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Adjusting the Income Approach Highlights AICPA FVS Conference Panel

Most of the audience questions during a panel discussion at the AICPA Forensic & Valuation Services Conference revolved around how to help make sure the income approach captures the impacts of the current environment. The panel, moderated by Jim Hitchner (Financial Valuation Advisors), included Lisa Cribben (Wipfli LLP), Harold Martin (Keiter), and Mark Zyla (Zyla Valuation Advisors LLC).

Their comments overall were geared to businesses that the pandemic has negatively impacted. The panel also made the point that, before you even get into the weeds of any valuation approach, you first need to determine whether the business can even survive. Once past that issue, can you still consider the market approach in today's world? While the market approach is "problematic" today, it is definitely not dead, as some experts may believe. Deals are still being done, but you need to do more investigation as to why the deal took place. Zyla observes that, for example, bargain hunters may be looking for owners forced to sell. Cribben notes that, if you can adjust the income approach to reflect the pandemic, you can also adjust the market approach. In fact, she did a separate session at the conference on this, but that's a topic for another article.

The panel did a good job revealing the current thinking behind various aspects of the market approach in response to the barrage of questions from the audience.

Timing of impact. The issue of when the pandemic was known or knowable may soon rear its head in court—with one side with the low value arguing one date and the other side with a higher value contending a different date. In the U.S., many are saying February or early March, and Hitchner and Martin have pinpointed it to an actual day—Feb. 24, 2020—when there was a downturn in the major market indices. One audience member then asked: If you are preparing a valuation now with a valuation date of Feb. 20, 2020, do you consider the impact of COVID-19? The panel agrees that, no, you would not consider it but include a subsequent event disclosure in the report.

The panel all agrees that the pandemic's impact on businesses varies by industry and geography. For instance, restaurants were hit hard but were closed down at different times in different areas. By around April, almost everything was shut down everywhere, so the impact was really being felt around that time.

Zyla brought up an interesting point: The economic downturn, in some respects, acted as an accelerator, i.e., the pandemic accelerated some of the existing trends, such as work from home or some of the impacts on real estate. Certain industries were starting to ramp up online businesses (such as pro sports moving to e-sports), which were given a new urgency by the pandemic. Bottom line: Think not only about the impacts, but also about the extent of the impacts and how it changes the "story" of the subject company.

A question came up about how long companies will see the impact of COVID-19. Again, it depends on the industry, but no one really

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knows. The best you can do is look to published resources for this, such as a McKinsey chart that shows that it will take more than five years for hard-hit sectors to recover.[1] Hitchner advised that you keep an eye on the healthcare field and the science behind the virus and coming vaccinations because the economic rebound will depend on what's going on in that area.

CCF vs DCF. A question from the audience: Is the capitalized cash flow (CCF) method dead? Cribben noted that she would never say that any approach is dead just because of COVID-19, as she pointed out that it all comes down to what you're assuming, how you're assuming it, and how you support it going forward. Hitchner commented that, conceptually, you could use a CCF if a company has been unaffected by COVID-19, but he "hasn't seen that yet," so the DCF is the method of choice.

The panel also advised the audience that you are not confined to a five-year DCF, which many people use, possibly out of habit. You can use a discreet period of any length based on when stability is assumed (stability not only in terms of cash flow but also with respect to capital expenditures and growth).

Techniques for projections. Hitchner notes that he is looking at probabilistic scenario analysis for projections and so is Martin, who pointed out that you get the same result if your cash flows and weightings are symmetrically distributed. The typical method is to use base-, best-, and worst-case scenarios assuming various time frames for recovery.

What about the use of Monte Carlo simulation? No one on the panel is using it in a standard DCF, acknowledging that you typically get similar

1 mckinsey.com/featured-insights/coronavirus-leading-through-the-crisis/charting-the-path-to-the-next-normal/covid-19-recovery-in-hardest-hit-sectors-could-take-more-than-5-years

results relying on management projections and doing a probabilistic scenario analysis. Zyla reported that he is not using any Monte Carlo, but it is used primarily for complex securities.

Treatment of PPP loans. The audience had a number of questions on the Payroll Protection Program (PPP) loans. In response to those questions, the panel made the following observations:

- In terms of the impact of the PPP on valuations, some companies that received the loans actually did quite well, so you could make an argument that, on the day the legislation passed, the value of those companies increased;
- Your valuation date is very important when assessing the level of impact of the PPP loans—on the day it was passed, there was a great deal of uncertainty surrounding the program, and that uncertainty dissipated as time went on;
- Hitchner recommends that PPP loans should be reclassified as a nonoperating asset, after factoring in the tax (related expenses are not deductible);
- In the DCF, the PPP loan would be treated similar to a nonrecurring event for cash-flow purposes, i.e., included in the discrete period (but carefully consider the tax impacts); and
- Cribben advised that you need to work with clients before automatically assuming the loans will be forgiven—in her experience, practically all clients who received the loan feel they have satisfied the requirements and expect it to be forgiven.

Cost of capital inputs. The panel noted that, in today's interest rate environment, if your cost of equity formula just uses those figures, you will end up with a rate that's lower than before the pandemic, which doesn't make sense in most cases. Hitchner says he is adding from 1% to 3% to the discount rate to reflect COVID-19 depending on the company and the impact. He is also using spot rates as opposed to a normalized or adjusted risk-free rate and is not adjusting the ERP. Zyla is looking at more forward-looking measures, such as the implied ERP from Aswath Damodaran (New York University, Stern School of Business) and is examining long-term capital structure.

Growth rates. The panel all agreed that growth rates have come down. This is based on an examination of historical growth, data on industry growth, and the long-term risk-free rate. Also, a number of different data sources are used to support the assumptions.

Danger of double counting. Zyla cautioned the audience about not double counting for the risks of COVID-19 when adjusting cash flows and adding a premium to the discount rate. Martin agreed and pointed out that you should be measuring two different things: you are looking at the variability in the cash flow under different scenarios, but your discount rate is reflecting the risk of achieving those forecasted cash flows.

Zyla, who is chair of the Standards Review Board of the International Valuation Standards Council, discussed a document from the organization's technical standards board.[2] The document explains that the phrase "valuation uncertainty" does not refer to "risk" as appraisers typically think of the term but rather the notion that the process of valuation now faces uncertainty in terms of market disruption, the availability of inputs, and the analyst's choice of a valuation method or model. He stresses the importance of disclosures in your valuations about your assumptions. For example, if the current environment has rendered certain data unusable, you need to explain how you made your adjustments for

2 Alexander Aronsohn, "Dealing With Valuation Uncertainty at Times of Market Unrest," IVSC Technical Standards Director, ivsc.org/files/file/view/id/1719.

that. Also, if you change your valuation approach or method, you need to explain the reasons why.

Final point. With all of the uncertainty, are valuations today just as reliable as before? The panel gave a resounding "yes" to that question. Valuations under COVID-19 are more difficult, but they are not less reliable. The profession is accustomed to dealing with uncertainty, such as valuing early-stage companies whose future performance is not predictable. And many valuers had to deal with the economic downturn of 2008. Analysts strive to make sure valuations are as reliable as possible regardless of the environment or nature of the economy.

Watch for coverage of other conference sessions in future issues of *Business Valuation Update*.