Article

The Coronavirus Pandemic:
Identifying Valuation Effects and Planning Opportunities for Private Clients

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Executive Summary

As you might expect, MPI is currently in close consultation with its clients given the volatility in financial markets, economic uncertainties, business shutdowns and other factors. The values of many privately-held businesses and investment partnerships, like most asset classes, have declined as a result of the crisis. The steepness of this decline, the duration of the economic effects of the crisis and the path to recovery will differ by industry and company position. To that end, we are hesitant to draw too many conclusions from price changes indicated by broad market averages, yet also know that the negative impacts on companies and individuals are far and wide.

One thing that is clear is that the current environment has created a unique wealth transfer opportunity for many high-net-worth individuals and business owners. When the time is right, strategies should be discussed with the counsel of a trusted and experienced advisor.

Estate Planning Opportunities

Prior to the pandemic, there were several conditions in place suggesting that high net worth individuals ought to strongly consider wealth transfer strategies in 2020. These factors, which are still present, include (1) higher annual federal estate and gift tax exclusion amounts that were enacted through the 2017 Tax Cuts and Jobs Act and are set to expire on January 1, 2026, (2) the potential for a change in administration and the makeup of Congress from the November 2020 elections, which could lead to an acceleration of the sunset or other tax law changes, and (3) lower interest rates, which make several strategies such as sales funded by notes and GRATs more favorable at the margin. The mid-term adjusted applicable federal rate ("AFR") (based on annual compounding periods) for April 2020 declined to 0.99% compared to 1.69% in January 2020 and 2.55% in April 2019.

With the coronavirus-induced crisis in 2020, the values of many equity and fixed income securities have declined significantly. Data commonly used as support for discounts for lack of control suggest that much greater discounts existed in March. Our research indicates that discounts for lack of marketability are correlated to volatility, among other factors, indicating that discounts for lack of marketability on privately-owned businesses should be higher during highly volatile periods, all other factors held constant.

For clients that are able and willing to focus on estate planning, there is potentially an opportunity to transfer privately-held assets at a substantially lower value and/or greater discount today than what would have existed just a few weeks ago. The potential benefit of taking advantage of this opportunity could be: (1) more effective use of unused exclusion amount; and/or (2) greater long-term wealth transfer per dollar gifted/sold if there is a future increase/rebound in value.

We further note that executors and representatives of estates with dates of death as early as July 31, 2019 should be considering use of the alternative date for valuation purposes. This election, which allows for the valuation of assets six months after the date of death, may prove incredibly useful for taxable estates given recent declines in asset values.

Thoughts from the MPI Team

While there are some similarities between the 2020 crisis and the "Great Recession" of 2007 to 2009, there are many important differences that need to be considered.

- This is a medical and healthcare crisis that is far reaching; it has no borders and has seemingly affected all industries in one way or another.
- There is tremendous uncertainty around the duration of the pandemic's effect on the U.S. economy, including the potential for the virus to return or linger into 2021.
- There have been complete and sudden business shutdowns per actual or implied government mandate. It is unclear how many businesses can withstand a lack of revenue or significant revenue declines for potentially months at a time. Highly leveraged companies are particularly at risk.
- Many industries are retooling or reorganizing to deal with the crisis, with some more capable of functioning with remote employees than others.
- The U.S. government has invoked rarely-used wartime powers.
- The U.S. government and Federal Reserve are in the midst of deploying unprecedented stimulus to the economy and financial markets. The timing and extent of the stimulus' effects are unclear at this time, but clearly there is a positive directional effect.
- Companies and individuals have been forced to learn how to restructure their daily lives and their methods of communication. Businesses are adapting to working remotely and finding new ways to conduct business that may be lasting.

Impact on the Valuation Process

Valuation multiples of many public companies have come down significantly, likely reflecting expectations for substantial earnings declines and incorporating higher equity risk premia. When valuing privately-held companies, this implies that multiples based on historical earnings (which are developed by reference to guideline public company multiples) may need substantial reductions. Within discounted cash flow models, while Treasury yields may have declined, equity risk premia have increased and higher discount rates on cash flows may be warranted. As noted below, these affects aside, forecasts prepared by companies and analysts as recently as January 2020 are likely out of date.

There is clearly a desire on the part of most investors to raise cash and build liquidity. This makes owning an illiquid asset such as stock in a privately-held business or privately-held investment company far less attractive at the present time. MPI's proprietary restricted stock study demonstrates that higher discounts are warranted for securities that are more volatile and more restricted, the latter being a function of either legal trading restrictions or block size constraints. In the current environment, there may be a basis for meaningfully higher discounts for lack of marketability in cases where equity risk has increased.

Market capitalizations of publicly traded companies utilized within the guideline public company method are down sharply. Company budgets for 2020 and even multi-year projections developed pre-crisis may no longer be meaningful. Private company executives are likely in the process of building new budgets and forecasts simply to manage cash flow during this period. Valuation experts will need to request and rely on new forecasts and, perhaps, develop various scenarios, for current valuation dates, coupled with consideration for the uncertainty of longer-term impacts, in order to produce reliable and defendable valuation opinions.

Currently, many companies in the midst of obtaining regular year-end valuation exercises are grappling with the concept that their year-end 2019 valuations are likely much higher than the valuation that would be appropriate towards the end of the first quarter of 2020. For some companies, this may create issues that go beyond the scope of valuation. The use of current information (including cash flow forecasts) that accounts for the impact of the crisis for the purposes of year-end 2019 valuations could be problematic under scrutiny.

When possible, business owners should consider obtaining a valuation update to a more current valuation date in order to assess the impact of the crisis on company value. This would seem to be highly beneficial for many clients currently engaged in wealth transfer planning.

Continual reassessment of financial forecasts will be called for as we move through and beyond the peak of the crisis. During due diligence, valuation analysts will need to present a series of questions and considerations to company management to gauge the unique risks pertaining to the company's current and future financial performance. Identifying differences by industry, company and geography will be imperative.

Takeaways

In recent weeks, the values of countless privately-held companies have declined. The durations of the coronavirus-induced pandemic and depressed asset values are hard to predict. The current environment may be favorable for clients ready and able to execute wealth transfer strategies. The MPI team has adjusted to the new working environment, and is ready to promptly act as a resource for you and your clients during this challenging time.

About MPI

MPI, a prestigious national consulting firm founded in 1939, specializes in business valuation, forensic accounting, litigation support and corporate advisory work. MPI provides fairness opinions, sell-side and buy-side advisory services through its investment banking affiliate MPI Securities, Inc. MPI conducts every project as if it is going to face the highest level of scrutiny, and its senior professionals have extensive experience presenting and defending work product in front of financial statement auditors, management teams, corporate boards and fiduciaries, the IRS, other government agencies, and in various courts.

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