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Valuation update – Planning strategies in light of COVID-19 - by Angela Sadang

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COVID-19 has had a devastating effect on the economy, financial markets and real estate values. What are the short- and long-term implications for financial projections? This article will provide the technical and factual information on the current situation to help you understand the effects of COVID-19 on business valuation.

Decrease in Business Values

Here are just a few reasons why the value of private assets may have declined due to COVID-19:

Actual and expected revenues and earnings may have decreased due to forced COVID-19-related closures or decreases in customer/client demand.

Interest-bearing debt may have increased to pay employees and other fixed continuing expenses.

For an asset holding company, such as a real estate holding company or a company holding investments in private and publicly traded equity, decreases in asset values may have reduced the value of the holding company. This is particularly evident when the holdings include publicly traded equity. This can also affect real estate assets due to COVID-19-related changes resulting from lower rental and occupancy rates.

For minority interests in privately held companies, discounts for lack of control and lack of marketability may have increased due to liquidity issues in the market.

Focus on cash flows, cost of capital (discount rate) and growth. A lot of thinking must now be applied to the risks associated with the cash flow of a particular business and the elements that are factored in the discount rate, as well as the risks involved in realizing the cash flows at the date of the valuation. For instance, the “risk-free” rate is now not entirely “risk free” and the unsystematic risk should now capture extra risks in light of COVID-19.

A key consideration in valuing companies will be assessing the impact of COVID-19 on near-term and longer-term financial projections that may not yet be known or quantifiable and/or likely will be subject to change. After one or two quarters of a plunging economy, there are many forecasts with respect to a recovery in a “V” shape, “U” shape or even “W” shape. In addition, certain industries will bounce back earlier than others. Even with governments reacting much faster than during prior economic crises through massive relief measures, recovery and growth will occur from a lower base than pre-pandemic levels and at a much slower pace and driven possibly by whether the fundamental change in consumer demand is favorable or unfavorable in the long term for the business.

December 31, 2019 valuation date versus March 31, 2020 valuation date. COVID-19 as a subsequent event, has no impact on December 31, 2019 valuations and should not be factored in December 31, 2019 valuations. As of December 31, 2019, willing buyers and sellers of a company’s stock would not have considered what we now know as COVID-19 in their negotiations.

A valuation as of March 31, 2020 will yield a dramatically different value versus a December 31, 2019 valuation date. COVID-19 was known and knowable as of March 31, 2020, and the uncertainty along with the more profound systematic and unsystematic risks would impact the valuation.

As a best practice, the valuation report should include a discussion on “subsequent events” and “known and knowable” concepts.

The standards pertaining to subsequent events issued by both the American Society of Appraisers (ASA) and the American Institute of Certified Public Accountants (AICPA) are consistent: “Generally the valuation analyst should consider only circumstances existing at the valuation date and up to the valuation date…. Subsequent events are indicative of conditions that were not known or knowable at the valuation date.” 1

Subsequent events or conditions that affect the value of the property can be taken into account only if they are reasonably foreseeable on the valuation date. Conversely, subsequent events which merely provide evidence of the value of the property on the valuation date can be taken into account, regardless of whether they are foreseeable on the valuation date. 2

Subsequent events may fall into one of two categories:

Those that affect value; and
Those that do not affect value but give evidence of value that existed on the valuation date. 3

Tax

The dismal economic forecasts due to the COVID-19 pandemic represent a unique opportunity for individuals to take advantage of low business valuations to minimize estate and gift taxes.

Lower values create a unique planning opportunity by allowing business owners to transfer a greater portion of their business assets and reduce their taxable estate. The recent decline in market valuations provides an opportunity to gift at lower values, potentially allowing you to gift assets using your lifetime exemption that would have otherwise resulted in a taxable event before the decline. Given the additional uncertainty surrounding the Presidential election and what might happen to the estate and gift tax exemption level, now may be the best time to do some gifting.

Following are a few strategies that take advantage of this volatile time where asset values are depressed and interest rates are extremely low. There are certain planning techniques such as grantor-retained annuity trusts (GRATs), sales to an intentionally defective grantor trust (IDGT), charitable lead annuity trusts (CLATs), spousal lifetime access trust (SLATs), swapping assets with a grantor trust, and intra-family loans–which are particularly effective in low-interest-rate environments.

One of the keys to many of these strategies is to obtain a supportable valuation of the assets involved in the strategy, especially when dealing with a closely held business or fractional interest in an investment partnership.

Financial Reporting

Impairment will be an elevated topic in financial reporting and given the drastic economic effects of COVID-19, we anticipate that many companies complying with GAAP will need not only to test their goodwill, but also their long-lived assets.

With respect to goodwill, ASC 350 requires an entity to consider whether an interim “triggering event” has occurred between the dates of its annual impairment testing.4 If a triggering event has occurred, then a quantitative analysis would ensue to determine if the carrying amount of goodwill exceeds its implied fair value. Determining whether a triggering event has occurred pursuant to ASC 350 requires an assessment of the totality of events or circumstances. See ASC 350-20-35-3C for a list of examples of “triggering events,” summarized as follows:

A significant decrease in the market price of the asset;
A change in the way an asset or asset group is being used or a change in its physical condition;
An adverse change in legal factors, regulation or business environment;
Past, current or expected cash flow losses associated with the asset or asset group; or
An expectation that the asset will be disposed of significantly before the end of its useful life.

During the financial crisis in 2008–2009, the Securities and Exchange Commission provided examples of events that may indicate that an interim impairment test is necessary. They included:5

Negative current events or long-term outlooks for specific industries impacting the company as a whole or specific reporting unit;
Not meeting analysts’ expectations or internal forecasts in consecutive periods or downward

adjustments to future forecasts;
 Planned or announced plant closures, layoffs or asset dispositions; or
 The market capitalization of the company below its book value.

The decline in value could be minor and temporary or could be major and permanent. It all depends on an ongoing assessment of a host of factors, such as those highlighted above. When assessing the need to perform an interim impairment test, a company should consider the duration and severity of the decline and the reasons associated with it. A test will likely be triggered by a decline related to an event that is expected to continue for an extensive period and detrimentally affect the company, combined with its below market book value. If a company has not experienced a decline in cash flows and expects that it will continue to meet its projected cash flows in the future, it does not necessarily mean that a trigger event has occurred considering a decline in market capitalization. However, many companies may need to reconsider their projected cash flows due to disruption in the global economy and the supply chain due to the increased uncertainty.6

Transactions/M&A

Whether to engage in a transaction now or consider alternatives such as asset sales and cost-cutting measures is a weighty decision for investors. An increase in certain types of transactions is likely to occur, including related party financings/recapitalizations to strengthen the balance sheet, address liquidity constraints or pursue acquisitions or initiatives, related party mergers and stockholder-led take-private transactions.

Because of the significant economic disruption caused by the COVID-19 pandemic, some companies are looking to significant existing investors for financial support.

Deal Activity Right Now

Phil Seefried, president of Capstone Headwaters, has developed a useful framework for the current pipeline in the deal market. His view is based in part on that firm’s national footprint in the $25 million to $250 million deal size space. According to Phil:

For deals signed but not launched, investors are generally waiting out the current uncertainty, with a handful of exceptions.

It is a mixed bag for deals in the market. Some are taking a wait-and-see approach and others are moving forward but process timing is being extended. Most buyers prefer in-person management meetings, so the current travel restrictions have created difficulties.

Many deals at or past the letter of intent stage are on hold while company-specific developments are closely monitored. Those moving forward: (a) involve strategic buyers; (b) address a mission-critical need or offer significant synergies; and/or (c) are capable of being completed with little or no debt financing.

If 2009 is a guide, recovery will take some time. After the liquidity meltdown in fall 2008, deal volume dropped in the first half of 2009, but not in valuations or in debt multiples. Completed transactions had plenty of momentum and represented a “flight to quality.” Lesser deals weren’t getting done at reduced multiples; they were put on hold and dropping out of the numbers. It was not until the second half of the year that deal pricing and debt loads took full account of the changes in market condition.

There will be a resurgence in distressed/workout activity. This has been anticipated for some time but will be accelerated, characterizing much deal activity heading into 2021.

Adjustments to financial performance for COVID-19 will become part of the discussion in every deal.

Conclusion

The effects of COVID-19 are manifested in unpaid rents, unused office space, business closures and unprecedented unemployment. These losses can be measured through appropriate valuation methods, and companies must start reviewing their businesses and engaging valuation professionals to assist in measuring the impairments, valuing their businesses and planning for the transfer of interests.

1 Statement on Standards for Valuation Services No.1, American Institute of Certified Public Accountants” (June 2007), pg. 20 at 43.
2 Morton v. Commissioner, T.C. Memo 1997-166 (April 1, 1997).
3 Shannon P. Pratt, “Should Subsequent Events Be Considered in the Present Value of a Business Entity?” Business Valuation Update, Business Valuation Resources LLC (March 2002)
4 See ASC 350-20-35-67. “Triggering event” refers to an event or change in circumstances that would more likely than not reduce the fair value of a reporting unit below its carrying amount.
5 Source: Report, “The Impact of COVID-19 on Impairment: Top Considerations for Businesses,” Houlihan Lokey, March 16, 2020, https://hl.com/pdf/2020/covid-19-impact-on-impairment.pdf
6 Ibid.

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