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Chapter

COVID-19 – What Business Owners Should Be Doing Now

The effects of the Coronavirus Pandemic are far-reaching, impacting people and businesses of all sizes across the globe. If you are a business owner considering an exit, the world may feel upside down at the moment.

A little over a month ago, macroeconomic indicators seemed stable with positive business and consumer sentiment. To say the events surrounding the Coronavirus have been disruptive may be the understatement of the new decade. For business owners who were about to start a process to monetize their business through a M&A process, the world may now look suddenly very different.

How private company transactions have been impacted by COVID-19

The recent global Coronavirus pandemic has materially changed the near-term outlook given increased market volatility, dramatic increases in unemployment and weakening economic forecasts. Many sales processes that were underway have been or will be delayed or suspended. It is likely that some buyers will look to opportunistically re-trade on terms. Activity is likely to remain lower until volatility and uncertainty subsides and there is more visibility into the impact of the virus pandemic on business and near term outlook.

For transactions currently in market the coronavirus creates several risks. Buyers will look to stress-test management forward projections and understand how coronavirus will impact earnings over the next several quarters or years. Corporate earnings will be significantly impacted across the spectrum, especially in the leisure, travel and hospitality industries through 2020 and perhaps into 2021. Debt markets are currently shut for many new issuers until the market stabilizes. The high cost of capital or lack of available credit will result in buyers not bidding for assets or lower purchase multiples from buyers. The risk appetite has contracted. Reference valuations for comparable public companies have declined. Smaller, private companies may be disproportionately impacted as investors tend to gravitate to higher 'quality' and more liquid assets in times of stress. Investors are also likely to re-evaluate business forecast assumptions and place more weight on potential haircut or downside scenarios.

Owners should anticipate fewer deals will get done over the next few months and it's likely that some deals that were nearing completion may see buyers looking to opportunistically re-trade on terms. Instead, now may be a time for business owners to focus on their business and their people. Priority number one is to make sure your employees, your suppliers, and your customers are safe. Take this time to focus on execution and planning with priority being in maintaining operations and implementing business continuity plans. An owner and management team will be measured on how they navigate all aspects of their business through this environment.

The impact on business valuation in the context of COVID-19:

In early 2020, the International Monetary Fund (“IMF”) projected growth in over 160 of its member countries. In the COVID-19 economic climate, that number has been flipped, and the IMF expects that over 170 countries will experience negative per capital income growth in 2020.

Some industries will fare better than others. Industries such as energy, financials, industrials, and discretionary consumer goods may be particularly hard hit in the near term. However, industries such as communication services, consumer staples, utilities, healthcare, and information technology may experience growth, albeit at slower rates than previously forecasted. Broadly speaking, however, business values across the board have taken a hit from the early part of 2020 due to the COVID-19 economic climate.

It is widely recognized that there are three general approaches to valuing a business:

- The income approach uses either a capitalization of cash flow method or discounted future cash flow method to convert anticipated benefits to value.

- The market approach determines value using two methods. The first compares the subject company to sales of similar businesses or business interests. The second compares the subject company to a set of guideline public companies.

- The asset approach relies on the underlying market value of the net assets.

An asset-based approach generally expresses the value of a company as a function of its underlying net assets. This approach is typically not a favored method for business valuations of going concerns. The income approach and market approach are more commonly used because they capture the future earning potential of the business.

The market approach valuation methods involve the identification, analysis, and selection of guideline publicly traded companies or guideline transactions, from which the market-derived valuation pricing multiples are used to provide an indication of value. Multiples of earnings, such as EBITDA, are most commonly relied upon.

Currently, the guideline public company market approach may be misrepresented by panic selling and bargain hunting. The volatility in the stock market from day to day leads to market capitalization being an unreliable indicator of value. Also, market multiples stemming from these unpredictable market conditions may not be indicative of long-term expectations. Further, there are less transactions taking place, leaving a small sample of benchmark transactions to rely upon to derive a market multiple.

Looking to the stock market, we know that stock prices are down (as of April 2020) and earnings are slumping. The two key drivers of value in the market approach, (i) earnings, and (ii) the multiple applied to the earnings, are both demonstrating that business values are down.

Due to the volatility in the stock market and small amount of transactions actually being completed, the income approach may be the best suited to address business valuations in the framework of COVID-19.

Under the income approach, there are three key value drivers: Current Cash Flows; Projected Growth of Cash Flows; Discount Rate.

Projected future cash flows are discounted to present value using a discount rate. In good economic times, the growth rate is positive, and the discount rate is lower, resulting in a higher business valuation. In times of an economic recession, the growth rate is low or negative, and the discount rate is higher, resulting in a lower valuation.

Valuations taking place during the COVID-19 pandemic should include cash flow projections that appropriately consider the current and future effects of the virus. Due diligence is important to confirm that cash flow projections not only reflect existing realities, but also include realistic expectations for the long term. Although there is still ambiguity about when life will return to normal, long-term growth forecasts should consider growth rate based on the long-term performance of the economy. For instance, Moody's Analytics projects that Real GDP Growth in the United States will decline -2.17% in 2020 but rebound to 2.68% in 2021. It is also important to keep proper documentation and work papers to support the reasonableness of cash flow projections.

Focus on execution and planning

Business owners should continue to focus on execution and planning. The first priority should be to successfully operate the business over the next several months and quarters. Implement business continuity plans to safeguard employees, customers, suppliers and all stakeholders and work to ensure there is limited disruption to operations. Leverage technology and be thoughtful of changing expectations and behaviors of customers and be willing to adapt your business to a changing economic and customer environment. Be prepared to consistently reforecast the short-term budget and long-term financial model for your company. Understand any liquidity constraints the business may have and take measures to shore up financing and insulate the business in the event of a drawn-out potential economic downturn.

The importance of leadership and resiliency

Resiliency and leadership of the management team will be paramount for financial buyers. Owners should assume there will be a lot of bottom fishing with Private Equity firms that have a lot of cash trying to pick up good companies cheap that have been hurt by the fallout of this crisis. The job of owners, their management teams, and the diverse professionals they depend on to help improve their business and thus their valuation is to help these business owners avoid this situation.

Obviously, the first thing is to survive by taking advantage of whatever programs are out there. Do whatever you can to keep key employees and even all employees. How a business owner acts now will be remembered for years to come. Good or bad. You can evaluate who is best to keep on and who to furlough as the next 4 months of unemployment may be better than a salary reduction with the $600/week kicker added.

Try to take some time in the midst of the crisis and chaos to think about how your industry might change on the other side. Customers, suppliers, credit availability, and how to attract employees etc. Engage in scenario planning. There will be things that were important to focus on before and something else after. There will be opportunities and challenges that emerge. Begin to position your business to respond to both. How best to de-risk the challenges and think about how to invest in the emerging changes that will create opportunities.

Keeping key management team members is key. Engage your management team in the strategic process and consider reduction in pay now (if needed) but maybe higher participation in a potential liquidity event in the future.

Paradigms are changing- To manage and motivate remote teams:

1. **Understand what drives your remote employees**
   As a remote leader, you don't get a chance to spend time interacting in person with your employees and discovering what makes them tick. A workplace behavioral assessment—such as the PI Behavioral Assessment ™ — can give you a wealth of information about your employees' drives, needs, and natural work style. It will help you understand how they like to work and be rewarded. For example, if you know someone has a low degree of extraversion, it might be OK to contact them infrequently. On the other hand, if an employee has high extraversion, you might want to spend more time interacting with them—even if it's grabbing a cup of coffee over Zoom. Especially now, when your employees are feeling uncertainty and fear, it's all the more important to communicate and support and serve your people in meaningful ways.

2. **Check-in on everyone's emotional state**
   The psychological impact of a pandemic and downturn isn't something you can ignore as a people manager. Yes, you should check-in on their workload and projects—but you should also check-in on their emotions. Don't be afraid to ask your people, "How are you feeling emotionally?" As Josh Bersin said, "In today's world, the CEO has to be the Chief Care Officer first." And the same goes for managers. In a crisis think *people first*. Are you doing all you can to support and lift up your team?

3. **Manage for substance and results, not adherence to a 9-5 schedule:**
   One of the top reasons employees enjoy remote work is they can fit work into their lifestyle. Whether they have morning childcare duties, like to work out midday, or serve as a caregiver for a family member, working from home can offer flexibility that allows them to live their life while still making a living. That's why a general best practice is don't judge your employee based on their adherence to a 9-to-5 schedule. Instead, evaluate remote performance on what they're able to produce—not how they produce it. *But right now, employees need even more schedule flexibility*. Mandatory school and workplace closures mean your people will be trying to be productive in spite of interruptions from kids, partners, roommates, and pets. Be cognizant and empathetic.

4. **Check- set clear expectations for remote workers:**
   Many of the steps above require a healthy dose of trust that your remote employees are doing the right things—even if they're doing it their way. However, this doesn't mean they're running the show. It's important to set and communicate clear expectations about how you'll judge their work performance and any practices, guidelines, or

updates you, as a manager, need to see. For example, if you really need people to tell you when they'll be away from their computers longer than an hour, communicate these requirements clearly from the outset.

5. **The real key to successful remote teams, is to create trust**
   Ultimately, many of these tips are about creating trust between you and your remote employees. Let them flourish in their own way—and always stay connected, communicating, and aligned.

Five Critical Actions for Manufacturers During a Recession

During the last ten years, most companies have been in either a steady-state or growth stage and have likely figured out how to manage their challenges at least in the short term. The challenges presented by a global recession, however, are much different than the challenges of managing growth. The companies that successfully navigate their way through the recession will almost all take the following five action steps as soon as possible and maintain them through the entire recession.

1. **Create and maintain a 13-week cash flow forecast** – Most problems can be solved if you have enough time to solve them. Creating a rolling 13-week detailed cash flow forecast will provide invaluable visibility as to if, and when, a company will face cash shortfalls and will provide the needed time to manage through those periods.

2. **Conduct a comprehensive profitability analysis** – Gaining a deeper understanding of the P&L will allow you to shrink the company's focus to its most profitable areas. Conduct a profitability analysis at different levels, including business segment, product line, SKU, and customer and be prepared to make tough but prudent decisions.

3. **Rebalance the Company's resources** – Under stress, many companies slash costs to remain profitable but do so in a way that wreaks havoc on its internal balance and damages long-term recovery. Scaling down the company's cost structure in a way that allows it to scale back up is the art of successful repositioning or restructuring.

4. **Develop a strategic plan for the new normal** – Once the company is stabilized by steps 1 - 3, the company will need to re-envision its future. A diagnostic of the Company's current state will provide the foundation for a new strategic plan and the insight needed to create an effective strategic and tactical plan.

5. **Communicate, communicate, communicate** – Companies that are most successful during times of downturn are those that most effectively communicate with their employees, suppliers, customers, lenders and investors. Cooperation, loyalty, and flexibility come from trust and openness.

Expect due diligence to change

The new normal in a post Coronavirus world investors and acquirers will have renewed focus in due diligence efforts evaluating business resilience and supply chain risks. For years to come, potential investors will be evaluating operational and financial performance of businesses during this period in order to measure the cyclicality, overall resilience and overall risk profile of a business.

Every owner needs a "COVID Notebook"

The "right" course of action for each business is unique, but your management team will also be measured on how you navigate this environment. To the extent possible, you should track any Coronavirus related impacts on your business and expect that at some point you may need to explain in detail how and why the business performed the way it did during this period of disruption. Having a "Coronavirus notebook" so future buyers can understand the exceptional events that your company and management team experienced will help you normalize your earnings and thus improve your valuation when your business and the market has put this exogenous event behind it and things have returned to the "new normal". Tracking "exceptional" events like contract delays, customer order cancellations, overtime costs, sick leave, supply disruptions, elevated transportation costs will help to normalize your earnings and valuation when this exogenous event has passed.

De-risking the business

For business owners with longer-dated time horizons to sell the business, use this time to evaluate every aspect of your business and focus on and invest in those that will help drive value in the business. Owners should use this time to invest in solutions to help de-risk the business. Despite the capital investment or potential to reduced margins it may be increasingly important to diversify your supply-chain to have multiple sources of supply that you are confident of. Owners should make sure they have adequate access to operating capital and access to credit lines to ensure the business can operate through a real crisis. Look into catastrophic insurance provisions and lending alternatives so these can be utilized during periods of uncertainty. Track business performance closely and take note of any exceptional events related to the Coronavirus disruption to enable robust discussion of this time period with potential investors in the future.

Since the value and success of most businesses depend on relationships that have been developed with customers by owners and/or key employees, the rapid emergence of unanticipated deaths due to the pandemic requires business owners and CEOs to have business agreements and contracts reviewed by their attorneys. Shareholder and operating agreements should be reviewed to make sure that provisions for death and disability are covered and adequate life/disability insurance is in place for owners and key employees. All other contacts, leases, and loan agreements should be reviewed to make sure that business interruption in the event of a pandemic and other force majeure events are properly and adequately provided for in these legal documents.

Take advantage of the historic wealth planning opportunities:

The generational wealth transfer opportunity that exists today is greater than at any point in modern US history, due to a confluence of three factors: 1.) Current Gift Tax Exemption Levels 2.) Depressed Valuations and 3.) the Stimulus Package's likely effect on taxes going forward.

To understand why this opportunity is so powerful, it's important to understand that the US tax code treats your ability to pass wealth to heirs other than your spouse as a privilege, not a right, and as such a gift/estate tax is levied upon any assets you transfer (either during your life or at your death). To ease the administrative burden on small estates, as well as focus on taxing wealthier families, the IRS has set a level- called the Lifetime Gift Tax Exemption- that is free from this gift tax, and only estate/gifts above this level are subject to the tax. That Exemption Level has ballooned from $1 million per person in 2001, $5 million in 2011, to over $11.5 million today. And the gift tax rate has come down from 55% to 40% over that period. So while a married couple can make a $23 million gift today and not pay a penny in gift taxes, in 2001 that gift would have triggered a gift tax of roughly $11.5 million.

Shares of privately owned businesses have always been an attractive asset to gift, given that there are effective strategies to reduce the valuation to account for the illiquidity of the shares, then lack of a public exchange on which to sell them, and the limited rights granted to a minority shareholder. Beyond those universal benefits, however, is the fact that the economic impact of COVID-19 on revenue, EBITDA, profitability, and growth almost certainly allow for a further reduction in that valuation. It is not a stretch to say that a business that was worth $10 million in December 2019 on the back of an 11 year bull market is worth substantially less in

April 2020, and a formal valuation firm can provide that assessment. With the prospect of an eventual economic recovery, and possibly significant stimulus and government support, as long as your business survives through COVID, this could be a once in a lifetime chance to value a strong business at a significant discount for gifting purposes. And all the future appreciation that occurs is shielded from the 40-55% gift/estate tax.

Speaking of the Federal Stimulus, 2020 began with the US Debt topping $20 trillion and the US running a $1 trillion per year deficit. The interest on that $20+ trillion debt cost almost $400 billion alone. Corporate and personal income tax revenue was roughly $3 trillion in 2019, meaning corporate and personal income taxes would need to be raised by 20% across the board just to generate enough revenue to cover the interest on our debt, let alone pay it down in any way. In short, taxes were already likely going up, perhaps substantially, in the coming decades. And the Stimulus Package has added $2 trillion to our debt, a number that will likely climb higher if this economic shutdown persists. So if politicians are looking to raise taxes in a way that is less likely to stunt current consumption or investment, and is also politically "safer" than raising income tax rates, reducing the Gift Tax Exemption closer to 2001 levels or raising the Gift Tax rate back to 55% are attractive options. In fact, the current $11.5 million Exemption is set to sunset back to the $5 million 2011 level in 2026, so even without any congressional action this opportunity has a limited shelf life.

So to summarize…The tax code currently allows for a historically high level of tax free gifting to your heirs or trusts for their benefit, at a time when business owners can mark the value of the company shares down substantially so that future appreciation avoids the 40-55% tax rate, and the growing $22+ trillion National Debt means the chances of either an gift tax rate hike or an exemption reduction in the future are quite high. Taking advantage of this timely opportunity will allow business owners to maximize the rate of return of their wealth over multiple generations.

Prepare now so you're ready on the other side:

If you are planning to sell your company in the near-term, beginning the preparation process now will increase your optionality and put you in the best position to hit the market when volatility subsides and the M&A window re-opens. When the risk appetite returns, there may be an imbalance between demand and available supply. There is a lot of liquidity in the system, funds raised by investors, such as private equity funds, but not yet invested on the sidelines. High quality companies that are primed and ready to capitalize on a reopening of a market window may be able to benefit from these circumstances.

While the current coronavirus pandemic will dramatically impact nearly all sectors of the economy, there will be near term opportunities for those companies that take advantage of the emerging trends and changes in behavior that could dramatically accelerate like tele-medicine, enabling remote work and education and e-commerce and delivery. Management teams that can pivot their business models to adapt and take advantage of these new trends that go main stream will be sought after.

Owners should expect activity to remain limited until uncertainty subsides and there is a return to normal or at least a "new normal". While the majority of buyers will need more visibility into the impact of the virus pandemic on business and near term outlook, there are many that will opportunistically acquire select assets at a discount to historical valuation levels or infuse needed capital into good companies who may need liquidity.

Over time, it's likely that investors and buyers will adjust their due diligence process based on the Coronavirus. In a post coronavirus world – at least for the next number of years – buyers are going to be much more focused on diligence, especially around exogenous events. Owners should expect key changes to the due-diligence process including evaluating business resilience, supply chain risk, management strength and business continuity plans. Owners and management teams that navigate successfully through this period by adapting to changes in trends, customer behaviors and expectations of potential investors or acquirers will likely come out of this and be in very high demand.