Business Valuations Meet COVID-19 - Win, Lose or Draw?

As the COVID-19 reaction clobbers economies around the world, business appraisers must consider its impact on business valuations. This **reduction in valuations** may be a silver lining in terms of **tax benefits** for those considering gifting or other asset transfers. It may also be a good time to follow Warren Buffet's rule of being "greedy when others are fearful". So, what will current business valuations tell us?

Because business valuations are based upon information **"known or knowable"** as of the valuation date, they must consider when COVID-19 first affected business values.

Using stock market indexes as a gauge, U.S. markets appear to have been "infected" about **February 24, 2020**. The Dow Jones Industrial Average broke below its 50-day moving average that day, in above-average trading volume and broke below its 200-day moving average in even higher volume the following day. A failed rally did not close above the 200-day line and by March 23rd, the index had plummeted approximately 36% from its close on Friday, February 21st.

Under the known or knowable premise, a valuation effective as of year-end 2019 should not consider the impact of COVID-19. However, for **later valuation reports**, the appraiser will be considering the need to include the effects of the pandemic in the appraisal report.

The financial implications of the pandemic can show up negatively in several ways. **Expected cash flows** for many businesses, which are the foundation of business appraisals, are likely to be lowered, perhaps materially. Even if historical economic income is used in the appraisal formula, the growth factor applied to the measure is likely to be less today than in late February, recognizing relevant risk factors.

Discount rates, which are another measure of risk, are expected to increase. Duff & Phelps, a publisher of data used in developing discount rates, is already recommending an increase in risk premia common to all businesses. Risk premia relating to industries hit harder by the pandemic are likely to increase, as are other business elements unique to the entity being appraised.

Discounts for lack of marketability (DLOMs) are also likely to be affected by the current situation. A **DLOM** reduces the value of an ownership interest to recognize the relative reduction in marketability (e.g., liquidity). The U.S. equity markets are the benchmark for liquidity, with the ability to sell a public stock over the phone and have cash in hand within three business days. Investors love liquidity and demand a discount when it's lacking. Therefore, even during "normal" times, private business interests are subject to **value reductions** due to the risk of a longer time from listing to sale. Studies have shown there is a correlation between market volatility and DLOMs, with higher volatility resulting in larger DLOMs. Given the current volatility in the U.S. equity markets, and expected reluctance of investors to undertake new investments in illiquid business interests, DLOMs are likely to increase.

Given this environment, it may be advantageous to commission a business appraisal for gifting or estate planning. It may also be a good time to evaluate acquiring an otherwise sound business or one with synergistic potential, where the value is reduced due to current stresses. We are available to discuss your options and opportunities.

You can reach the author, Mitch Hoffman, at 303-486-0005, or other firm members at 303-486-0000. We are available to assist with valuations, taxing situations, and litigation support for family law and damages. See our firm bios and more information at www.moneytalkswetranslate.com.

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