Corporate Planning: Navigating “Value” in Times of Choppy Market Activity

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In the uncertainty of this social distancing economy and volatile equity and debt markets, how should business owners and professionals of private companies think about value and the impact on corporate planning and financial reporting initiatives? In this article, we consider the difference between “price” and “value,” which may assist C-suite executives with internal planning and reporting efforts.

As we enter what many are considering a bear market and the end of one of the longest bull markets in recent history, one cannot help but draw some parallels to the time period from 2007 to 2009.

Approximately 12 years ago, we saw record oil prices, the S&P 500 top 1,500 points (amazing at the time), real estate values were peaking, and a high level of consumer sentiment. The subsequent declines in the equity markets hit nearly everyone by surprise as the sub-prime debt market collapsed and we all came to grips with the realization that a severe economic recession and financial crisis was upon us. With widespread uncertainty around the future, we experienced significant daily volatility in the markets and widespread uncertainty. To some extent, the mental and emotional stresses resulting from the financial crisis and Great Recession (as well as shifts in the way broad industries now operate) continue to linger. As a society, we have some level of anxiety remaining from the prior economic down cycle, which is important to consider as we look to understand the current environment.

Beginning in late February, we found ourselves again in an environment with a high level of uncertainty which at first led to a general panic across the globe. This panic manifested in the markets, with the S&P 500 retreating from topping 3,300 points in mid-February to less than 2,300 points in mid-March. The S&P 500 has since returned to exceed 3,000 points by mid-June, only this time the uncertainty is different with many investors feeling that current pricing exceeds value. Further, volatility as measured by the CBOE Volatility Index remains well above its historical average and has begun to tick up again in June.

The daily ups and downs in the markets are often driven by the introduction of “good” and “bad” news, developments with government stimulus, commentary by government officials and the Fed, and, of course, the latest updates regarding COVID-19. Prices of individual companies are generally even more volatile. This market reaction is a natural, human response to uncertainty and is similar to what we observed in 2008 and 2009. To some degree, it is entirely possible that the level of volatility we see today is fueled in part by our relatively recent experiences during the Great Recession and financial crisis of 2008. Regardless, at any given time, the market may reflect *pricing* of equity securities and a shift away from business fundamentals (i.e., financial statement data and analysis, *objective* assessment of risk and future returns, quantitative and qualitative comparisons across industry players, etc.). Without a doubt, company fundamentals have become much more uncertain since we do not know the extent of the economic impact caused by social distancing and the recent closures of many businesses. In fact, 49% of the companies in the S&P 500 that made earnings announcements have withdrawn earnings guidance completely.[1]

This brings us to the point of how value is ultimately derived, which is an assessment of risk and return. In other words, the *value* of an investment is measured first by the return that the investor expects to receive whether via a future cash flow stream, future capital appreciation, or its expected utility. The second half of the equation is an assessment of the risk in achieving that return (which is typically measured by looking data deriving from the public markets). The higher the risk, the lower the value and vice versa. The idea of value is not always consistent with how companies are priced, particularly in times of crisis.

The concept of price vs. value can be analogized to a raft vs. a submarine in stormy waters. A raft, floating on the surface of the water, is at the mercy of the choppiness of the water and can be equated to current pricing behavior in the public markets. The massive swings that occur in equity *prices* (for example, volatility that coincides with the release of new information as the investing community searches desperately for some level of certainty) may not be indicative of a company's true *value*. On the other hand, *value* can be equated to the submarine, which, sitting beneath the surface of the water, will rise and fall as the currents change but will not necessarily see the same choppy movement as compared to the raft.

The concepts above are not intended to suggest that the values of businesses are immune to market volatility or the economic impacts of current events, but rather to convey that true *value* will generally not exhibit the same level of volatility from one day to the next. In a business valuation, the impact of factors such as COVID-19 and economic uncertainty can be measured (at least to some degree) via quantitative adjustments to expected future cash flows. Store closures, changes in demand and pricing for products or services, increasing operating costs, investment in additional equipment, and the like can be measured with some level of objectivity as a cash flow adjustment. These types of adjustments tend to remove some subjectivity in assessing business risk and the ability for a company to achieve expected cash flow returns. In this way, the value of an investment may fluctuate based on the fundamentals of the business. Short-term external conditions may be offset by the ability of a company to persevere in the long-term, which provides relative stability in value from one year to the next. Additional subjective considerations that may not be determinable from a cash flow perspective, but certainly impact business risk, may include broad changes in investor sentiment toward specific industries, changes in merger and acquisition activity in the markets, and potential changes in government regulation and incentives. The point is that a proper valuation will quantify as much as possible within the expected cash flows of a business to reduce the "guesswork" inherent to assessing future risk. This is what moves an analysis away from providing a *price* and back to *value*.

For business owners who may be thinking that the bottom is falling out from under their organization's value, or perhaps those who are concerned about volatility in pricing, it may be helpful to take a step back and think objectively about what drives value. Pricing in the markets, while indicative of the direction in which value may be headed, will not necessarily provide an exact measurement of current

[1] Gartner, Inc. – through May 12, 2020.

value. Therefore, it is best to maintain a mindset toward value that more closely resembles the submarine, rather than the raft, and focus on the most important task; that is running your day-to-day business. MPI's valuation professionals are available to help you understand value. Please contact us if we may be of assistance.

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