The Edward P. Gallogly American Inn of Court

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The Impact of the Coronavirus on Business Valuations for Rhode Island Divorce Purposes

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I. Retention of the Business Valuation Expert

A. Retention of the business valuation expert is an important first step, in the business valuation process.

i. Certified Public Accountants with a business valuation designation are generally well-trained and well-suited to assist.

ii. Other family law lawyers are a great referral source for recommending an experienced business appraiser familiar with the Rhode Island Family Court system.

iii. Of most importance is the valuation expert's level of experience, in completing a specific valuation assignment. Inquire as to the valuation expert's experience in depositions and testifying at trial.

B. Tips for the initial conversation with the prospective business appraiser.

i. First, lawyers should resist the urge to simply ask how much and how.

ii. Request the expert’s CV.

- Ask about relevant experience, in Rhode Island Family Court.
- Ask if the expert has ever testified.
- Inquire as to how involved the expert is in the local and national business valuation community. Does the expert publish; does the expert teach or regularly attend BV seminars?
- Ask if the expert is familiar with certain landmark Rhode Island business valuation cases.

- Based on how the expert interprets and treats certain issues, he or she may or may not be the right expert for your client.
- Remember the business valuation expert is required to be an advocate, for his or her opinion of value.
- The lawyer is an advocate, for the client.
- Inquire about the business valuation standards the expert follows.

C. Preparation for the initial conversation with the prospective business appraiser.

i. It is very helpful for the divorce lawyer to have some financial information, even if limited, regarding the business, to be valued.

ii. The valuation expert needs some idea, as to the size and complexity, of the business valuation assignment, in order to quote a fee.

iii. The expert will ask you for information about revenues, profitability, number of employees, ownership interest to be valued, information about the nature and history, of the business, what the business actually does, whether revenues are increasing or decreasing, and some idea as to the assets and liabilities, of the business.

iv. A great deal of this information can be found in the current business income tax return or financial statements. The business valuation expert can guide the attorney, as to where to locate specific information.

v. Also information can be located on the Company's website and the Rhode Island Secretary of State's Corporate Database.

vi. The expert will need to know if the business interest was acquired before or during the marriage, as more than one business valuation may be required.

vii. The business appraiser will also need to know if some or all of the business interest was acquired by gift or inheritance.

viii. The business appraiser may also inquire if the case, based on the type, size and complexity, of the business, and the dynamics of the litigants, is suitable for a joint retention. Some cases are and some cases are not.

D. Moving the process forward

i. Once the business appraiser has sufficient information, a fee or estimated fee can be provided.

ii. Some appraisers will quote an hourly rate and provide an estimate of hours. Some appraisers will quote a flat fee, for the engagement (not including deposition or trial time).

iii. A time frame should be discussed. Keep in mind divorce cases have an odd ebb and flow and each case is different.

iv. The lawyer and expert should communicate regularly as to the status of the case and when information is being provided.

v. Once instructed the business appraiser will provide an engagement letter, document request list and a company questionnaire.

vi. Types of business valuation work product:

- Full formal report
- Calculated value

vii. Understand what a business valuation includes and does not include. A business valuation is not a financial forensic audit.

II. <u>The Impact of the Coronavirus on Business Valuation for Rhode Island Divorce Purposes</u>

A. The Economy

Rhode Island Economic Indicator
(A joint publication of the Center for Global and Regional Economic Studies at Bryant University and The Rhode Island Public Expenditure Council, Update for Q2 2020)

Pandemic causes historic contraction of economic activity and employment in Q2 2020

Congressional Budget Office 10 Years Out

- The US economy could take the better part of a decade to fully recover from the coronavirus pandemic and related shutdowns…
- …the sharp contraction triggered by the coronavirus caused it to mark down its 2020-30 forecast for US economic output by a cumulative $7.9 trillion, or 3% of gross domestic product, relative to its January projection.
- GDP isn't expected to catch up to the previously forecast level, until the fourth quarter of 2029…

https://www.wsj.com/articles/decline-in-factory-output-eased-in-may-but-recovery-set-to-be-slow-11591006623

Professor Edinaldo Tebadi – Bryant University – Estimates a 10 year-recovery period

- There is a disconnect between the stock market and the economy.

- As the Coronavirus shows resurgence nationwide, the economic environment becomes more uncertain.

- Many economists predict that closely-held businesses will see recovery in 2022 to 2023.

- Many businesses have not been negatively impacted, from a financial perspective, by the Coronavirus.

- Many businesses have been negatively impacted, from a financial perspective, by the Coronavirus, but hopefully will begin to recover in 2021, 2022 and 2023.

- Many businesses have been negatively impacted, from a financial perspective and have closed or will close.

- What this information tells us is that the overall economy may take years to fully recover. The effects on states and municipalities may be long lasting. Many closely-held businesses may recover in two to three years. Some sooner and some not at all.

THREE STEP PROCESS

3. Stabilization

2. Recovery and Rebuild

1. Survival

THREE STEP PROCESS

1. 2020
2. 2021
3. Terminal Year

PROBABLE ISSUES

- Market participants may often times conclude the multiple applicable to a given company should be lower in the post-COVID-19 world.
- The process will lead to lower values than would have been derived prior to February 2020 because earning power and cash flow projections will be lower; risk premium applied to develop a cost of capital will be greater; and the expected long-term growth rate in earning power will be lower.
- That may change over time as the virus is better understood and controlled, vaccines become available, global and local economies fully reopen and business cash flows rebound, but that is not the world that exists today as it relates to business valuation.
- The pandemic has significantly reshaped certain traditional industries, such as retail and hospitality, and accelerated the adoption of technologies. Certain impact to our societies may be here to stay long-term.

FOCUS ON ECONMIC DATA AND INDUSTRY REPORTS

- When will the Economy return to normal?
- When will the industry return to normal?
- Do we adjust for this in the cash flows or discount rate? Or both?
- Crystal Ball – Who can forecast whether or not an industry will survive or thrive again?

DOES INCOME NORMALIZATION CHANGE?

- Can management project Company earnings?
- Does management have any recovery forecasts?

B. Understanding Basic Valuation Concepts

i. The two primary methods used in the income approach to valuation:

- The Capitalized Earnings Method
- The Discounted Cash Flow Method

Each method has two components - an after-tax cash flow component and a discount rate and capitalization rate component.

Both methods are forward looking, based on expected future cash flows of the business.

The discounted cash flow method is not allowed in some family court jurisdictions, such as California. However, the capitalization of earnings method is simply a truncated discounted cash flow method. Assuming stable growth each method provides the same result.

V. I am about to show you some numbers. Please don't close your eyes. Focus on the concepts.

Assumes	
Last Year Cash Flow	$250,000
Discount Rate	23.0%
L-T Growth Rate	<3.0>%
Capitalization Rate	20.0%

Capitalization of Earnings Method

After-Tax Cash Flow	$250,000
Growth Rate	1.03%
	$257,500
Capitalization Rate	÷ 20.0%
Estimated Value	$1,287,500

Discounted Cash Flow Method

	Yr 1	Y2	Y3	Terminal Value
	$257,500	$265,225	$273,182	$281,377
				÷20.0%
				$1,406,885
Discount Rate	x .8130	x .66098	x .5374	x .5374
	$209,348	$175,308	$146,808	$756,060

Estimate Value: $1,287,524

C. Valuing a business during the current pandemic – tools in the appraiser's tool box.

i. Utilize the capitalization of earnings method and increase the capitalization rate.

\$257,500	\$257,500	\$257,500	\$257,500	\$257,500	\$257,500
÷ 18.0%	÷ 19.0%	÷ 20.0%	÷ 21.0%	÷ 22.0%	÷ 23.0%
\$1,430,556	\$1,355,263	\$1,287,500	\$1,226,190	\$1,170,455	\$1,119,565

An increase of 5 percentage points to the cost of capital reduces value by approximately 22%.

Assessing Economic Risk Due to COVID-19

Risk Free Rate

Equity Risk Premiums

Size Premium

XYZ Company	12/31/19	6/30/20	Source
Risk Free Rate (RF)	2.25%	1.18%	www.bvresources.com
Equity Risk Premium (ERP)	6.91%	6.17%	Duff & Phelps
Size Premium (SP)	5.22%	4.99%	Duff & Phelps
Specific Company Risk			Appraiser
Discount Rate	14.38%	12.34%	

Using appraiser judgement to assess an appropriate discount rate is more important than ever.

ii. Utilize the discounted cash flow method.

Assumes

Last Year Cash Flow	$250,000
Discount Rate	23.0%
L-T Growth Rate	<3.0>%
Capitalization Rate	20.0%

After-tax cash flow for 2020 is expected to be 50% of 2019 ($125,000) and 75% of 2019 ($187,500) in 2021 and return to normal ($250,000 x 1.03% = $257,500) in 2022.

Pre-Covid Value:

After Tax Cash Flow	$250,000
Growth Rate	x 1.03%
	$257,500
Capitalization Rate	÷ 20.0%
	$1,287,500

DCF

	2020	2021	2022	2023
	$125,000	$187,500	$257,500	$265,225
				÷ 20.0%
				$1,326,125
	x .8130	x .66098	x .5374	x .5374
	$101,625	$123,934	$138,381	$712,660

Estimated Value $1,076,600 – a 16% decrease in value compared to pre-Covid estimated value.

iii. The appraiser could also consider applying the discounted cash flow method and increasing the discount rate and the capitalization rate. This would probably make sense in the proceeding example.

iv. The appraiser could also consider applying a discount for lack of marketability discount to account for the effects of the Coronavirus. This is a little spongy, but a consideration.

v. Consideration of PPP loans.