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Valuing Your Business in a Volatile Economy

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Introduction

- The Global COVID-19 Pandemic has a had profound impact on all aspects of U.S. society.
- This has resulted in significant volatility in the overall economy and in most industries.
- Some businesses have experienced a slowdown, while others have seen more consistent operations and a smaller number have actually been busier.

Introduction

- There is also more uncertainty in the future outlook for many businesses depending on how long the pandemic lasts.
- The Paycheck Protection Program loan has provided a sources of capital for most companies and possible loan forgiveness would offset lost income.
- This significant volatility has impacted the valuation of all companies and has created additional challenges and opportunities for ownership transition.

Financial Impact and PPP Loans

"We're lost, but we're making good time."

- Yogi Berra

Financial Impacts

- Operating results during the closures immediately following the start of the pandemic.
- Current level of activity and outlook for the near future as compared to budget and past years.
- Long-term outlook for business following pandemic.
- Accounting for PPP loan proceeds and forgiveness.

Financial Results During the Pandemic

- Many companies have experienced reduced sales and also higher costs to produce products or services.
  - For some companies, this has just meant lower profits than in recent years.
  - However, other companies are operating at losses that could extend for the rest of the year and into 2021.
- These losses will be reflected in the interim and year-end financials for 2020 that are shared with key financial statement users.
- There could also be loan covenant violations based on interim and year-end results.
- Some companies may even need to consider possible going concern issues.

Long-Term Outlook

- It is critical to assess the long-term outlook in order to make strategic business decisions.
- Some products or services may no longer be viable while there could be a stronger market for others.
- Changes may also be needed to the way businesses operate process, including increased automation and remote work.
- Major changes caused by the pandemic make this a great time to reevaluate things such as plant or office capacity, product and service offerings and employment levels.

Impacts of the Pandemic on Revenue

- The quantity and quality of your sales drives all else within your business!
- Was your business forced to close or could you remain open during the pandemic?
- How have societal changes impacted the demand for your products and services?
- Businesses should have a written sales and marketing plan defining what products and services are sold.
- A sales and marketing plan should also provide details for all aspects of your sales process indicating how and when sales are made.
- Has this plan but updated to reflect significant changes that may be necessitated by the pandemic?

Impacts of the Pandemic on Operations

- Businesses cannot operate unless they can provide a safe work environment for their employees including compliance with many new rules and regulations.
- Many businesses saw disruptions in supply chains for materials, supplies or subcontracted services.
- There may also be significant changes in sales methods and distribution channels.
  - Salesman may not be able to visit customers in person.
  - Technology will be even more critical to support your sales and distribution plans.

Impact of the Pandemic on Competitors

- How is the rest of your industry reacting to the pandemic?
- Carrying out competitive intelligence can be an important part of your sales and marketing plan.
- During times of major change like the current pandemic, it is even more critical to understand what the competition is doing.
- Are competitors continuing to operate at similar levels, or have they cut back on some product and service offerings or made significant changes in price, quality, or distribution of products and services?

Polling Question #1

PPP Loan Initial Accounting

- **So, you received the money, now what??**
  - Segregate those funds.
    - Separate bank account; or
    - Separate general ledger account
  - Initial accounting should be:
    - Debit: Cash $XXX,XXX
    - Credit: PPP Loan (Debt) $XXX,XXX
  - Continue to record expenses as you have in the past.
  - Move PPP funds out of segregated cash account and into operating cash account as needed for eligible expenses.

PPP Loan Forgiveness

- **Forgiveness Application Process**
  - Once submitted to the lender, lenders have **60 days** to review your application and submit their decision to the SBA.
  - SBA then has **90 days** to evaluate your application.
  - If application is submitted within **10 months** after the end of the Covered Period, the borrower is <u>not required</u> to make any payments until the forgiveness amount is remitted to the lender by SBA.
  - If the loan is fully forgiven, the borrower is not responsible for any repayments.
  - Any portion that is not forgiven is subject to repayment at 1% interest.
    - 2-year term for loans originated prior to June 5, 2020 (can request extension to 5 years)
    - 5-year term for loans originated on June 5, 2020, or later

PPP Loan Forgiveness - Accounting

- **How to account for forgiveness**
  - The amount of the forgiveness should be brought into income, generally recorded as "Other income" in financial statements.
    - Debit: PPP Loan (Debt) $XXX,XXX
    - Credit: Other Income $XXX,XXX
  - *But WHEN?*
  - Two potential sources of conflicting guidance:
    - FASB ASC Topic 470, *Debt*
    - IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*
  - SEC has indicated it would not object to an SEC registrant accounting for a PPP loan under either standard.

PPP Loan Forgiveness - Accounting

- **How to Account for Forgiveness**
  - FASB ASC Topic 470, *Debt*
    - Initially record the cash inflow from the PPP loan as a financial liability and accrue interest.
    - Do not impute additional interest at a market rate.
    - Continue to record the proceeds from the loan as a liability until either:
      - (1) the loan is partly or wholly forgiven, and the debtor has been legally released; or
      - (2) the debtor pays off the loan.
    - Reduce the liability by the amount forgiven and record a gain on extinguishment once the loan is partly or wholly forgiven and legal release is received.

PPP Loan Forgiveness - Accounting

- **How to Account for Forgiveness**
  - IAS 20, Accounting for Government Grants and Disclosure of Government Assistance
    - Nongovernmental entity that is not an NFP (that is, it is a business entity):
      - Expects to meet the PPP's eligibility criteria; and
      - Concludes that the PPP loan represents a grant that is expected to be forgiven; then
      - It may analogize to IAS 20 to account for the PPP loan.
    - Once there is reasonable assurance that conditions for forgiveness will be met:
      - Income can be recognized systematically in the same period as related costs.

PPP Loan Forgiveness - Accounting

- **How to Account for Forgiveness**
  - Other considerations
    - Taxability of related expenses
      - Deferred taxes (C-Corp.)
    - Subsequent events
      - Non-calendar year end companies –
        - Have you satisfied ALL conditions for forgiveness?
        - Can you be reasonably certain that forgiveness will occur?
      - Application submitted prior to year end, but not approved until after year end?

Business Valuation Overview

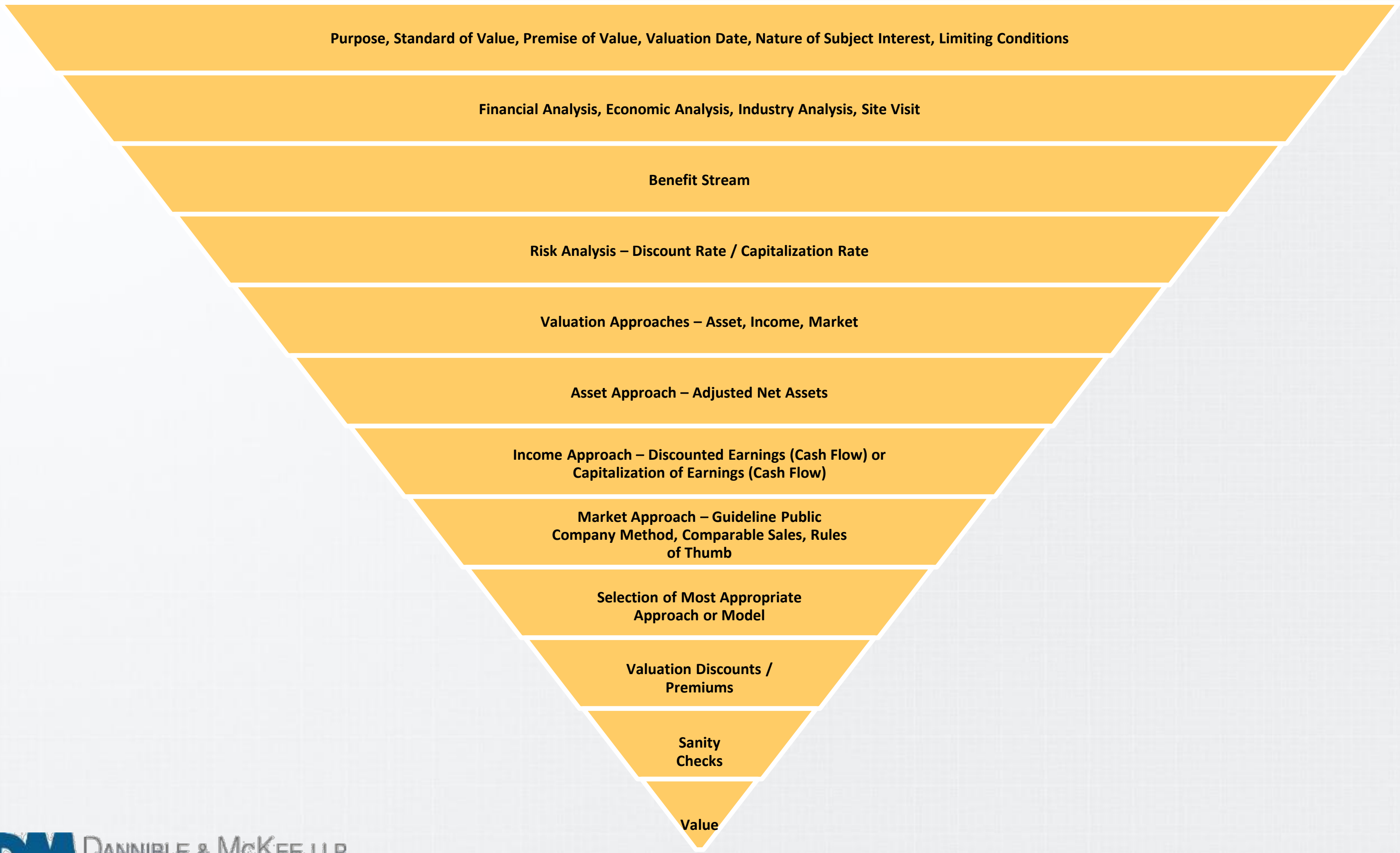
"I knew the record would stand until it was broken."

- Yogi Berra

Valuation of Closely-Held Businesses

- A proper business valuation is <u>both</u> an **art** and a **science**.
- The science of business valuation is represented by systematic approaches, quantitative analysis, fact gathering and research about the subject company, the industry in which it operates and other internal and external factors impacting the company's business and ability to generate future cash flow.
- The art of business valuation is represented by those who have the depth of experience and expertise in the science of valuation to achieve the best result by weighing the underlying components of value and taking into account <u>all relevant issues at hand</u>.

The Valuation Process



Fair Market Value

- IRS Revenue Ruling 59-60 defines **Fair Market Value** as:

"the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property."

Fair Market Value

- **Fair Market Value** standard is the most recognized and accepted standards used in all tax situations (estate, gift, income tax, purchase price allocations, etc.).
- Key elements of the **Fair Market Value** standard are that the parties to the transaction are "hypothetical," the transaction is at "arm's-length" and that the buyer and seller are able and willing.
- **Fair Market Value** will contain a premium for control and a discount for minority interest.
- Because a fair market is based on a hypothetical buyer and a hypothetical seller, this value can be affected by an actual buyer or seller's unique motivations.

Fair Value

- **Fair Value** is defined by the *Uniform Business Corporation Act* as "the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action" (stockholder's value).
- The **Fair Value** standard possesses some characteristics of **Fair Market Value** in that there is commonly a willing buyer but not a willing seller. However, the parties are typically known and the buyer may be more knowledgeable than the seller.
- Many valuation experts consider **Fair Value** to be **Fair Market Value** without discounts for minority interest or lack of marketability.

Investment Value

- **Investment Value** is the value to a particular investor, which reflects the particular and specific attributes of that investor.
- In contrast to **Fair Market Value**, the **Investment Value** standard identifies a particular buyer or seller and the attributes that buyer or seller brings to the transaction.
- Also commonly referred to as **Synergistic Value** because of synergies between the buyer and seller (geographic location, specific product or service offerings, know-how, customer base, competition, etc.).
- The **Investment Value** standard is typically used in merger/acquisition transactions.

Levels of Value

Strategic Value of Closely-Held Business Sold to Outsider ↔ **Synergistic Value**
(Investment Value or Acquisition Value)

Premium 10% - 40%

"Deal Zone" – sales price to outsider

Internal Transfer Price
- No premium for control
- No discount for minority interest ↔ **Fair Value of Closely-Held Business**
(Stockholder's Value)

25% - 50% Discount

Value for Income, Estate and Gift Tax
-Premium for Control and Discount for Minority Interest
-Marketability Discount ↔ **Fair Market Value**
(IRS Value)

Elements of Value – Revenue Ruling 59-60

- IRS Revenue Ruling 59-60 introduced eight (8) factors that must be considered in determining the fair market value of a closely-held business.
  - The nature of the business and history of the enterprise since its inception.
  - The economic outlook in general and the condition and outlook of the specific industry in particular.
  - The book value of the stock and financial condition of the business (**Asset Approach**).
  - The earning capacity of the business (**Income Approach**).

Elements of Value – Revenue Ruling 59-60 (*Cont.*)

- The dividend-paying capacity of the business.
- Whether or not the enterprise has any goodwill or intangible value.
- Sales of the stock and the size of the block of stock to be valued.
- The market price of stocks engaged in the same or similar line of business having their stocks actively traded in a free or open market (**Market Approach**).

Valuation Approaches

- Valuations of closely-held businesses fall into any one of three (3) general approaches.
  - **Asset Approach** – Value of the business is based solely on the value of the entity's assets net of liabilities, including both tangible and intangible assets.
  - **Income Approach** – Most widely used method of valuing a closely-held business where value is the sum of the present values of the expected future economic benefits attributable to the ownership interest.
  - **Market Approach** – Value of a closely-held business is determined by reference to the market values of comparable companies who are either publicly-traded or were recently sold in the private marketplace.

Polling Question #2

Business Valuation Amid Current Uncertainty

"A nickel ain't worth a dime anymore."

- Yogi Berra

Valuation of Closely-Held Businesses

- For most closely held businesses, the value of the business is by far the largest investment of the business owner.
- Still most owners have never had a valuation performed for their business and don't have a true sense of its value.
- This would be like putting money in an investment account every month, counting on that money for your retirement, but never opening the monthly statement to monitor the value in your account!
- Business values may have changed significantly as a result of the pandemic so determining the value of your business could be even more critical.

Impacts of the Pandemic on Business Value

- Operating losses during the 2020 year would reduce the book value of the Company, which in turn would directly reduce that element of the business value.
- These losses would also factor into historical average earnings that are generally used as part of the income approach.
  - However, historical earnings are only used as a proxy for future earnings.
  - If losses in 2020 are considered to be temporary or unusual, a normalizing adjustment could be made.
  - In determining the historical average earnings, the appropriate weighting of the 2020 year will also need to be considered.
- Projections for future years will be even more critical and may impact the historic income or EBITDA levels used in the valuation or the risk factor (multiple) applied to the amounts determined.

Impacts of the Pandemic on Business Value

- The PPP loan will also be a significant consideration in valuing manufacturing businesses in 2020.
- Most manufacturers will have their PPP loans fully forgiven and this will be recognized in 2020 valuations even if final approval does not occur until 2021.
- The PPP loan forgiveness will increase book value, helping to replenish losses or provide for additional book value for those companies still operating at a profit.
- The income from PPP loan forgiveness is a nonrecurring item that should not be included as part of income for valuation purposes.

Increases or Decreases in Book Value

- The Book Value of a business will generally have a direct impact on its valuation.
- For example, if all other things are the same and a business holds $1 million in additional cash, that business should be worth $1 million more.
- As a result of the Pandemic, book value may have changed may have fluctuated more significantly than normal as losses would reduce book value for some companies while others have retained income to be more conservative.
- As indicated above, possible PPP loan forgiveness would also increase book value and it will be critical to determine when forgiveness should be recognized for accounting, tax and valuation purposes, helping to replenish losses or provide for additional book value for those companies still operating at a profit.

Book Value Examples

	Keep PPP Loan on the Books			Record PPP Loan Forgiveness		
2020 Income	Loss	Income	Income	Loss	Income	Income
Distributions	Normal Level	Normal Level	None	Normal Level	Normal Level	None
Book value Dec. 31, 2019	**$ 2,000,000**	**$ 2,000,000**	**$ 2,000,000**	**$ 2,000,000**	**$ 2,000,000**	**$ 2,000,000**
Net income for 2020	(500,000)	600,000	600,000	(500,000)	600,000	600,000
Distributions to shareholders	(400,000)	(400,000)	-	(400,000)	(400,000)	-
PPP loan proceeds	800,000	800,000	800,000	800,000	800,000	800,000
PPP loan obligation	(800,000)	(800,000)	(800,000)	-	-	-
Book value Dec. 31, 2020	**$ 1,100,000**	**$ 2,200,000**	**$ 2,600,000**	**$ 1,900,000**	**$ 3,000,000**	**$ 3,400,000**

Changes in Average and Projected Earnings

- In determining value, the earnings capacity of a business should be forward looking as it is future earnings that will be available to a buyer of the business.
- However, average historical earnings will often be used as the best way to estimate future earnings.
- Significant consideration will be needed to determine how the volatile 2020 year should factor into the average of historical earnings.

Changes in Average and Projected Earnings

- Any PPP loan forgiveness income would generally be considered as non-recurring and would be subtracted from income.
- The pandemic's impact on 2020 operating income could also be considered as non-recurring, including losses caused by lower sales along with additional expenses due to safety measures and other changes.
- The more critical factor will be to consider the outlook for future years and how this is best represented by average income from 2020 and other recent years.

Average Income Examples

	Actual For Year Ended December 31,					December 31,
	2015	2016	2017	2018	2019	2020
Income (loss) from operations	$ 400,000	$ 450,000	$ 500,000	$ 550,000	$ 600,000	$ (200,000)
PPP loan forgiveness income	-	-	-	-	-	600,000
Net Income (Loss)	$ 400,000	$ 450,000	$ 500,000	$ 550,000	$ 600,000	$ 400,000
Valuation adjustments						
Shareholder bonus	50,000	60,000	40,000	70,000	60,000	-
Rent expense to related party	(20,000)	20,000	30,000	-	40,000	20,000
PPP loan forgiveness income	-	-	-	-	-	(600,000)
Adjusted Net Income (Loss)	$ 430,000	$ 530,000	$ 570,000	$ 620,000	$ 700,000	$ (180,000)

	2019	2020
Simple average		
Average earnings	$ 570,000	$ 448,000
Multiplier	4.00	4.00
Goodwill factor	$ 2,280,000	$ 1,792,000
Weighted average		
Average earnings	$ 612,000	$ 362,000
Multiplier	4.00	4.00
Goodwill factor	$ 2,448,000	$ 1,448,000

Impacts on the Market Approach

- Determination of income under the Market Approach will also be significantly impacted by the recent volatility.
- Key company metrics used in Market Approach calculations include revenue, number of employees, earnings, EBITDA, and book value, all of which may have fluctuated.
- In addition, as a result of current market factors and future outlook, the actual multiples applied to these company metrics may also have changed.

Polling Question #3

Succession Planning Overview

"If you don't know where you're going, you'll end up someplace else."

- Yogi Berra

What is a Business Succession Plan?

"An established framework within a business enterprise which provides for the orderly transition of all aspects of the business upon the occurrence of an event or series of events, whether foreseen or unforeseen."

Introduction to Transition Planning

- Ownership transition is an issue that **MUST** be addressed in every closely-held company.
- The lack of a clearly-defined ownership transition plan can:
  - Lead to confusion and disputes among key employees and family members.
  - Cause disruptions in business operations.
  - Result in the dissolution of value to existing and future owners.

The Need for Ownership Transition

- To foster company growth through the admission of new owners.
- To poise the business for unexpected opportunities.
- To create a market for existing owners upon death, disability, retirement or separation from service.
- To add expertise or retain key personnel.
- To plan for a business owner's most significant retirement asset.

Challenges in Transition Planning

- **Economic Challenges**
  - Devalued or depleted retirement assets from the recession have delayed retirements and have stalled transition planning.
  - More stringent lending environment reduces available financial resources to implement ownership transition (i.e. lack of borrowing capacity).

- **Demographic Challenges**
  - 78 million "Baby Boomers" are being replaced by 20% less "Generation Xers."
  - Younger generations are generally more cautious, more life-balanced and have fewer financial resources.
  - Demand for talent has exceeded supply.

Opportunities in Transition Planning

- Retain existing talent through ownership.
- Attract outside talent from competitors.
- Business expansion through mergers and acquisitions.
- Favorable interest rate environment for companies with borrowing capacity.
- Additional available capital from PPP loan forgiveness.

Two (2) Types of Transition Plans

- **Internal** – transition of existing ownership to family members and/or key employees who have or will take an active role in the business
  - Common internal ownership transition strategies include gifts, cross-purchases, redemptions, stock bonuses, deferred compensation and employee stock ownership plans (ESOPs).
- **External** – transition of existing ownership to individuals or entities outside the business enterprise
  - Common external ownership transition strategies include mergers, stock acquisitions, asset acquisitions and liquidations.

Internal Ownership Transition Plans

Pros	Cons
• Continuation of the company	• Lack of future owners
• Access to a pool of buyers who are in the company	• Candidates for ownership may be more risk adverse
• Assurance of a reasonable return	• Funding through current operations
• Ongoing control until retirement	• Possible transfer for less than maximum value
• Continuance of salary and benefits	• Greater risk post-transition if management not properly transitioned

External Ownership Transition Plans

Pros	Cons
• Possible transfer for maximum price	• Difficulty in finding right buyer
• Provides for greater liquidity and less risk for existing owners	• Confidentiality
• Shorter time frame	• Post-merger integration can be difficult due to cultural differences
• Add new talent, skills, markets or service offerings	• Loss of control and identity
	• Staff / client retention

Ownership Transition Vehicles

- Vehicles used to transfer equity ownership or synthetic equity to the next generation include:
  - Stock Issuances
  - Cross-Purchase Transactions
  - Stock Redemptions
  - Stock Bonuses
  - Stock Options, Phantom Stock & Stock Appreciation Rights (SARs)
  - Recapitalizations
  - Gifts

Funding Mechanisms

- Funding mechanisms to provide capital to effectively transfer equity ownership include:
  - Insurance
  - Installment Sales
  - Qualified Retirement Plans
  - Employee Stock Ownership Plans (ESOPs)
  - Nonqualified Deferred Compensation

Transition Vehicles & Funding Mechanisms

- The use of any of the above transition vehicles and funding mechanisms is driven by:
  - The goals of the parties in ownership transition (particularly the sellers),
  - The retirement horizon of the selling generation,
  - The degree of control to be retained,
  - The size of the company,
  - The pool of potential buyers, and
  - A host of other financial and non-financial considerations.

Transition Vehicles & Funding Mechanisms

- A proper plan is one that will "mesh" the goals of the selling generation and the buying generation and address the key concerns of:
  - Timing,
  - Affordability,
  - Tax-efficiency, and
  - Cash flow.

Polling Question #4

Current Challenges and Opportunities for Ownership Transition

"When you come to a fork in the road, take it."

- Yogi Berra

Best Practices

- Start transition planning early.
- Work to prepare the next generation.
- Communicate a clear vision to family, key employees, fellow owners and other members of transition "team."
- Develop a written plan.
- Incorporate your succession plan as part of your overall business/strategic plan as well as your corporate culture.
- Anticipate and address conflict.

Effects of the Pandemic on Ownership Transition

- The impact of the pandemic will also need to be considered when planning for ownership transition.
- Internal and external sales in process or being contemplated in 2020 were often put on hold.
- Valuation of some companies may have declined, and this could delay some transitions until values rise to a level that is acceptable to the seller.
- In other situations, lower current values could make transactions more affordable to buyers.
- This could also be good time for gifting of ownership to a next generation of family members based on current values and the structure for estate and gift taxes.

Current Environment for Ownership Transition

- The most critical factor will be the future cash flow as this will be needed by both internal and external buyers to pay for the purchase.
- Funds from PPP loan, especially if forgiven, will also be an important consideration in any ownership transition plan.
  - Depending on timing for forgiveness, should any excess cash from the PPP loan be credited to shareholders in 2020 or 2021?
  - Can retained capital from PPP loan forgiveness be used to help fund a stock buyback?
- The current structure for capital gains tax could make 2020 an attractive time for sellers.

Business Acquisitions and Sales

- Successful companies continuously evaluate both possible business acquisitions and sales.
- The pandemic can provide an excellent opportunity for an acquisition or sale.
- Acquisitions could involve direct competitors or might provide for entry into new markets, possibly at a bargain price.
- Selling or closing unprofitable areas of your business should also be regularly evaluated.
- Proceeds from PPP loans could also be used to help pay for acquisitions or could be retained by sellers as part of their value is a sale.

Business Acquisitions and Sales

- Acquiring the competition might be easiest way to gain market share.
- In evaluating a potential acquisition within your industry, you must also consider what will happen if the target is acquired by another competitor or someone entering the industry.
- To learn of companies that are interested in selling, you must keep your ear to the ground and communicate with resources within your industry.

Business Acquisitions and Sales

- You can also seek out possible acquisition targets, either directly or through an intermediary such as a business broker.
- Acquiring a struggling company might be less costly but remember there are reasons they are struggling, and you will need to determine how you can improve their results.
- It is critical to understand the value of your company and how businesses are valued in your industry.

PPP Rules for Ownership Changes

- The SBA recently issued additional guidance for situations when there is a change in ownership of a PPP borrower.
- According to the notice, a "change of ownership" occurs for PPP purposes when at least one of the following is true:
  - At least 20% of the common stock or other ownership interest of a PPP borrower is sold or otherwise transferred, whether in one or more transactions, including to an affiliate or an existing owner of the entity;
  - The PPP borrower sells or otherwise transfers at least 50% of its assets (measured by fair market value), whether in one or more transactions; or
  - A PPP borrower is merged with or into another entity.
  - Note that all sales or transfers that have occurred since the date of the approval of the PPP loan must be aggregated.

PPP Rules for Ownership Changes

- Regardless of a change in ownership, the PPP borrower remains responsible for:
  - Performance of all obligations under the PPP loan;
  - The certifications made in connection with the PPP loan application, including the certification of economic necessity;
  - Obtaining, preparing, and retaining all required PPP forms and supporting documentation.
- Before closing any change-of-ownership transaction, a PPP borrower is required to notify the PPP lender in writing of the contemplated transaction and provide the PPP lender with supporting documentation.
- The PPP lender must notify the SBA within five business days of the completion of a transaction.
- Some changes in ownership may require SBA approval, with the SBA having 60 calendar days to review and provide a determination of its approval.

Conclusion

- The Pandemic has caused societal and economic changes that have had a dramatic impact on many businesses.
- The value of their company is often the most significant asset of business owners and in volatile times it is even more critical to understand how that value is determined.
- Business values will be impacted by current results and changes in book value including possible impact of the PPP loan forgiveness.
- More critical is the future outlook for the business.
- Recent volatility provides both challenges and opportunities in that should be considered as companies evaluate their plans for ownership transition.

Questions

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