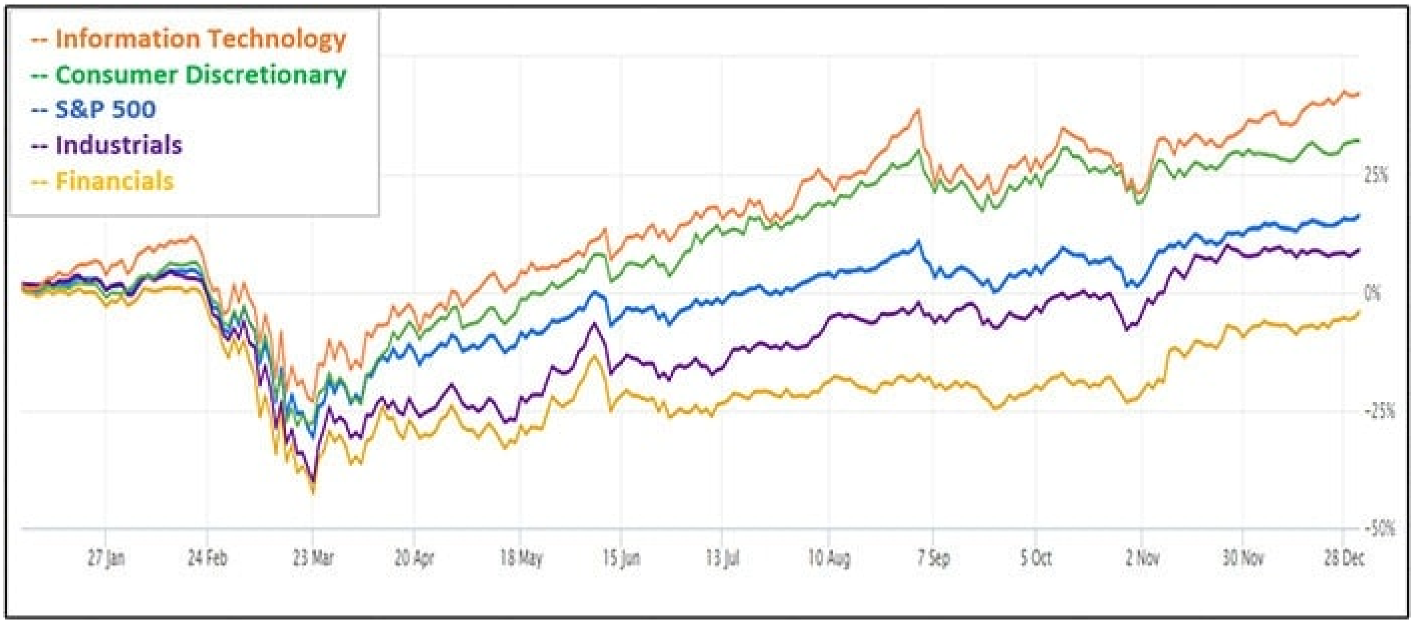
VALUING A BUSINESS IN A VOLATILE MARKET

In mid-March of 2020, the global pandemic related to the COVID-19 virus shut down the US economy. This created a unique operating environment for businesses and forced valuation analysts to adapt some of their models and methods in order to consider the impact of the COVID-19 pandemic on the value of a business. This article will look at the different ways businesses were affected by the pandemic and how valuation analysts take these factors into account.

How COVID-has 19 impacted the market

The pandemic had a negative impact on many businesses, however, some companies thrived due to the sudden changes in the marketplace that gave certain industries a competitive advantage. The chart below compares the S&P 500 index to the information technology, consumer discretionary, industrials, and financials sectors for the year 2020.



Source: *Wall Street Journal, Market Data*

The chart illustrates that when the market crashed in mid-March, certain sectors such as information technology and consumer discretionary recovered quickly and went on to greatly outperform the market (as measured by the S&P 500), while other sectors such as industrials and financials took much longer to recover and went on to greatly underperform the market.

Specific examples of businesses that had unusually profitable years in 2020 include online retailers, manufacturers of specialty products (such as paper packaging products, personal protective equipment, chemical cleaning supplies, and recreational/exercise equipment), and fast service restaurants that offered to-go, drive-thru, or delivery options.

For some of these businesses, increased profitability was only temporary, while for others it opened the door to new revenue channels as business owners adapted to the new environment.

How valuation analysts can adapt their models

The valuation methodology is fundamentally forward-looking, that is, valuation analysts are valuing a business's future earning potential. Under the income approach, this can be done in one of two ways.

Capitalization of Earnings

The Capitalization of Earnings method is where the valuation analyst analyzes historical cash flows to project a single period, which is then capitalized using a discount rate to arrive at an estimation of value. Suppose the valuation analyst chooses to use this method. In that case, it may be necessary to normalize out the impact of COVID-19 on the 2020 financials, as well as look at several historical periods prior to the pandemic in order to determine normal operating levels for the company.

Discounted Cash Flow

The Discounted Cash Flow method utilizes a multi-period forecast of the company's future earnings (often over a 3-to-5-year period) and then discounts those cash flows to the present. The discount cash flow method allows valuation analysts and business owners to build on their future expectations as they may differ from previous historical periods. Using this method allows the valuation analyst to build in the company's recovery from the pandemic over several periods.

2021 was a recovery year for many businesses, creating two abnormal years that valuation analysts need to sort through to project a normalized earnings stream. This is why it is important to consult with business owners as to whether they expect operations to return to pre-pandemic levels or to differ over the next several periods. This will help valuation analysts to determine which income approach method is appropriate to use.

When using the market approach, valuation analysts need to consider the COVID-19 impact on the transactions/publicly traded companies and how that may be impacting multiples. Additionally, valuation analysts should consider the impact of the pandemic on their discount rate to include any uncertainty or additional risk, as investors often require a greater return for any added risk to their investment.

How business owners can proceed

Business owners should make sure that the valuation analyst understands that COVID-19 had a disparate impact on companies; valuation methods and models must be adjusted accordingly. It is important to hire valuation analysts with valuation credentials to ensure professional standards are being followed and that they are staying apprised of any changes in the valuation industry through continuing education.

Another consideration for business owners to keep in mind is how the valuation date might impact the value of their business. If operations, the economy, or industry are changing rapidly, the value of their business will most likely be impacted. In many cases, the timing of a business valuation during economically volatile times can be crucial. For example, the valuation date for a gift and estate valuation. Businesses are typically valued as of the date of death or date of the gift. However, for estate valuations, federal tax law allows for an alternative valuation date of six months after the decedent's death. Selecting the alternative date could lead to reduced tax liability if the subject company has declined in value or holds assets that have declined in value. Alternatively, if the subject company has increased in value or holds assets that have increased in value, selecting the earlier date may be more advantageous.