Assessing Additional Economic Risk Due to COVID-19

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Somewhere between my third and fourth Zoom call on business appraisal and economic damages issues on a recent workday, I was struck with a thought on how to capture the impact of this incredibly unique circumstance that has increasingly enveloped pretty much every aspect of our work just now.

To further set the stage, I listened in recently to the first of a two-part webcast series produced by Business Valuation Resources on the impact of COVID-19, featuring Gary Trugman, Michelle Gallagher, Stacy Collins and Harold Martin.[1] These four individuals hit it out of the park with their insights and suggestions, but I was left with the notion that we, particularly as business and IP appraisers, likely need to remain extremely flexible in the days and weeks and months ahead. We will need to adjust our projected cash flows, modify the unsystematic risk in our discount rates, tamp down our market multiples, and otherwise do our best to capture the impact of all of this within the valuation methods we choose to apply in any given circumstance to derive indications of value, regardless of the engagement purpose.

Later in that same day, I convened a Zoom call between members of the Expert Resource Connection group I am honored to be part of to discuss how we are all dealing with the impact of the COVID-19 virus. My biggest take away is that we are all being challenged by all aspects of this in ways we could not comprehend just 90 days ago.

I also found some insightful remarks by Edwina Tam, a partner at Deloitte in Hong Kong, which were included in the May 2020 issue of *Business Valuation Update*.[2] She points out that, in determining the nature and extent of the impact of current market uncertainties on the business and valuation assumptions, a number of specific issues would need to be considered, such as store or facility closures, customer loss or decreased traffic, production delays, risk of losing significant contracts, and others. "Implicitly, these uncertainties need to be reflected in the cash flows; however, a risk-appropriate discount rate also needs to be considered," she says. "There is no set approach to account for market uncertainties as the impact will be different for different businesses in different regions."

As I try to take all of this in and relate it to the business appraisal and related work we do, I wonder if there is an appropriate way to address an estimate of how this will impact the value of closely

[1] Extreme Uncertainty: How Valuation Experts Should Respond to Today's Volatility and Risk; Free BVR Webinar, April 7, 2020; recording available at: https://sub.bvresources.com/trainingeventpast.asp?webinarid=768
[2] Global BVU News and Trends, *Business Valuation Update*, March 2020, Vol. 26, No. 5, page 33.

held businesses going forward, as of a given point in time. I believe we need to expand our thinking with respect to how we consider and assess the estimated impacts on the specific business enterprise and its industry sector we are confronted with in an engagement. How to quantify the risk associated with the short- and long-term impacts of the COVID-19 virus is the magical question. Another way to put this is while we now have a reasonably good grasp of when the onset of COVID-19 was "known and knowable", valuation analysts are now incredibly challenged, like never before in many instances, with the necessity to make a determination of the duration and depth of the economic impact within each assignment undertaken in the post COVID-19 era. Below is an analytical framework that can be utilized by the valuation professional to identify the attributes that may apply to any particular appraisal assignment where the subject company will be affected by COVID-19.

BUSINESS CHARACTERISTICS AND COVID-19 RISK FACTORS: SUMMARY

Note: The Risk Ratings are designated as "High", "Medium" or "Low" and are the valuator's reasoned assessment of the factors that are particular to the subject ownership interest as of the date of valuation[3]. It is critically important to be cognizant of what was considered "known and knowable[4]" as of the valuation date as the focus of this assessment.

Industry/External	Short-Term RISK	Long-Term RISK
1. Is this industry more highly susceptible to closing?	Low	Low
2. Are there significant innovations that could change the industry?	Low	Low
3. Will the industry be impacted by supply chain issues upon re-opening?	Low	Low
4. Does the industry traditionally have customer loyalty or will there potentially be shifts in customers post COVID-19?	Low	Low
Physical Operations – Service Entities	Short-Term RISK	Long-Term RISK
5. Was the business shut down?	Low	Low
6. Do clients come individually or in groups?	Low	Low
7. Do clients receive services individually or in groups?	Low	Low
8. Do services require "hands-on" (dental, hair salons,)?	Low	Low
9. Are client contacts short duration (haircuts) or long duration (concerts)?	Low	Low
10. Is there a pent-up demand for the services?	Low	Low

[3] All ratings are set to "Low" for this example template and would be subject to adjustment based on the professional judgment of the analyst.
[4] Refer to the timeline produced by Jim Hitchner of Valuation Products and Services that does an excellent job of articulating the timeline of the COVID-19 virus and when certain aspects should have been known and knowable.

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11. Can services be provided remotely?	Low	Low
12. Can services be delivered or picked-up?	Low	Low
13. Have clients been lost that are unlikely to return?	Low	Low
14. If recommended "social distancing" is enforced, does it limit the number of clients that can be served?	Low	Low
15. Are employees required to spend significant time in close physical contact with other employees?	Low	Low
16. Is Personal Protective Equipment necessary and available?	Low	Low
17. Can the operations be restructured based upon COVID-19 concerns?	Low	Low
18. Are qualified employees available?	Low	Low
19. Will furloughed employees be likely to return?	Low	Low
20. What skills are required for the necessary workforce?	Low	Low
Physical Operations – Products Entities	Short-Term RISK	Long-Term RISK
21. Was the business shut down?	Low	Low
22. Can products be delivered or picked-up?	Low	Low
23. Are employees required to spend significant time in close physical contact with other employees?	Low	Low
24. Is Personal Protective Equipment necessary and available?	Low	Low
25. Can the operations be restructured based upon COVID-19 concerns?	Low	Low
26. Does the demand for the product remain strong?	Low	Low
27. Were significant contracts lost and how likely are they to be reinstated?	Low	Low
28. Are the suppliers available and stocked with the necessary raw materials?	Low	Low
29. Are supplies sourced domestically or from foreign sources?	Low	Low
30. How will technology change the way business is conducted?	Low	Low
31. Will labor be readily available with the proper skills and training as demand returns?	Low	Low
Financial Risk: Current Status and Historical Trends	Short-Term RISK	Long-Term RISK
32. Does the Company have significant excess working capital?	Low	Low
33. Is there significant debt?	Low	Low
34. Does the Company have significant goodwill and has it been impaired?	Low	Low
35. Does the Company have significant investment assets that have lost value?	Low	Low
36. Did the Company receive PPP funds?	Low	Low
37. Will PPP funds be utilized for forgivable expenses?	Low	Low
38. Is there other economic assistance that should be considered, including deferral of expenses and state and local assistance?	Low	Low

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Management	Short-Term RISK	Long-Term RISK
39. Does management have a plan to fully reopen, close or modify any parts of the business closed down?	Low	Low
40. Does management have the competence necessary to run the enterprise in a post COVID-19 environment?	Low	Low

The indicated level of risk for each element can be adjusted from low to medium or high based upon the answers to the above questions. There may be different emphasis put on the risk factors for the short-term as opposed to the long-term for any given element. The identified elements are not necessarily all inclusive and the analyst should try to take a wide view of the circumstances present in any given assignment.

If this analysis is being used in conjunction with a Discounted Cash Flow model under an Income Approach where the future results of operations are being projected, care must be taken to not double count risk factors that are taken into account in the projection, as compared to any adjustments to industry and enterprise unsystematic risk. Regardless, this framework can also be useful in building support for the assumptions that will underlie the projected financial activity. There may be different risk factors and weightings thereon for projections that are "worst case", "most likely" and "best case".

Diving a bit deeper into the modeling of prospective cash flows and the impact of COVID-19 thereon, be reminded of the need to use your best efforts to first assess the estimated duration and depth of the impact on your valuation target and its industry sector. A number of critical questions emerge:

- Does the enterprise have sufficient working capital to sustain itself through whatever periods of economic slowdown or losses are being projected?
- Does the analyst need to put more emphasis on projecting out the balance sheet and capital structure of the enterprise than would have been necessary in prior periods?
- How much working capital is needed throughout the projection period and is what once may have been considered excess now be considered to just adequate or falling short of the projected needs?
- How do any Paycheck Protection Program (PPP) funds enter into the picture of what is being forecast?
- How should the PPP proceeds and the operating expenses paid with such funds be treated for tax purposes within the DCF method being utilized?
- Does it make sense to consider different discount rates for different discrete periods within the period being projected to the point of future sustainability?

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What we do know is that we now have a myriad of added complexities to consider in most valuation assignments we will be encountering in the months and likely years ahead. The cost and timelines for our work will increase, but often in an environment that will not be accommodating to these realities. Hopefully we will begin to get some clarity in the next several weeks and months with respect to the long term impact on the economy and specific industry sectors, like travel and hospitality, but we may not have a totally clear picture for years. This clarity may be more evident in certain industry sectors and geographic regions, with others lagging. In the meantime, a structured framework of this type to support your assumptions may be helpful as an addition to your workpapers and possibly within your expert reports.

(Note: I want to recognize the assistance of Charlotte Hart, CPA, CVA, in the preparation of this article.)

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