Reflective questions like: is transaction data outdated, or is there more or less confidence in cash flows than before, should be part of the normal quarterly valuation process.

Use caution with forward multiples
Ensure that both the numerator (e.g. total enterprise value) and the denominator (the performance metric, (e.g., EBITDA) of the forward multiple are contained in the same frame of reference. Market data is updated daily, but forward estimates are not. Ensure that the metric has been adjusted for COVID-19 impacts, otherwise forward multiples may be understated in the event of a sudden market drop.

Calibration is still key
In the AICPA’s guide, entitled Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies calibration may help explain fair value. Valuation assumptions may be calibrated from the last observable fair value market indication (i.e., an arm’s length transaction in the company’s securities) to the measurement date. Even in a market dislocation, calibration provides valuable context for relative quarter-over-quarter movements, and a framework for assessing changes in company or asset performance and markets.
In these volatile times, choosing an adviser requires a firm that has the technical skills and practical experience to provide sound, objective, and independent advice. KPMG’s professionals provide that experience and knowledge along with a trusted name, and can help market participants meet their valuation needs through this challenging time.

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