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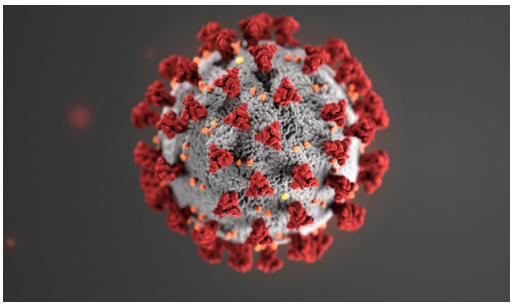
COVID-19: The Financial and Valuation Impact

BY: Harold L. Deiters III, Joseph Ammirati, and Pasquale Rafanelli

Although the world has faced several major pandemics over the last 100 years, one of the worst was the 1918 influenza pandemic, also known as the Spanish flu. The Spanish flu infected approximately 500 million people worldwide, which at the time was about a third of the Earth's population. The fatality rate for the Spanish flu was calculated at approximately 2%.



Jump forward 102 years to 2020 and we have COVID-19, also known as Corona Virus. Although it is somewhat of a moving target as more deaths occur and broader diagnostic testing is performed, the global fatality rate for COVID-19 as of April 1, 2020, is approximately 5%, although in the U.S. it is about 2.16%. Some experts believe the 5% figure is significantly lower because of doubts about the accuracy of China's reporting of the cases, where COVID-19 originated.

A global, novel virus that keeps us contained in our homes, is already reorienting our relationship to the outside world, even to each other. While this pandemic presents uncertainty about the future, it also presents opportunities. For example, there is more sophisticated and flexible use of technology today; just look at Zoom and the success that they have had as a result of this pandemic.

No one knows exactly what will come next, but we can look to the past to help predict the future and use this knowledge to determine how the virus will impact the economy, industry, and the manner in which experts will value businesses.

Corona Virus Impact on the Market and Economy

The National Bureau of Economic Research (NBER) defines a recession as a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employments, industrial production, and wholesale-retail sales. Since 1980 there have been four periods of negative growth that were considered recessions.

The first recession was during the period July 1981 to November 1982, and lasted approximately one year and four months. This recession was largely due to the Iranian Revolution which caused oil prices to surge around the world during the 1979 Energy Crisis.

After a long expansion period in the 1980s, inflation began to rise and the Federal Reserve responded by raising interest rates from 1986 through 1989. This weakened growth resulted in the next recession, which was during the period July 1990 to March 1991, and lasted approximately eight months.

After the second longest expansion period on record, the U.S. experienced another recession during the period March 2001 to November 2001, which lasted approximately nine months. This recession was largely due to the dot.com bubble burst, fraud, accounting scandals (like Enron and WorldCom), and the events of September 11th.

The most recent recession, which is referred to as the Great Recession, was during the period December 2007 to June 2009, and lasted approximately one year and six months. This recession was largely due to the sub-prime mortgage crisis and collapse of large financial institutions.

It took the U.S. economy approximately five years to return to the level it was at prior to the Great Recession, leading us into the longest expansion period in U.S. history which lasted over 128 months through February 2020.

We can only hope that this pandemic ends sooner rather than later, and that our recovery is as long-lasting as it was after the Great Recession.

COVID-19 Impact on Valuations

A pandemic like COVID-19 will not change the valuation standards or the valuation expert's requirement to consider the three Approaches: (i) Asset Approach, (ii) Market Approach, and (iii) Income Approach. What will be affected is how we apply these approaches.

To help understand how the economy plays a role in valuations, Empire reviewed the sales of private transactions as reported by Deal Stats[1] during the period from 2006 to 2019 to see what impact the Great Recession had on valuation multiples. There are two widely used pricing multiples that experts consider when reviewing the transactions and determining value: (i) Price / Net Sales and (ii) Price / EBITDA.

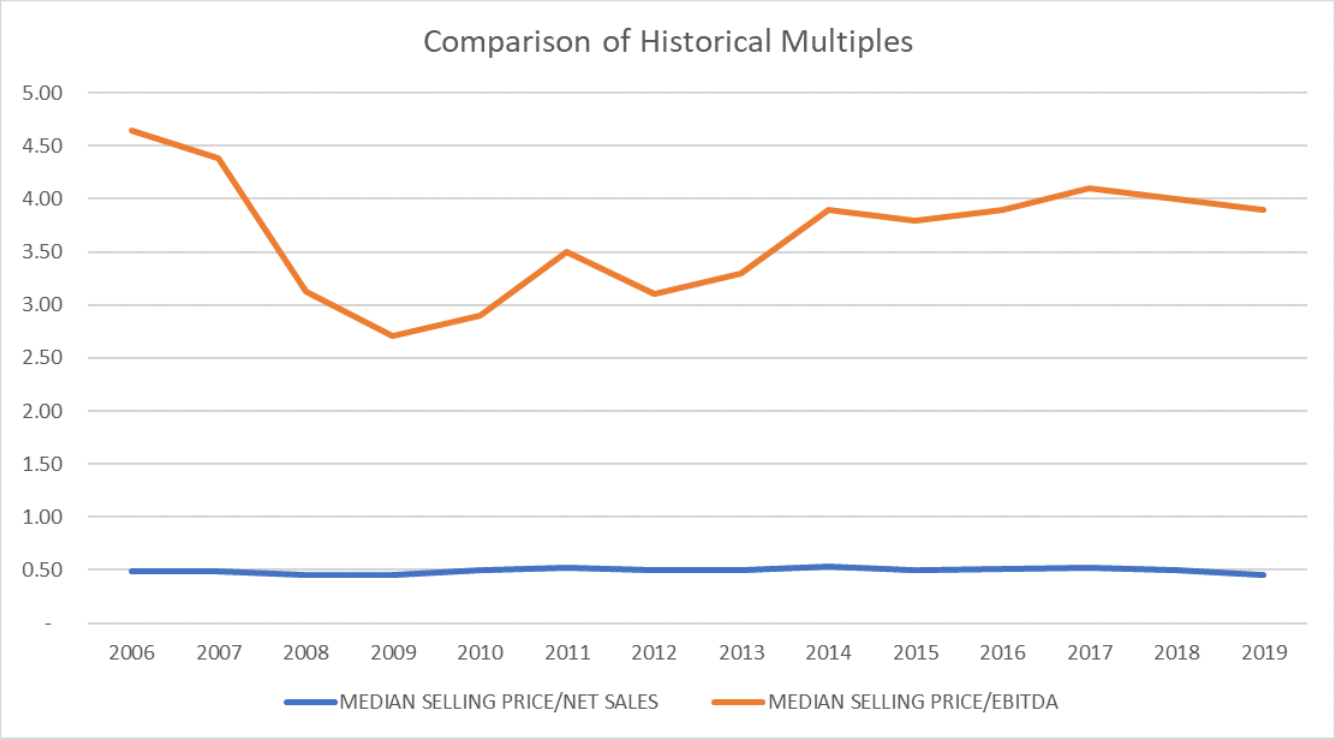
Price/Net Sales

The Price/Net Sales multiples have remained stable with very little fluctuation for most industries during the years 2006 through 2019, ranging from a low of approximately 0.45 times in 2009 and 2019 to a high of 0.53 times in 2014. Based on reported sales, businesses were selling for approximately the same multiple of revenues during both the good times and the bad times.

Price/EBITDA

The Price/EBITDA multiples had a little more fluctuation than the Price/Net Sales multiples, ranging from a low of 2.7 times in 2009 to a high of 4.6 times in 2006. We should note that the Deal Stats databases do not provide the required details to determine what normalization adjustments and due diligence was done to arrive at the reported EBITDA.

Below we have provided a line graph that depicts of the trends noted in the Price/Net Sales and Price/EBITDA multiples.



1. Deal Stats was previously published as Pratt's Stats from October 1997 to June 2018 when it was rebranded as Deal Stats. Prior to the rebranding, the industry sales multiples were reported in six industries by their SIC codes. After the rebranding, the industry sales multiples were broken down by NAICS codes allowing for more precise reporting. The charts contained here are based on the information provided on the BV Resources website in the quarterly reports.

While the state of the economy does play a role on the value of a business, the biggest impact on increasing or decreasing values during the post COVID-19 will largely relate to declines in net sales and EBITDA rather than the changes in multiples.

Therefore, in order to attempt to determine how COVID-19 will impact valuations, we must consider and understand the following factors: (i) Cash Flows; (ii) Growth; and (iii) Risk.

Cash Flow

The cash flow of a company depends on its net income, or profit, which is the revenue less expenses. As the revenues of a company are reduced due to clients' fear of virus contamination, the impact is immediate on the net income because the expenses of a company typically will not decline as rapidly as the revenues. This reduction in profits will have a direct impact on cash flow and ultimately the value of the company.

Growth

The valuation of a company considers the projected growth of the company for the foreseeable future. This is important for investors as they seek to understand the long-term viability of the company into which they are looking to invest their money. When a pandemic like COVID-19 is taken into account, it's hard not to lower the industry and the national economic perspectives on growth in both the short-term and the long-term. As a result, the revised industry and national economic growth projections will have an immediate impact on any company's growth forecast. As the uncertainty of the future mounts over time, a company becomes less attractive to investors, which will have a direct impact on the value of the company.

Risk

There are two types of risk associated with operating a business: the environmental risk (external risks) and operational risk (internal risks). A company can be negatively impacted by external risks when the economy is not doing well due to the impact from a pandemic like COVID-19, or when the industry in which the company operates is considered a high-risk industry. The same is true when the internal risks are deemed high by investors; for example, a company has very few clients (no diversification), or one key person running the company.

Subsequent Event Considerations

A subsequent event is an event that occurs after the valuation date, but before the issuance of the report. Subsequent events may materially affect the fair market value of a company, which is the appropriate standard of value in most cases (i.e., estate or gift tax filing, marital dissolutions, etc.). The definition for fair market value is contained in IRS Revenue Ruling 59-60. The definition states "the price at which property would change hands between a willing buyer and a willing seller…both parties having reasonable knowledge of the relevant facts." This definition is interpreted to mean what facts were "known" or "knowable" as of the valuation date.

It is essential we differentiate between events that could be foreseen at the valuation date and those events that could not. For example, consider whether an agreement executed shortly after the valuation date with a new major customer would likely be known or knowable at the valuation date. If it was being negotiated prior to the valuation date, then it most likely would be considered known or knowable at that point and included. On the other hand, a major storm that causes major damage to the business and its facilities shortly after the valuation date would not have been known or knowable and, therefore, should not be considered in the valuation. However, the differentiation is not always so obvious and must be thoroughly examined and considered by the valuator in each instance.

The Statement of Standards on Valuation Services #1 ("SSVS #1") makes an exception for unforeseen national emergencies like the one we are currently dealing with the COVID-19 virus. SSVS #1 states that "In situations in which a valuation is meaningful to the intended user beyond the valuation date, the events may be of such nature and significance as to warrant disclosure (at the option of the valuation analyst) in a separate section of the report in order to keep users informed. Such disclosure should clearly indicate that information regarding the events is provided for informational purposes only and does not affect the determination of value as of the specified valuation date."

When selecting the appropriate date, it is important to talk with your advisors. For example, in estates there are two options in selecting the valuation date; you can use the date of death or the alternate valuation date (six months after the date of death). For gift tax valuations, the valuation date should be the date of the gift's transfer, so instead of transferring the asset as of January 1, 2020, you could consider transferring the asset as of March 1, 2020. In divorce situations or shareholder disputes, the date of filing of the case is typically, but not always, the valuation date. Discussions with the clients and/or counsel may be necessary in certain instances, particularly when litigation is involved and a valuation is needed in order to establish the appropriate valuation date.

What's Next

With all that's happening with COVID-19 and the market, most people are not thinking about the future, but are living in the present with concerns of what the future will bring. If you are the owner of a business, now is the time to start thinking about, and preparing for, the future. As a business owner, what you do today, and the ground work that you lay, will set up the future and could very well be the deciding factor as to whether or not you will be successful.

As the COVID-19 pandemic is continually evolving, it is essential for business owners to partner with the right professionals early on in the process. We at Empire have the background and knowledge to become your trusted advisors, and assist you and your business in these changing times.

Since our founding in 1988, Empire Valuation Consultants has grown into one of the nation's leading and most respected independent valuation firms, with a staff of over 80 employees in New York City, Long Island, Boston, Rochester, West Hartford, and San Francisco. Our valuations are prepared by senior accredited valuation experts holding one or more of the following professional credentials: CFA, ASA, IA, CPA, CGMA, and ABV. We provide valuations to attorneys, accountants, business owners, private equity and hedge funds, commercial bankers, investment bankers, trust departments, insurance agents, and financi l planners, among others. We bring excellence and integrity to every engagement through our team of highly skilled individua s who are among the finest our industry has to offer.

Harold L. Deiters III, CPA/ABV/CFF/CGMA, CFE, MAFF/CV**A**, is the Managing Partner of the Long Island office of Empire Valuation Consultants. Harold brings more than 25 years of experience and is a trained professional in preparing business valuations and performing forensic accounting. His experience covers valuations for matrimonial and estate tax purposes, gift planning, shareholder disputes, economic damages, and buy/sell agreements. He has extensive experience in tax return preparation, accounting, and auditing both public and privately held companies, including manufacturing, wholesale and retail distribution, professional service organizations, and not-for-profit organizations. Harold has been qualified as an expert in New York State Supreme Courts in Nassau County, New York County, and Federal Court in the Eastern District of New York and the District of Massachusetts.

hd@empireval.com | 631.719.3226

Joseph Ammirati, CPA/ABV/CFF, ASA is a Director at Empire Valuation Consultants who brings more than 20 years of experience providing business valuation, forensic accounting and advisory services to closely held companies, attorneys, accountants, and financial professionals. He has performed valuations of business interests for a variety of purposes including, but not limited to, family law matters, estate and gift tax matters, business damages, corporate litigation, shareholder disputes, and enhanced earnings calculations. Joseph also serves as an Adjunct Professor at Long Island University C.W. Post, where he has been teaching Fraud and Forensic Accounting since September 2014.

jammirati@empireval.com | 631.719.3258

Pasquale Rafanelli, CPA/ABV, ASA, CVA/CBA/MAFF, CFE, CDFA®, is a Senior Manager at Empire. Pasquale brings more than 13 years of experience providing business valuation, forensic accounting, and advisory services to closely held companies, attorneys, accountants, and financial professionals. He has performed valuations and forensic examinations of various classes of equity, general and limited partnership interests, carried interest, limited liability company membership interests, C-Corporations, S Corporations, stock options, and warrants. These valuations and forensic examinations have been for purposes including gift and estate planning, employee stock ownership plan administration, other corporate planning and reporting, buy/sell, merger and acquisitions, family law matters, business damages, lost profits, corporate litigation, and shareholder disputes. Pasquale received his BS degree in accounting with a minor in criminal justice, and his MS with a concentration in information systems from Long Island University – C.W. Post.

prafanelli@empireval.com | 631.719.3222