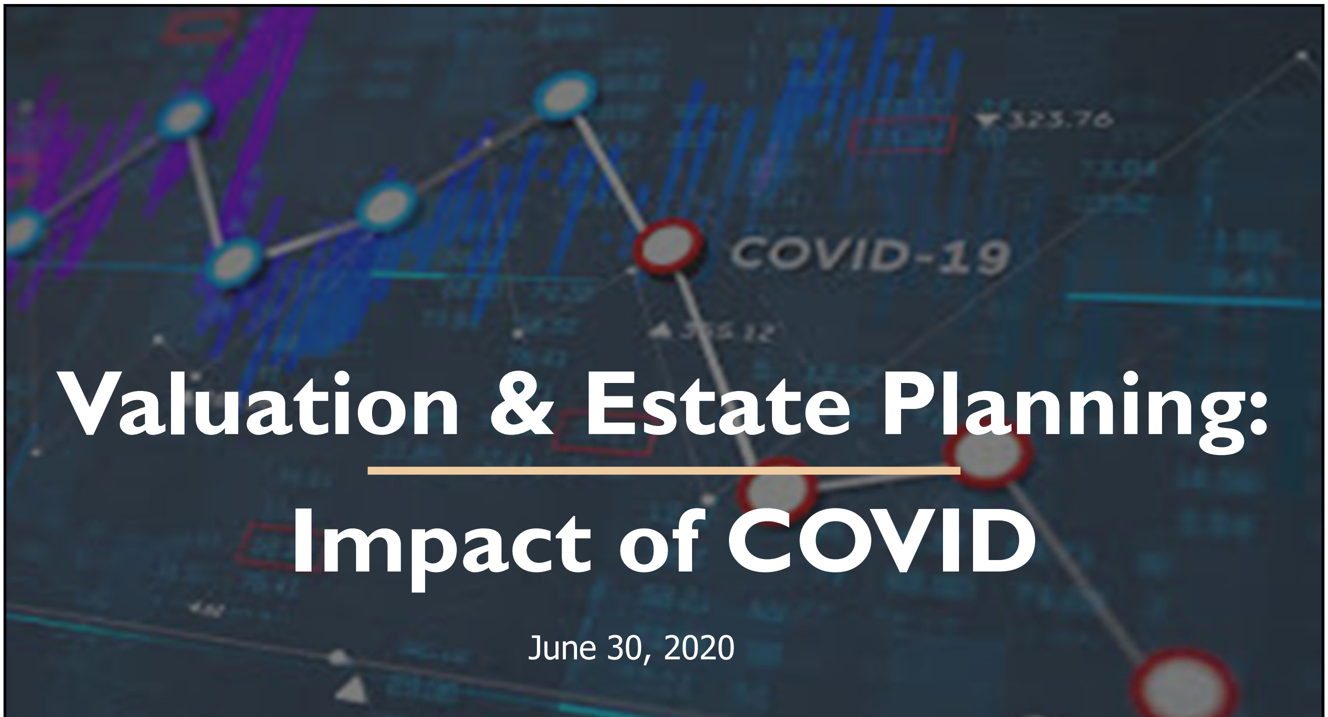


# Valuation & Estate Planning: Impact of COVID

June 30, 2020


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# Executive Summary

- Valuation date / transfer date considerations in light of COVID.
- Given the rebound in equity markets, has the opportunity for gifting passed?
- Impact of PPP loans and CARES Act on business valuation.
- How are valuation methods and techniques impacted by the crisis?
- Impact of the crisis on valuation discounts.
  - Discount for lack of control.
  - Discount for lack of marketability.
- Considerations when using real estate and art appraisals.

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# Valuation Date / Transfer Date Considerations

COVID-19 Timeline: When did the severity of the virus become known or knowable?

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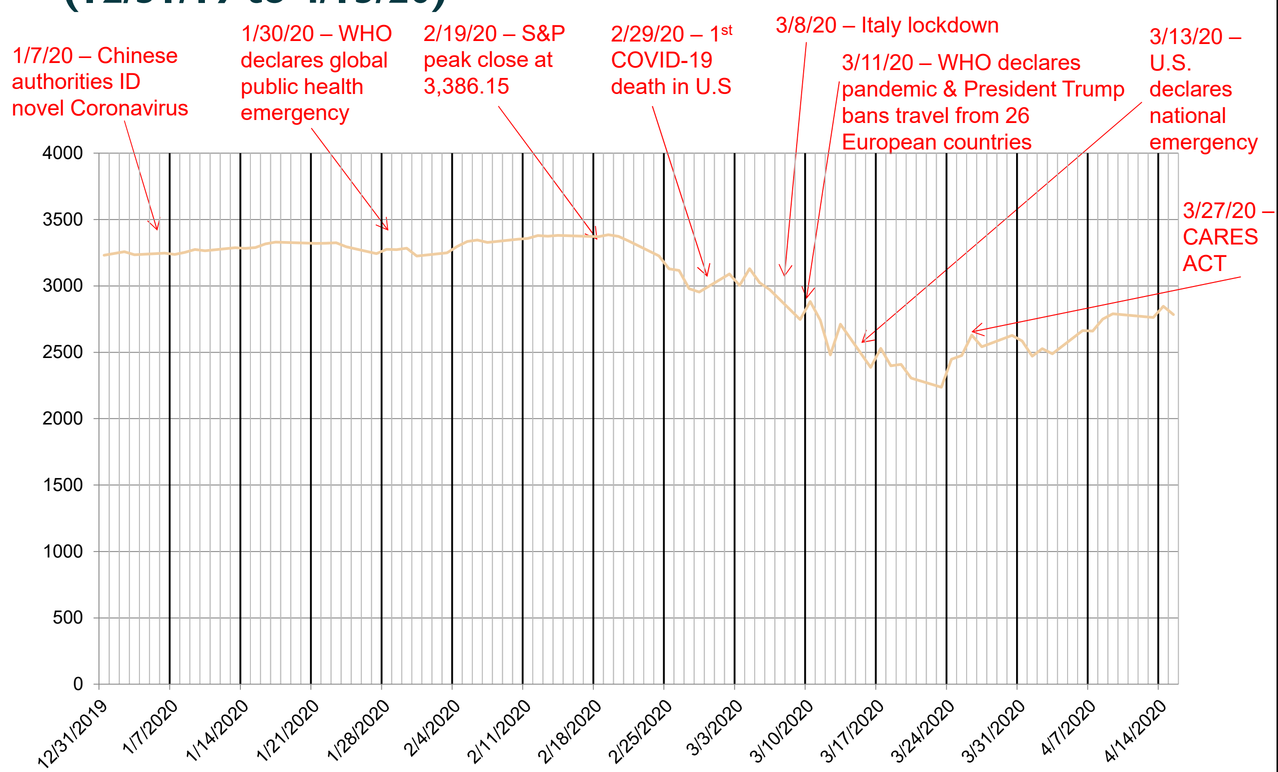
# S&P 500 Closing Price Trend
## (12/31/19 to 4/15/20)

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# Timeline Considerations

- COVID-19 was a news item, especially with respect to the outbreak in Wuhan, China, as early as January 2020.
- U.S. equity markets, as measured on the previous slide by the S&P 500, did not react significantly until the second half of February.
- The severity of the impact on the U.S. economy was clearly being contemplated in U.S. financial markets by March 2020.
- For taxable estates with a date of death after August 1, 2019, it may be useful to consider the alternate valuation date election and to discuss the impact of the timeline with your valuation expert.

# Wealth Transfer Planning Landscape

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# With the Rebound in Equity Markets, has the Gifting Opportunity Passed?

- For many clients, NO…
- While, broad stock market indexes have rebounded significantly from the March lows, indexes like the S&P 500 are dominated by several large firms
  - Average stock down 36% from 52-week high
  - 59% of S&P 500 company stocks are down 30%+ from 52-week highs
  - Average stock down 21% year-to-date
- Industries differences are glaring
  - Hot: Technology Software & Services, Telecom, Gaming, Ecommerce, Delivery Services
  - Cold: Travel, Leisure, Hospitality, Real Estate, Energy, Food Service, Brick & Mortar Retail, Consumer Discretionary, Industrials, Banking, etc.
- Valuation discounts remain elevated
- Regardless of changes in asset values, may still be reasons to consider gifting/selling assets now.

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# Current Wealth Transfer Opportunity: Not All About COVID

- The stars have aligned for what is potentially a unique opportunity to maximize the efficient use of exclusion amounts and transfer significant wealth at a relatively low cost.
- Four stars in alignment:
  - First: High estate and gift tax exclusion amounts (2020: $11.58mm per individual / $23.16mm per married couple) per the 2017 TCJA that are in place through 1/1/26.
  - Second: We are in an election year. There is the potential for a significant change in the political landscape in Washington DC, with some speculation that the sunset could be accelerated to as early as 1/1/21 or new tax legislation could bring other adverse changes for clients,
  - Third: The COVID-19 induced crisis caused declines in most asset classes in March 2020, and the values of many privately held companies and investment partnerships have declined substantially. This created an opportunity for private business owners and families to transfer wealth at a lower effective cost with potentially greater upside. While the rebound in equity markets may have diminished some opportunities, numerous industries and businesses have not recovered to nearly the extent as others.
  - Fourth: U.S. Treasury interest rates have dropped even further, leading to sharp declines in the AFR and Section 7520 rates for the second quarter. This provides meaningful benefit to clients doing planning with GRATs and note-funded sales, among others.

# Summary of AFR & Section 7520 Rates through June 2020

| | | Short-Term AFR | Mid-Term AFR | 7520 Rate |
|---|---|---|---|---|
| January | 2019 | 2.72% | 2.89% | 3.40% |
| February | 2019 | 2.57% | 2.63% | 3.20% |
| March | 2019 | 2.55% | 2.59% | 3.20% |
| April | 2019 | 2.52% | 2.55% | 3.00% |
| May | 2019 | 2.39% | 2.37% | 2.80% |
| June | 2019 | 2.37% | 2.38% | 2.80% |
| July | 2019 | 2.13% | 2.08% | 2.60% |
| August | 2019 | 1.91% | 1.87% | 2.20% |
| September | 2019 | 1.85% | 1.78% | 2.20% |
| October | 2019 | 1.69% | 1.51% | 1.80% |
| November | 2019 | 1.68% | 1.59% | 2.00% |
| December | 2019 | 1.61% | 1.69% | 2.00% |
| January | 2020 | 1.60% | 1.69% | 2.00% |
| February | 2020 | 1.59% | 1.75% | 2.20% |
| March | 2020 | 1.50% | 1.53% | 1.80% |
| April | 2020 | 0.91% | 0.99% | 1.20% |
| May | 2020 | 0.25% | 0.58% | 0.80% |
| June | 2020 | 0.14% | 0.33% | 0.60% |
| July | 2020 | 0.14% | 0.34% | 0.60% |

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# Business Valuation Impact

How is the COVID-19 crisis affecting closely held businesses and the process of appraising equity/debt interests therein?

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## How Will COVID-19 Impact the Valuation of Closely-Held Businesses?

- Valuation experts often start by assessing changes in actual and expected revenues and cash flow.
  - ➢For many industries and businesses, revenues and cash flows have plummeted, and there is great uncertainty about the depth and lengthy of the downturn, and, subsequently, the speed and degree of the recovery.
  - ➢Current impacts may follow essential/non-essential business classifications.
  - ➢Future impacts may vary if changes in behavior occur as a result of the crisis.

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# Essential vs. Non-Essential

## Essential

- Medical, healthcare
- Telecommunications
- Information technology systems
- Defense
- Food and agriculture
- Transportation systems
- Critical manufacturing
- Energy and utilities
- Financial services
- Government facilities
- Emergency services, law enforcement
- Water and wastewater
- Public works
- Essential retail (e.g., grocery stores, pharmacies)

## Non-Essential

- Travel
- Leisure
- Most brick and mortar retail
- Many restaurants / bars
- Entertainment venues / live events
- Discretionary product manufacturing
- Casinos
- Fitness centers
- Shopping malls
- Amusement parks, carnivals, water parks, and bowling alleys
- Barbershops, hair salons, tattoo and piercing parlors, and certain other personal care services

**** These are partial lists presented for discussion purposes only. Classifications may vary by state and may vary over time.*
*Sources: U.S. Department of Homeland Security; Connecticut Business and Industrial Association*

# Impact of COVID on Valuation Approaches

- Capitalization of Earnings Method
  - In many cases, this method will be difficult to apply because of earnings fluctuations.
- Discounted Cash Flow Method
  - With additional diligence and management guidance, can be applied to directly account for current downturn and projected speed and degree of rebound
  - Multiple projection scenarios may enhance the analysis; contemplate whether a business is expected to see a "V-shaped" recovery, a "Nike Swoosh" recovery, or otherwise
  - Cost of capital (discount rate) may need to be higher
  - Attention needs to be paid to cash flows from investment activities (e.g., working capital changes, capital expenditures)
  - Historical financial statements may not be as meaningful. Conversely, historical results could guide development of recovery cases. How companies recovered from prior downturns (e.g., 2008/2009 financial crisis) could be instructive.
  - Must properly account for government loans and grants to the extent applied for, received or potentially available in the future.

# Impact of COVID on Valuation Approaches

- Guideline Public Company Method (using publicly traded companies to derive valuation multiples)
  - Can be highly instructive, subject to timing considerations
  - Might be the best indication of how the market is valuing companies in certain industries given uncertainties in earnings forecasts
  - Need to have appropriate guidelines
  - When computing multiples, make sure underlying data is consistent from one company to the other (e.g., have public market analysts updated earnings estimates yet?)
- Guideline Transaction Method (using mergers/acquisitions to derive valuation multiples)
  - Limited transactional data; most data come from pre-crisis transactions
  - Crisis-era transactions should be considered with caution ("distressed transactions" may not be suitable for use in the context of the willing buyer/seller test)

# Impact of COVID on Valuation Approaches

- Some companies will not survive the crisis due to funding constraints, forced shutdowns and/or other factors
- The valuation process, including diligence, modeling and analysis, will be more complex and onerous in many cases
- Debt and preferred stock in distressed companies may fully or partially take on common equity characteristic.
  - In the most distressed situations, an enterprise value allocation using an option pricing method may be appropriate to value debt, preferred equity and common equity
  - Treating all portions of the capital structure as call options on enterprise value with distinct seniority / claims
- Changes in consumer and business behavior may have long-term impacts
- Impacts will vary widely by company, industry and geography
- Business facts and circumstances always matter, but possibly now more than ever

# Impact of the CARES Act

- Funding
  - ❑ PPP loans
  - ❑ EIDL loans
- Payroll Tax Relief
  - ❑ Families First Coronavirus Response Act (FFCRA)
    - ▪ Emergency Paid Sick Leave Act
    - ▪ Emergency Family and Medical Leave Expansion Act
  - ❑ Credits & Deferrals
- Income Tax Relief
  - ❑ NOL Treatment
  - ❑ Interest Deductibility
  - ❑ AMT Credits
  - ❑ Facilities Improvements Write Off

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# Valuation Discounts

Has the crisis affected discounts for lack of control and lack of marketability?

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# Discount for Lack of Control

- This discount is typically applied to a controlling interest value when necessary to adjust for lack of control associated with a non-controlling interest
  - Limited partnership interests typically lack control over business affairs, management, distributions, amendments, liquidation, etc.
  - Non-managing membership interests in LLCs
  - Common stock in C corporations and S corporations representing less than 50% of the voting power
- Most often applied as a step in valuing non-controlling interests in entities that are valued using an asset approach
  - Real estate limited partnerships or LLCs
  - Limited partnerships and LLCs holding liquid and/or illiquid securities
- Publicly-traded closed-end funds, business development companies (BDCs), and publicly-registered limited partnerships are often used as benchmarks
- Concluded discounts generally represent a weighted average of the benchmarks based on relative values of the underlying assets

# Trends in Closed-End Fund Discounts: First Quarter 2020

| Sample | # of Funds | 12/31/19 | 01/31/20 | 02/29/20 | 03/31/20 |
|---|---|---|---|---|---|
| Gov't Bonds & Agency | 4 | **6.5%** | 5.8% | 7.1% | **9.3%** |
| Capital Appreciation | 8 | **11.7%** | 11.5% | 12.2% | **14.0%** |
| Real Estate | 10 | **6.2%** | 6.6% | 10.3% | **13.1%** |

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# Trends in Closed-End Fund Discounts: Second Quarter 2020

| Sample | # of Funds | 4/15/20 | 5/15/20 | 5/31/20 | 6/15/20 |
|---|---|---|---|---|---|
| Gov't Bonds & Agency | 4 | 8.4% | 7.6% | 8.0% | **6.6%** |
| Capital Appreciation | 8 | 13.7% | 14.5% | 14.7% | **14.8%** |
| Real Estate | 10 | 12.4% | 15.4% | 13.9% | **13.9%** |

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# Discount for Lack of Marketability

- The MPI Restricted Stock Study shows that several factors drive marketability discounts, including:
  - Size – equity market capitalization
  - ***Volatility of the stock (significantly affected during crisis periods such as the present)***
  - Price-to-book value ratio (think asset coverage)
  - "Holding" period / restriction period
  - Security registration status
  - Long-term Treasury rates
  - Market performance
- Other considerations:
  - Market liquidity issues
  - If a company was expected to seek a liquidity event soon, has that changed?
  - Importance of dealing with the facts of each case

# Private Equity Secondary Market

- The secondary market for private equity limited partnership interests helps inform discount determinations on private fund interests.
- This market is also an indicator of overall liquidity in secondary equity markets and investor sentiment towards risky assets.
- Listed private equity funds are currently trading at a median discount of 20% vs. 10% pre-crisis.
  - ➢ Median discount of 30%, excluding premiums, vs. 24% pre-crisis.

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# Private Equity Secondary Market

- Quotes from market participants:
  - "Unloading stakes [in private equity funds] won't be an easy task…"
  - "Bid-ask spreads in the secondary market are now wide, making it hard to get deals done…deal flow will be held back until investors have clarity surrounding this year's private equity marks…."
  - "Pockets of distressed investment opportunities may arise where sellers, under pressure and in need of cash, are willing to accept large discounts for their stakes in funds."
  - "The secondary market may see some younger assets selling…as investors might like to get out of their unfunded commitments…"
- All signs point to higher discounts in this market than pre-crisis, similar to what we saw during the 2008/2009 financial crisis.

*Sources: Private Equity Insights; Institutional Investor; Marketwatch.com.*

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# Blockage Discounts

- In many cases, blockage discounts will be greater today vs. pre-crisis on account of factors including volatility, overall market liquidity, etc.
- With publicly-traded stock:
  - Change will depend on company stock volatility and whether the expected holding period has changed.
  - Need to be careful not to unreasonably project current market volatility over long periods.
  - In the current environment, a planning opportunity may exist for individuals owning large blocks of thinly-traded public company stock.
- The concept of a blockage discount may apply to other asset classes, including real estate and art.

# Considerations When Obtaining Real Estate and Art Appraisals

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# Using Real Estate Appraisals in the COVID-19 Era

- The valuation date of the appraisal is key
  - Appraisals with pre-March valuation dates could be outdated
- Current appraisals may suffer from a lack of COVID-19 period transactions; what is the appraiser using for comparables?
- Income approaches could be more subjective
- Best practice is to ensure you understand the appraiser's thought process, selected methods, data used and assumptions made
- Not all properties are affected in the same manner; geographic differences within the same asset class may also exist
  - Commercial
  - Multifamily
  - Retail
  - Single family homes
  - High-end single family residential

# Using Art Appraisals in the COVID-19 Era

- The valuation date of the appraisal is key
  - Appraisals with pre-March valuation dates could be outdated
- Current appraisals may suffer from a lack of COVID-19 period auctions; many auction houses were not allowed to operate
- Need to be aware of appraiser's thinking and reliance on approaches used
- Different types of artwork may be impacted by the crisis differently

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# Speaker Biographies

# Todd G. Povlich, CFA, ASA

Managing Director – Private Client Appraisal Group
Management Planning, Inc.

Todd is a Partner at MPI and is based in the firm's New York City office.  Since joining MPI, Todd has determined the value of closely held securities of companies and partnerships in many industries for a variety of purposes, including estate and gift tax, income tax, matrimonial proceedings, employee stock ownership plans, corporate planning and restructuring, financial reporting, sale, merger, stock purchase plans and buy-sell agreements.

Todd oversees MPI's Private Client Appraisal Group, which handles the firm's tax-based valuation assignments. Todd has prepared valuations of closely held operating companies, asset holding entities, as well as other securities such as undivided interests in real estate, closely held promissory notes, preferred stock, restricted stock and derivatives.  While his experience spans a variety of industries, Todd specializes in the valuation of alternative asset management firms and carried interest, and regularly assists the firm's clients with handling estate and gift tax audits.

| | |
|---|---|
| Education: | Chartered Financial Analyst®, CFA Institute<br>M.B.A., Concentration in Finance: Rutgers University, 2009<br>B.S., Major in Finance: The College of New Jersey, 2003 |
| Associations: | Accredited Senior Appraiser ("ASA"), American Society of Appraisers (Designated in Business Valuation)<br>Member, Estate Planning Council of New York City, Inc.<br>Member, New York Society of Security Analysts<br>Member, New York State Society of CPAs<br>Adjunct Professor – The College of New Jersey Business School<br>Faculty – Southern Federal Tax Institute (2017-2019)<br>Faculty – Massachusetts Continuing Legal Education, Inc. (2017, 2019)<br>Faculty – New Jersey Society of CPAs (2018) |

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# Daniel M. Kerrigan, CFA, ASA

President
Management Planning, Inc.

Mr. Kerrigan has over twenty years of business valuation experience. Valuations prepared by Mr. Kerrigan span a multitude of industries and company sizes. Mr. Kerrigan has testified in defense of his opinions (and has been accepted as an expert witness) in various venues including U.S. Federal Tax Court and other local jurisdictions. He also advises clients on various corporate finance matters, including mergers and acquisitions. As head of the firm's transaction and advisory practice, Dan oversees MPI's sell-side and buy-side M&A activities and fairness opinion services. The advisory and valuation engagements conducted by Mr. Kerrigan have also been used to analyze potential liquidity options available to owners of middle-market companies, effect corporate restructuring, create new classes of equity, maintain compliance with Employee Stock Ownership Plans and other ERISA plans, and effect intra-family ownership transfers, among others.

| | |
|---|---|
| Education: | The Wharton School, University of Pennsylvania - M.B.A.<br>The College of New Jersey - B.S. |
| Associations: | Chartered Financial Analyst (CFA) Charterholder<br>CFA Institute<br>CFA Society New York<br>American Society of Appraisers<br>Registered Representative of MPI Securities, Inc. (Series 7, 79, 28, 63, 24) |

# Scott A. Nammacher, CFA, ASA

- Scott has over 35 years of experience in financial consulting, business valuations and acquisitions/divestitures. He spent six years doing acquisitions, divestitures, special financings, and general financial consulting for PepsiCo (including its acquisition of KFC) and Marigold Enterprises, a boutique management consulting & leveraged buyout firm. His background includes experience with Arthur Andersen & Co., where he managed equity, debt, warrant/option, NOL and intangible asset valuations, along with general financial consulting engagements. He has been with Empire since 1992.
- He is an Accredited Senior Appraiser with the American Society of Appraisers and has served on the Board of Governors for the ASA as its Business Valuation Committee. He is a Chartered Financial Analyst (CFA). He chaired an annual valuation conference in New York for over 20 years, co-chaired the largest business valuation conference ever held and has been an active speaker in the field.
- Scott has valued a wide variety of publicly and privately-held companies for acquisitions, share repurchases, financial reporting, estate and gift tax reporting, recapitalizations, and general corporate planning and litigation purposes. He has also valued many kinds of other financial and intangible assets.
- He coauthored a book, *Investing in Junk Bonds; Inside the High Yield Debt Market*, John Wiley & Sons, New York, New York, 1987 (including a Japanese translation published in 1988) and several articles on "junk" bonds. He earned his MBA in Finance from NYU's Stern School and an undergraduate degree in Business from the U. of Minnesota.
- He has testified in US Tax Court, Bankruptcy Court, Delaware Chancery Court, State Supreme Courts, and arbitration venues in the Northeast, South and Western states. He has acted as a neutral valuation experts in numerous cases in the northeast area.



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# Kevin G. Kane, CFA, ASA

- Kevin is a Managing Director of Empire Valuation Consultants. He is a Chartered Financial Analyst® (CFA) charter holder and an Accredited Senior Appraiser (ASA) of the American Society of Appraisers.
- Kevin has valued many businesses, ranging from large multi-national companies to small local businesses, including household name product manufacturers, large real estate holding conglomerates, private REITs, real estate development companies, apparel manufacturers, restaurant franchises, movie theaters, nightclubs and many others.
- One of Kevin's specialties is valuing professional sports franchises including those in the National Football League, National Hockey League, National Basketball Association, Major League Soccer, and Triple-A and Major League Baseball. These valuations and fairness opinions are generally prepared for teams in relation to gift and estate tax, recapitalizations, and other corporate planning purposes.
- His intangible asset valuation assignments have included patents, literary works, movie and music rights, guaranty fees, split dollar arrangements and carried interest. Additionally, he has prepared valuations of in-process research and development, technology, tradename and other intangible assets for fair value purposes.
- Kevin lectures on valuation topics to various professional and educational organizations, including the American Society of Appraisers, Monroe County Bar Association, the Western New York and New York City Chapters of the ASA, the Pierro Law Group Intergenerational Wealth Planning Conference, Wealth Counsel, Business Enterprise Institute, and the University of Rochester Simon School of Business.



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