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GYF BUSINESS VALUATION &
LITIGATION SUPPORT SERVICES GROUP



GYF VIRTUAL CPE DAY 2020
November 12, 2020



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***Navigating Business Valuation
in Times of Uncertainty***



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INTRODUCTION

Navigating Business Valuation in Times of Uncertainty



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INTRODUCTION

Three Great Unknowns for Business Valuation

1. The short-term, mid-term and long-term health and economic effects of Coronavirus (COVID-19)
2. The short-term, mid-term and long-term economic effects of the stimulus packages offered by Congress and the Administration in response to Coronavirus (COVID-19)
3. The short-term, mid-term and long-term effects associated with the results of the Presidential and other elections



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INTRODUCTION

Associated Problems/Issues for Business Valuation

- Eroding consumer confidence
- Slowing employment growth
- Shrinking income as unemployment benefits expire
- As-of-yet unconfirmed permanent changes in consumer behavior
- Uncertainty with respect to the virus and the vaccine



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INTRODUCTION

Facing the Unknown

- For many companies, the problem is longer-term solvency, given possible fallout from the shutdown
- The significant unknowns present the most challenging issues for managing a company through the pandemic and beyond
- The significant unknowns are equally challenging for those being asked to value these businesses



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INTRODUCTION

Critical Planning Opportunities

- With respect to equity valuation, the current circumstances, as dire as they might seem, present opportunities with respect to:
 - *Estate and gift tax matters*
 - *Litigation matters involving valuation issues (shareholder buyouts, divorce)*
 - *Business mergers & acquisitions*



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BACKGROUND



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BACKGROUND

Brief Refresher on Value and Valuation

- All value is “forward looking”
- Valuators must focus on what is “known or knowable” at the date of valuation
- Valuation is fundamentally risk assessment and measurement, with risk considered in three primary areas:
 - *Expected future economic benefits (free cash flows)*
 - *The risk rate associated with those future economic benefits*
 - *Specific equity interest attribute discounts/premiums*



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BACKGROUND

Impact of COVID-19

- As a result of where the economy currently stands, businesses may face a broad spectrum of unanticipated challenges:

| | |
|-----------------------------------|---|
| – <i>Supply chain disruptions</i> | – <i>Reduced cash flows</i> |
| – <i>Labor shortages</i> | – <i>Inability to obtain credit</i> |
| – <i>Revenue declines</i> | – <i>Inability to continue as a going concern</i> |
| – <i>Increase in bad debts</i> | |



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BACKGROUND

Impact of COVID-19

- Three steps to assessing value in the COVID-19 world:
 1. *Develop an intimate understanding of the economic effects of the pandemic on the subject company in the current year (2020)*
 2. *Develop an understanding of the economic effects of the pandemic on the subject company in the recovery period (2021, 2022, 2023?)*
 3. *Develop an understanding of that period in the future when constant growth and normalcy returns for the subject company's operations (terminal year)*



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BACKGROUND

Impact of COVID-19

- Applying the 3-step approach will require careful prognostication on the part of business valuers
 - *Most economists and commentators are expecting a gradual return for the economy to a level of normalcy*
 - *The challenge will be to develop a strong understanding of the economic effects of the pandemic for 2020 and into the future*
 - *What happens if a vaccine is delayed or if there is a severe second wave of the virus in 2021*



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BACKGROUND

Topics to Be Covered:

- Date of Valuation Considerations
- Valuation Methodologies
- Valuation Discounts
- Current Issues Affecting Valuation
- Valuation Opportunities
- Conclusions and Practical Considerations



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DATE OF VALUATION CONSIDERATIONS

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DATE OF VALUATION CONSIDERATIONS

Critical element of any valuation project

- What is “known or knowable” at effective date
 - *Most valuers believe that the impact of COVID-19 must be included in valuations with dates beginning in late February 2020*
- What about subsequent events?
 - *How are they considered, if at all?*



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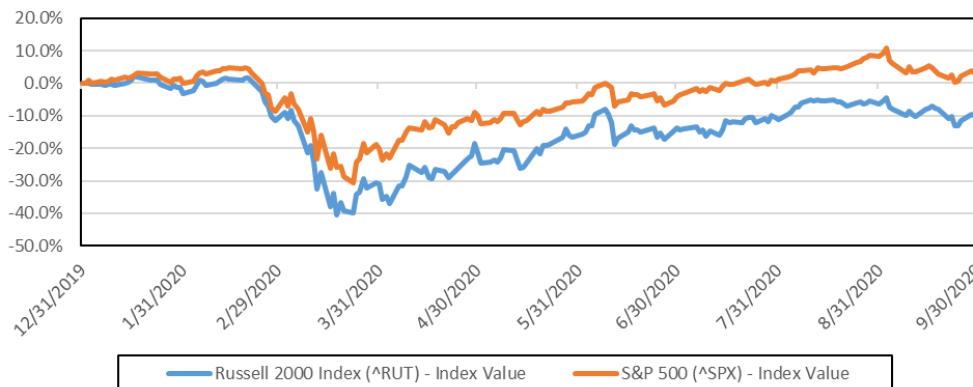
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DATE OF VALUATION CONSIDERATIONS

Index Performance - 2020 YTD



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DATE OF VALUATION CONSIDERATIONS

Impact of COVID-19 on Date of Valuation

- Valuation is a process of risk assessment at any date of valuation
- Valuation is point-in-time specific
- A 2020 date of valuation carries with it many complex and difficult judgment(s) by the valuator with respect to what may have been “known or knowable” at any particular date



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DATE OF VALUATION CONSIDERATIONS

Impact of COVID-19 on Date of Valuation


- Earlier dates of valuation in 2020, corresponding with specific federal and state mandates shutting down parts of the economy, would seem to have the greatest risk
- A date of valuation subsequent to the release of the results of the Presidential election must consider the impact of the election results on specific industries, the economy, and public markets




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VALUATION METHODOLOGIES


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VALUATION METHODOLOGIES

Income Approach

- Primary drivers for calculating value:
 - Numerator: *Future expected economic benefit stream*
 - Denominator: *Risk associated with realization of future economic benefits*
- Perhaps the most direct means of incorporating forward-looking valuation concepts into the estimation of value



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VALUATION METHODOLOGIES

Income Approach

- Two primary methodologies:
 1. *Discounted future economic benefit (cash flow) method (DCF)*
 - Series of calculations over a discrete period with terminal value
 2. *Capitalized future economic benefit method (CCF)*
 - Single calculation with growth presumed to be constant
- Both methods are based on forward-looking inputs



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VALUATION METHODOLOGIES

Income Approach – Numerator

- Future revenue and expenses will in many cases experience fluctuations from historical results
 - *Increased emphasis will be placed on Management-prepared forecasts*
 - *Risk is best handled in the development of the future expected economic benefit streams*
 - *It is incumbent upon the valuator to do more than just accept Management's forecasts carte blanche*



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VALUATION METHODOLOGIES

Income Approach – Denominator

- The discount rate is selected to align the relative risk associated with an investment in the subject entity compared to alternative investment options and their associated rates of return
- The discount rate must consider the factors Management included in the forecasts (but not “overlap”)
- Times of crisis with extraordinary market volatility require valuers to view the inputs in the development of the risk rate through a different lens



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VALUATION METHODOLOGIES

Income Approach – Denominator

- Under the Build Up Model

$$k_e = R_f + ERP + R_s + CSR_P$$

where,

k_e = equity cost of capital

R_f = risk-free rate

ERP = equity risk premium

R_s = size premium

CSR_P = company-specific risk premium



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VALUATION METHODOLOGIES

Income Approach – Denominator

- Current Issues
 - *Additional risk in receipt of future cash flows for many businesses*
 - *Risk Free Rate – 20-year Treasury Bond rate*
 - *Most valuers are adding additional risk into the company-specific risk premium*
 - *Must be careful to ensure that risk anticipated in applying an additional CSRFP is not double counted*



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VALUATION METHODOLOGIES

Income Approach – Method Selection

- DCF versus CCF
 - *Use of a single period CCF poses a variety of issues*
 - *Subject company's history may have no relevance to the future expectations*
 - *The best solution is to use a multi-period DCF model which allows for varying levels of growth*



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VALUATION METHODOLOGIES

Income Approach – Final Thoughts

- Application of the income approach for dates of valuation post-COVID-19 will continue to be challenging
- Changes occurring regionally, nationally and globally are material and fluid
- Adjustments need to be made to both the numerator and the denominator in the income approach calculation, however, care must be taken to avoid duplication



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VALUATION METHODOLOGIES

Market Approach

- Predicated on the concept of comparability
- Basic equation underlying the market approach

$$\text{Equity Value} = [(\text{Price/Parameter})_{\text{comp}} * \text{Parameter}_{\text{subject}}] - \text{Debt}_{\text{subject}}$$
- Can lead to incorrect conclusions of value due to:
 - *Limited availability of quality data*
 - *Difficulty in properly assessing and applying data*
 - *Misapplication due to lack of sufficient similarity*



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VALUATION METHODOLOGIES

Market Approach

- Guideline Public Company Method
 - *Public market multiples may not be entirely relevant*
 - *Multiples applied to historical earnings may no longer be relevant*
 - *Proper application will vary depending on the date of valuation*
 - Before late-February 2020 COVID-19 news: it is best to apply the GPCM in the same way normal guidance would dictate
 - After late-February: valuation will require consideration of forward-looking multiples



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VALUATION METHODOLOGIES

Market Approach

- Guideline Completed Transaction Method
 - *Focuses on observances of value indicators produced through closed and completed acquisitions*
 - *Valuators will want to carefully consider the use of multiples derived from transactions occurring during and in the wake of this crisis*
 - *Typically used as a confirming, rather than primary method*



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VALUATION METHODOLOGIES

Market Approach

- Primary issues for valuator consideration using GCTM
 - *During 2020, very few transactions are available*
 - *Reconciliation of pre-COVID-19 transactions and post-COVID-19 assessment are difficult, at best*
 - *How best to modify pre-COVID-19 multiples for the effects of COVID-19*



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VALUATION METHODOLOGIES

Market Approach

- Primary issues for valuator consideration using GPCM
 - *As of October 31, 2020, stock market values have held fairly strong*
 - *Interpreting public market response to the economic effects of the COVID-19 pandemic is necessary to ensure that the subject company will act similarly*



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VALUATION METHODOLOGIES

Cost/Asset Approach

- Determination of value predicated upon assessment of each asset and liability on a company’s balance sheet
- Used most often where value of equity is based on value of underlying assets – holding companies
- May need to consider cost/asset approach in situations where the value on a going concern basis is less than the appraised asset values (net of liabilities) but greater than orderly liquidation value



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VALUATION DISCOUNTS



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VALUATION DISCOUNTS

General Considerations

- Discounts are required to reconcile value conclusions from the use of imperfect methodologies to the subject interest under valuation
- Numerous internal and external factors can affect the application and the size of a discount
- There are no prescribed ranges of discounts



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VALUATION DISCOUNTS

Discount for Lack of Marketability

- “An amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability”
- Privately held businesses generally lack a ready market and are historically difficult to sell
 - *The COVID-19 environment adds greater risk and likely makes marketability even more difficult*
 - *Question is how best to quantify this additional risk for lack of marketability*



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VALUATION DISCOUNTS

Discount for Lack of Marketability

- There has been an increase in price volatility and uncertainty surrounding sustainability of business operations
- Expected distributions and dividends can heavily influence the level of the discount for lack of marketability
- Lower future expected distributions and dividends (investment yield) would bode for lower non-controlling interest values



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VALUATION DISCOUNTS

Discount for Lack of Control


- “An amount or percentage deducted from the value of an ownership interest to reflect the relative absence of control perquisites”
 - *Inability to elect directors, appoint management or set policies*
 - *Inability to determine cash distributions/dividends*
 - *Inability to determine when and how to sell the company*
- The question arises as to whether an absence of control attribute in a subject equity interest causes the value to be less




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CURRENT ISSUES AFFECTING VALUATION

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CURRENT ISSUES AFFECTING VALUATION

The Effect of the CARES Act on Valuation

- Key Elements
 - *Paycheck Protection Program (PPP) loans*
 - *Emergency Economic Injury grants*
 - *Economic Injury Disaster Loan (EIDL) program*
 - *Modification of the IRC §163(j) interest limitation*
 - *Bonus depreciation clarification (retail glitch clean-up)*
 - *Temporary repeal of the 80% limitation for NOLs*



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CURRENT ISSUES AFFECTING VALUATION

The Effect of the CARES Act on Valuation

▪ Key Elements

- *Addition of a five-year carryback for NOLs for losses incurred in 2018, 2019 and 2020*
- *Temporary repeal of excess loss limitations on non-corporate taxpayers if the loss amount exceeds \$250,000 (\$500,000 MFJ)*
- *Employee Retention Credits*
- *Employer Payroll Tax Delay (employer share of the social security tax)*



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CURRENT ISSUES AFFECTING VALUATION

Subsequent Events


- The following should be addressed in within a valuation report's subsequent event disclosure:
 - *Uncertainties associated with the economic ramifications of the COVID-19 pandemic*
 - *The application of certain provisions of the CARES Act*
 - *Potential changes in federal income tax law (if deemed appropriate)*




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VALUATION OPPORTUNITIES




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VALUATION OPPORTUNITIES

Estate Planning Opportunities


“Be fearful when others are greedy and greedy when others are fearful”

– Warren Buffet

- The global pandemic and current political climate combine to create significant estate planning opportunities



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VALUATION OPPORTUNITIES

Estate and Gift Planning Valuations

- Date of Valuation – Gifting
 - *Date is strategically chosen by taxpayer through guidance from legal counsel*
 - *Impacting factors for date selection:*
 - Investment risk is greatly increased
 - Valuation discounts, namely the DLOM, have increased
 - Current tax environment and proposed changes to estate and gift tax laws



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VALUATION OPPORTUNITIES

Business Mergers & Acquisitions

- Quickly transitioning from a long-running sellers' market to one favoring buyers
- Value creation in deal making is now more critical than ever
- Likely to see an increase in sellers willing to offer financing to bridge capital needs that may not be currently available from third parties



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VALUATION OPPORTUNITIES

Exit Planning

- Exits may be delayed, transactions put on hold
- Additional runway may be needed for planning purposes
- Business owners may need to explore other planning options



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CONCLUSIONS & PRACTICAL CONSIDERATIONS



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CONCLUSIONS & PRACTICAL CONSIDERATIONS

Final Thoughts

- The value of many privately held businesses will be negatively impacted by the COVID-19 crisis
 - *At one end of the spectrum will be companies experiencing a minor or temporary decline in value*
 - *At the other end, the decline in value will be significant and potentially permanent*



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CONCLUSIONS & PRACTICAL CONSIDERATIONS

Final Thoughts

- Any opinion of value will include the assessment of a host of factors
- Valuation is predicated on what is known or knowable as of a specific date, and value will change over time
- Consideration should be given to opportunities during this time



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Questions?

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