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Navigating Business Valuation in Times of Uncertainty

A Discussion of the Impact of the Current Economic Environment on the Value of Closely Held Businesses and Planning Opportunities

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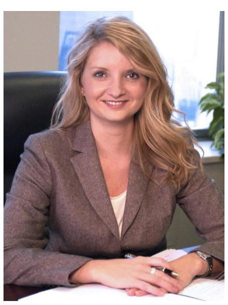

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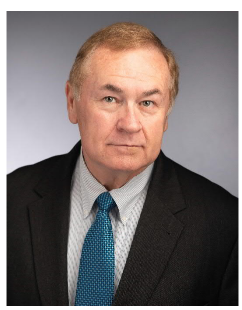

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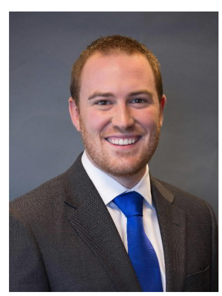

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INTRODUCTION

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INTRODUCTION

- ***Three Great Unknowns for Business Valuation***

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

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- ***An "Episodic" Event***
  - While the impact of the Coronavirus on the U.S. and worldwide economies cannot be denied, experts do not uniformly agree on the expected time of recovery
  - In a June 2020 Wall Street Journal survey, approximately 69% of economists polled felt that the recovery will require a gradual improvement over an extended time period

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- ***Associated Problems/Issues for Valuation***
  - Eroding consumer confidence
  - Employment growth slowing
  - Shrinking income as unemployment benefits expire
  - As-of-yet unconfirmed permanent changes in consumer behaviors
  - Uncertainty with respect to the virus and the vaccine

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- ***Economic Impact***
  - Without question, there has been an economic "contraction" in the United States and worldwide
  - Real gross domestic product (GDP) decreased at an annual rate of 31.4 % in the second quarter of 2020
  - Inflation-adjusted (real) gross domestic product (GDP) declined quarter-over-quarter by 9.4% in the second quarter alone

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- ***Economic Impact***
  - The CBO projects a federal budget deficit of $3.3 trillion in 2020, more than triple the shortfall recorded in 2019
    - Primarily the result of the economic disruption caused by the 2020 coronavirus pandemic and the enactment of legislation in response
  - At 16.0% of GDP, the 2020 deficit would be the largest since 1945
    - Note: the CBO had projected a federal budget deficit of $1.1 trillion in its March baseline projection

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- ***Core Economic Challenge***
  - Federal Reserve is generally front and center in battling economic downturns
  - Not the case for COVID-19
    - There really has been no major liquidity problem(s)
    - The most challenging issue has been the temporary shutdown of very broad parts of the economy

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- ***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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- ***Legislative Initiatives***
  - Congress, along with the President, have taken record-breaking steps to bolster businesses with the intention, and hope, of leap-frogging the current episode
  - In effect, these measures are intended to "mitigate" the negatives experienced by companies with respect to the economic disruptions caused by the pandemic

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- ***Presidential Campaign Matters***
  - While "politics" is not directly the domain of the business valuator, an opinion of value must consider the future economic effects which are dependent upon the outcome of the election
  - With Mr. Biden in the lead, consideration must be given to the potential tax changes he may initiate post-election (if President Trump is not re-elected). Mr. Biden's proposed corporate tax increase, alone, would alter future "free" cash flows

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- ***Critical Planning Opportunities***
  - With respect to equity valuation, 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

- ***A 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
  - Care should be taken to ensure that procedures and processes are in conformity with professional standards to ensure an appropriate outcome

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BACKGROUND

- ***A Brief Refresher on Value and Valuation***
  - Valuation is fundamentally risk assessment and measurement
  - Risk in business valuation is contemplated and considered in three primary elements of the business valuation process:
    - Expected future economic benefits (free cash flows)
    - The risk rate associated with the expected receipt and timing of those future economic benefits
    - Specific equity interest attribute discounts/premiums

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BACKGROUND

- ***Impact of COVID-19***
  - Today's overriding topic of discussion and the primary driver of the economy's current economic woes
  - Keep in mind (and differentiate from historical economic downturns)
    - This crisis was caused by something other than "normal" factors within the U.S. economy – as noted, it is event-based
    - Given the abrupt social and economic impacts, fear has impacted all industries to a degree

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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:
    - Supply chain disruptions
    - Labor shortages
    - Revenue declines
    - Increase in bad debts
    - Reduced cash flows
    - Inability to obtain credit
    - Inability to continue on as a going concern

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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 three-step approach will require some careful prognostication on the part of business valuators
    - Most economists and commentators are looking for 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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TOPICS TO BE COVERED IN THIS PRESENTATION

- ***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

- ***Critical element of any valuation project***
  - What is "known or knowable" at effective date
    - Most valuators 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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DATE OF VALUATION

- ***Impact of COVID-19 on Date of Valuation***
  - Valuation is a process of risk assessment at any date of valuation
  - Valuation is date (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

- ***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 after the Presidential election may further impact value due to the effect of the election results on the public markets, economy, and specific industries

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VALUATION METHODOLOGIES

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INCOME APPROACH

- ***Based on economic principle of anticipation***
- ***Income approach is the simplest way to determine future economic benefit streams as well as to assess associated risk***
- ***Past performance has little or no relevance – especially now***

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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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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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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
  - Must assess the impact of the pandemic on both near-term and long-term forecasts
  - It is incumbent upon the valuator to do more than just accept Management's forecasts carte blanche

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INCOME APPROACH – NUMERATOR

- ***The preference of many commentators, including a number of judicial decisions, is that risk is best handled in the development of the future expected economic benefit streams***
  - The consideration of risk in the forecasts generally requires more careful consideration by the valuators and future expected economic benefit stream (generally projected free cash flows)
  - The Courts (in particular) and other government entities (the IRS) are not as confident in subjective discount rate premiums and discounts

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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 valuators to view the inputs in the development of the risk rate through a different lens***

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INCOME APPROACH – DENOMINATOR

- ***Under the Build Up Model***

$$ke = Rf + ERP + Rs + CSRP$$

where,

ke = equity cost of capital

Rf = risk-free rate

ERP = equity risk premium

Rs = size premium

CSRP = company-specific risk premium

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INCOME APPROACH – DENOMINATOR

- ***Under the Modified Capital Asset Pricing Model***

ke = Rf + ERP (b) + Rs + CSRP

where,

ke = equity cost of capital
Rf = risk-free rate
ERP = equity risk premium
(b) = beta
Rs = size premium
CSRP = company-specific risk premium

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INCOME APPROACH – DENOMINATOR

- ***Risk-free rate***
  - 20-year Treasury Bond rate
    - As reported in Federal Reserve Bulletin on December 31, 2019 2.31%
    - As reported in Federal Reserve Bulletin on March 31, 2020 1.15%
    - As reported in Federal Reserve Bulletin on September 30, 2020 1.23%
  - Duff & Phelps recommends that this number be “normalized” to a level of 2.5% (effective 6/30/20)

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INCOME APPROACH – DENOMINATOR

- ***Equity risk premium***
  - Duff & Phelps recommendation to adjust ERP
    - Based on current market conditions, U.S. ERP recommendation is increased from 5% to 6% when developing discount rates beginning on March 25, 2020 and thereafter, until further guidance is issued
    - This ERP recommendation is to be used in conjunction with a normalized risk free rate of 3% (prior to 6/30/2020) or 2.5% (after 6/30/2020)

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INCOME APPROACH – DENOMINATOR

- ***Risk premium – other/additional risk***
  - Four areas of consideration:
    1. Size premium
    2. Industry risk premium
    3. Company-specific risk premium
    4. If using MCAPM, adjustments to beta

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INCOME APPROACH – DENOMINATOR

- ***Risk premium – other/additional risk***
  - Most valuators are adding additional risk into the company-specific risk premium
  - Must be careful to ensure that risk anticipated in applying an additional CSRP is not double counted in the determination of the benefit stream (numerator in the DCF) or in the determination of discounts taken elsewhere and outside the basic calculation

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INCOME APPROACH – DENOMINATOR

- ***Long-Term Growth Rates in a COVID-19 World***
  - Historically, long-term growth rates used by most valuators were at 5% or less (per VPS survey, as of 11/15/19):
    - 57% of respondents used 3% to 5%
    - 38% of respondents used 3% or less
  - GDP Trends and Long-term Growth
    - Historical nominal GDP growth has been 2.9% (1926-2019)
    - Inflation projected in Livingston Survey (June 2020) at 2.0% per year for each of the next 10 years

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INCOME APPROACH - METHOD SELECTION

- ***DCF versus CCF***
  - Use of a single period CCF poses a variety of issues for the valuator in a COVID-19 environment
    - Subject company's history has no relevance to the future expectations, at least in the short-term to mid-term time period
    - In such a case, the capitalization rate has to incorporate a growth rate that facilitates a weighted average growth rate over time to get to an appropriate determination of value

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INCOME APPROACH – METHOD SELECTION

- ***DCF versus CCF***
  - The best solution, albeit it difficult in application, is to use a multi-period DCF model to allow for the use of a discrete forecast period until operations and financial results return to as somewhat normal level
  - The terminal value, then, can capture growth into the future in a more conventional market

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INCOME APPROACH

- ***Application of the income approach for dates of valuation post-COVID-19 has been, and will continue to be, challenging for some time into the future***
- ***Changes occurring regionally, nationally and globally are material and fluid***
- ***While valuators may find that adjustments need to be made to both the numerator and denominator in the income approach calculation, care should be taken to avoid duplication***

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MARKET APPROACH

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

$$\text{Value} = [(\text{Price/Parameter})_{\text{comp}} * \text{Parameter}_{\text{subject}}] - \text{Debt}_{\text{subject}}$$

- ***Primary methods under the market approach:***
  - Guideline public company method (GPCM)
  - Guideline completed transaction method (GCTM)

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MARKET APPROACH

- ***Primary benefits***
  - Relies on actual, third-party data
  - If properly used, brings market realities into the analysis
- ***Can lead to incorrect conclusions of value due to:***
  - Limited availability of quality data
  - Difficulty in properly assessing and applying data
  - Misapplication of indicators of value due to lack of sufficient similarity

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MARKET APPROACH

- ***Guideline public company method***
  - Value multiples developed from identification and analysis of companies traded freely on an open stock exchange in the public markets
  - Prices from public markets incorporate risk-vs-return considerations of independent, third-party investors
  - Use of public company multiples directly correlates value to market investor expectations

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MARKET APPROACH

- ***Guideline public company method***
  - Care must be taken, both currently and in the future, when relying on multiples
    - Public market multiples may not be entirely relevant now or before COVID-19
    - Multiples applied to historical earnings (LTM) may no longer be relevant

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MARKET APPROACH

- ***Guideline public company method***
  - Proper application will vary depending on the date of valuation
    - If the date of valuation pre-dates late-February 2020 COVID-19 news, it is best to apply the GPCM in the same way normal guidance would dictate
    - If the date of valuation post-dates the release of late-February COVID-19 news, valuation will require consideration of forward-looking multiples

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MARKET APPROACH

- ***Guideline completed transaction method***
  - Focuses on observances of value indicators produced through closed and completed acquisitions
    - By definition, the transactions are completed “prior” to current dates of valuation
    - Numerous databases capture private-company transactions
    - Frequently, detailed information is not sufficient to interpret deal structure and draw meaningful inferences as to comparability
  - Typically used as a confirming, rather than primary method

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MARKET APPROACH

- ***Guideline completed transaction method***
  - This method became difficult to apply after the enactment of the Tax Cuts and Jobs Act
  - Could yield conflicting results based on any tax law changes
  - Valuators will want to carefully consider the use of multiples derived from transactions occurring during and in the wake of this crisis

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MARKET APPROACH

- ***Primary issues for valuator consideration using GCTM***
  - As of September 30, 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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MARKET APPROACH

- ***Primary issues for valuator consideration using GPCM***
  - As of September 30, 2020, stock market values have held fairly strong
  - Interpreting public market response to the economic affects of the COVID-19 pandemic is necessary to assure that the subject company will act similarly

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COST/ASSET APPROACH

- ***Determination of value predicated upon assessment of each asset and liability on a company's balance sheet***
- ***Approach not useful for operating companies with significant unrecorded intangible value***
- ***Used most often where value of equity is based on value of underlying assets – holding companies***

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COST/ASSET APPROACH

- ***May need to consider in situations where income approach values are significantly depressed***
- ***Asset holding company values may decline based on value of underlying assets***
  - Marketable securities
  - Real estate based on changes in occupancy rates
  - Commercial property, including both office space and retail space, are expected to suffer long-term

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COST/ASSET APPROACH

- ***In applying the cost/asset approach, and especially the net asset method thereunder, consideration must given to:***
  - Functional or operational obsolescence
  - Economic obsolescence
  - Value on a going concern basis that is less than the appraised asset values (net of liabilities) but greater than orderly liquidation value
  - Note that while this approach applies most often to tangible assets, it can equally apply to intangible assets

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VALUATION DISCOUNTS

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VALUATION DISCOUNTS

- ***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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DISCOUNT FOR LACK OF MARKETABILITY

- ***Generally defined as, "an amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability"***
  - Uncertain time horizon to complete a sale
  - Risk as to the eventual sales prices
  - Inability to hypothecate a sale or borrow against the estimated value of stock

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DISCOUNT FOR LACK OF MARKETABILITY

- ***Privately held businesses, and equity interests therein, 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
  - The question is how best to quantify this additional risk for lack of marketability

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DISCOUNT FOR LACK OF MARKETABILITY

- ***There has been an increase in price volatility and uncertainty surrounding sustainability of business operations***
- ***These factors will increase the discount for lack of marketability, and in some cases, the increase could be material***

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DISCOUNT FOR LACK OF MARKETABILITY

- ***The pandemic should be considered in looking at holding periods relevant to the determination of the discount for lack of marketability***
- ***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 noncontrolling interest values***

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DISCOUNT FOR LACK OF CONTROL

- ***Generally defined as "an amount or percentage deducted from the value of an ownership interest to reflect the relative absence of control perquisites"***
  - Inability to elect directors or appoint management
  - Inability to determine cash distributions/dividends
  - Inability to set company policies or business course
  - Inability to purchase or sell assets
  - Inability to determine when and how to sell the company

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DISCOUNT FOR LACK OF CONTROL

- ***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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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)

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THE EFFECT OF THE CARES ACT ON VALUATION

- ***Key Elements***
  - Temporary repeal of the 80% limitation for net operating losses (NOLs)
  - 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)

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THE EFFECT OF THE CARES ACT ON VALUATION

- ***Key Elements***
  - Employee Retention Credits
  - Employer Payroll Tax Delay (employer share of the social security tax)
    - In effect, an interest-free loan

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ANTICIPATED IMPACT OF THE PRESIDENTIAL ELECTION

- ***The effect of the election on depends on dates of valuation***
  - For pre-election dates of valuation, any mention of the election and the potential changes under a different administration is best limited to subsequent event disclosures
    - Would include substantial changes to the corporate tax rates, etc.
  - For post-election dates of valuation, valuators will still be likely to address anticipated changes in subsequent event disclosures
    - However, depending on outcomes, language may need to be stronger than in pre-election dates of valuation

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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, and
  - Potential changes in federal income tax law associated with a potential change in administrations (if deemed appropriate)

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A Discussion of the Impact of the Current Economic Environment on the Value of Closely Held Businesses and Planning Opportunities

VALUATION OPPORTUNITIES

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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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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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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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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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CONCLUSION

- ***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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CONCLUSION

- ***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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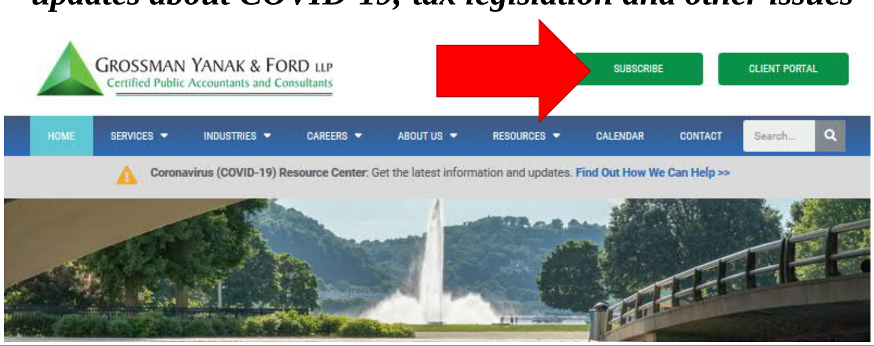
CONCLUSION

- ***Please go to www.gyf.com to subscribe to receive timely updates about COVID-19, tax legislation and other issues***



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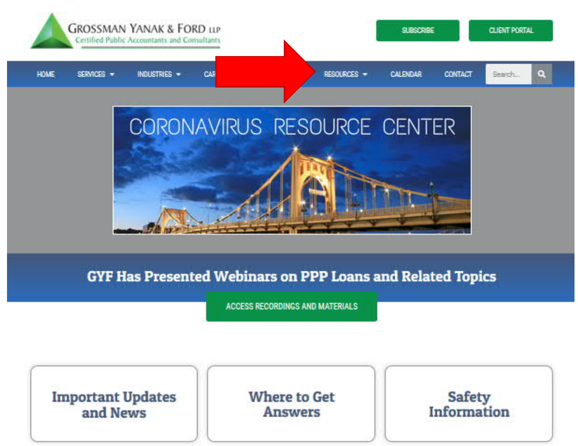
CONCLUSION

- ***Visit our website's Coronavirus Resource Center to access webinars, updates and links to important info***



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THANK YOU!