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General

Post-COVID-19 Valuations and Appraisals: What Effects Did the COVID-19 Economy Have on Business and Real Estate Values?

Cathy L. Reece, Moderator
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Hon. Mary Jo Heston
U.S. Bankruptcy Court (W.D. Wash.) | Tacoma

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B. Riley Advisory Services | New York

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2022

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SEPTEMBER 8-10, 2022

1

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SEPTEMBER 8-10, 2022 • FOUR SEASONS LAS VEGAS

Post-COVID Valuations and Appraisals:

What Effects Did the COVID Economy Have on Business and Real Estate Value?

2

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3

WHAT WILL WE BE COVERING?

- Cash Flow is still important to valuation and operations
- What factors impacted Cash Flow
- Valuation Methods are evolving
- Valuation and Discounted Cash Flow considerations
- Short-term v. Long-term considerations
- Factors in Discounted Cash Flow
- Impact on Sales and Prices
- Take-away points

4

THE IMPORTANCE OF CASH FLOW

Why is cash flow important to business operations?

"CASH IS KING!"

- Liquidity
- Meet Demands Of Capital Structure (e.g., Debt Service)
- Risk Management
- Expansion/Growth
- Provide Returns to Investors

Why is cash flow important to business valuations?

Two valuation methodologies are commonly used:

- **Income Approach**
  - Projected cash flows determine value
- **Market Approach**
  - Historical cash flows determine value

5

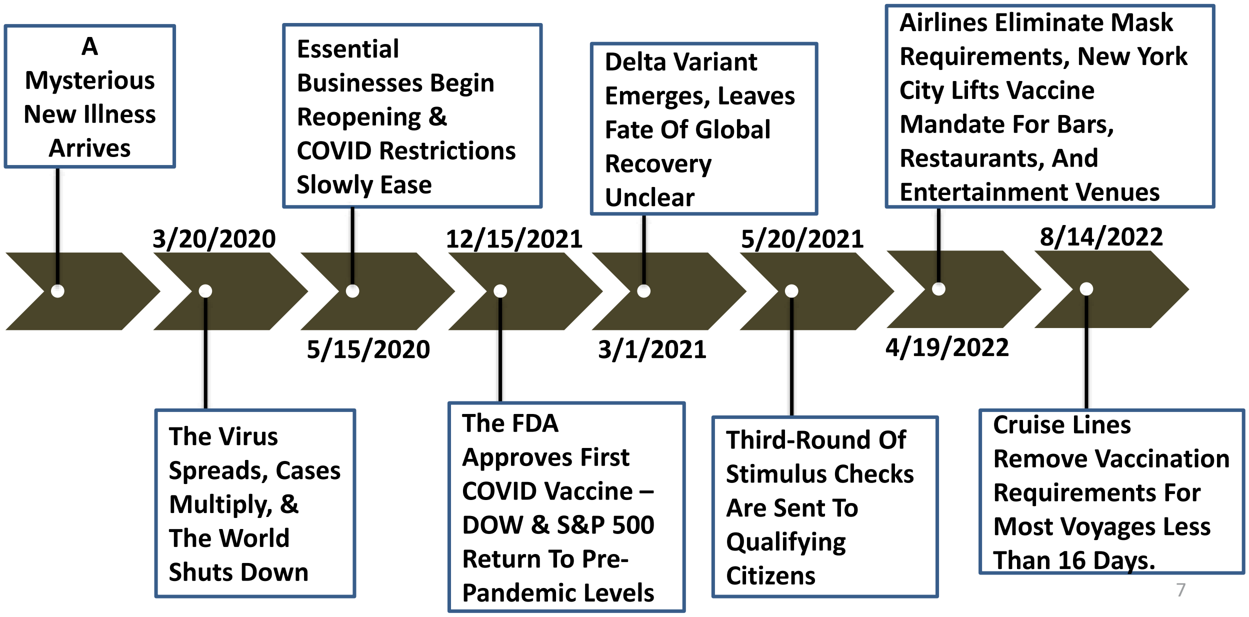
THE IMPORTANCE OF CASH FLOW

How did companies react to COVID?

- Disney:
  - Cost saving measures (furloughed 100,000 employees and cut executive pay 50%)
  - Experienced blockbuster growth in direct-to-consumer business (Hulu/ESPN/Disney+)
- Carnival:
  - Combatted net loss of $10.2 billion by selling fixed assets (ships), offering new equity, and acquiring new debt
  - Raised $19 billion in debt and equity, concluded 2020 with $9.5 billion in cash with virtually no ordinary business revenue
- Amazon:
  - Implemented new policy to counter supply constraints and maintain sales (e.g., Amazon announced order mid-March 2020 that its warehouses would only accept household staples, medical supplies, and "other high-demand products")
  - Bolstered targeted advertising (e.g., Amazon's revenues from advertising in the first quarter of 2020 were up 43.8% from the previous year)

6

What Impacted Cash Flow During COVID?



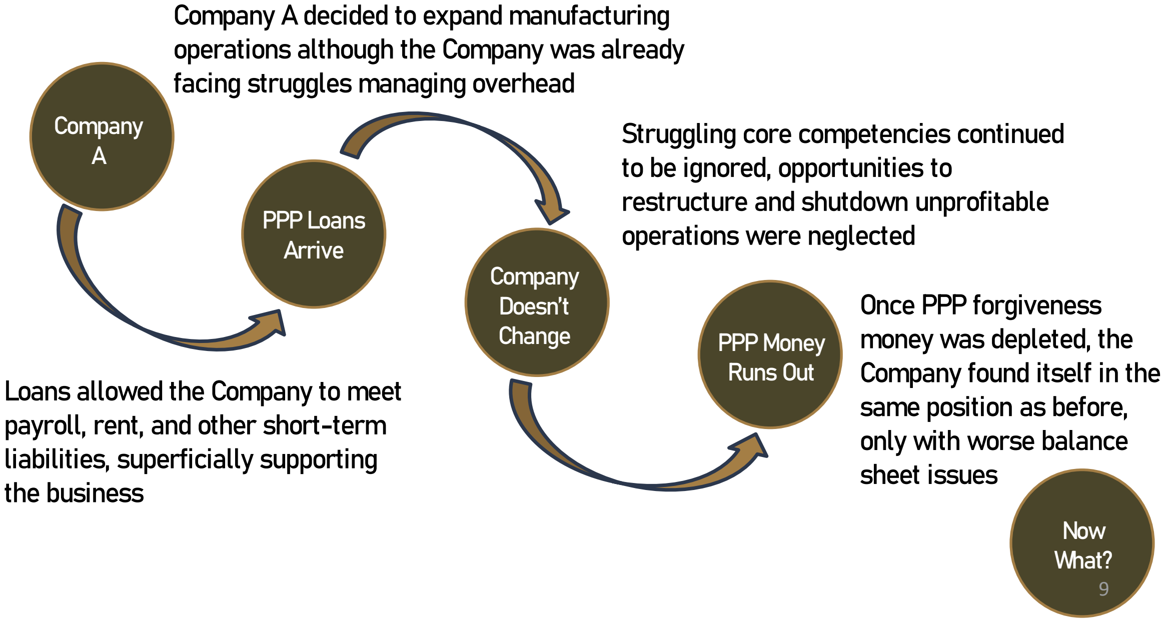
7

What Impacted Cash Flow During COVID?

- Positive Effects:
  - PPP Loans
  - Expansion Of Digital Marketplaces
  - Winners: UberEats, Netflix, Amazon, Zoom, Apple, Tesla
    - Netflix subscriptions increased 16 million during the first quarter of 2020
- Negative Effects:
  - Supply Chain Delays
  - Inflationary Pressures
  - Supply, Demand, & Labor Shortages
  - Losers: MGM Resorts, Norwegian Cruise Line, Darden Restaurants, United Airlines Holdings

8

Case Study – Founder Run Business



Valuation Methodologies in the Still Evolving "New Normal"

1. The pandemic is now (mostly) in the rear-view mirror
2. That said, the changes in society and markets related to the pandemic are continuing

10

Valuation Methodologies in the Still Evolving "New Normal"

3. Other factors not related to the pandemic are having a significant impact on business and the economy (e.g., Ukraine war, government actions)
4. The challenge is to incorporate the impact of these factors in the valuation analysis

Valuation and DCF Considerations in the "New Normal"

1. We apply the three traditional valuations methods (income approach, market approach, and cost approach) as we always have
2. With market approach valuation methods, the factors previously discussed are factored into market multiples to some extent

Valuation and DCF Considerations in the "New Normal"

3. With income approach methods such as a DCF analysis, the challenge is to incorporate these factors into the projections
4. Many factors can be viewed from a risk viewpoint; that said, it is generally better incorporate these factors into the projected cash flows rather than the discount rate

13

Short-Term v. Long-Term Considerations

1. Before the pandemic, mature companies were often considered to be at normalized levels of factors such as margins and growth rates
2. Even mature companies may face greater change in these variables than before the pandemic

14

Short-Term v. Long-Term Considerations

3. To what extent will the company revert to the pre-pandemic norms, or will the post-pandemic norms reflect permanent change?
4. Consider scenario analysis in order to analyze the impact of changes in assumptions

15

Factors to Consider in Current DCF Valuation Analyses-Macro

1. How has the subject industry been impacted?
2. How has the subject company's geographic market been impacted?

16

Factors to Consider in Current DCF Valuation Analyses-Macro

3. How has the subject company's segment within the industry been impacted (note that this segmentation can reflect many factors such as a geographic area and position in the market)
4. Price v. value considerations

17

Factors to Consider in Current DCF Valuation Analyses - Micro

1. Supply chain issues – commodity pricing and availability
2. Labor markets
3. How has company management addressed these factors since the start of the pandemic?
4. Inflation (including real v. nominal)

18

IDENTIFICATION OF THE LASTING IMPACT AND SALES ON ONGOING BUSINESS

INTRODUCTION

COVID Overall Impacts

-Shock to the world impacting all aspects of business & life

OVERVIEW CURRENT SITUATION

- The past two+ years has been one of the most dramatic periods in CRE history. Now at mid-2022, we have seen four interest rate hikes, inflation reaching a 40-year high, and two consecutive quarters of contracting GDP.
- Question Everyone is asking is where do we go from here?

19

Overview Current Situation - Continued

- What's the outlook for the rest of 2022 if the economy and CRE face continued rising inflation?
- How will CRE react to rising interest rates, labor and construction costs?
- What subsectors and geographies face the biggest challenges in the face of these influential economic drivers?
- Are there any potential areas of strength/optimism despite these economic obstacles?

20

- **PROPERTY OVERVIEW**
  - Impact on the Different Categories of Real Estate
    - Commercial
    - Multi-Family
    - Retail
    - Residential
- **IMPACT ON DIFFERENT SALES PLATFORMS**
  - Brokerage Sales During COVID
    - Initially virtually stopped due to Government & health restrictions & inability to work remotely efficiently
    - Companies ill prepared for COVID. Required time to set up remote working practices
      - *Due diligence impacted*
      - *Government restrictions & intervention lock downs etc.*

21

- **Auctions During COVID**
  - Live Auctions Cancelled

    -Already dying out but spell death note for them
  - On-Line & Sealed Bid Platforms Bloomed
    - *Already the way forward & bloomed to take center stage*
    - *Efficiency & acceptance leaps forward by buyers, sellers and the Courts*
    - *Ease of bidding for buyers*
    - *This bidding platform opened the pool of buyers which were regionally based to the entire world*

22

- After Initial Issues Continued at Slower Pace Then Due to Build-Up of Demand Raced Ahead
  - *Introduction of virtual tours, matterport & greater on-line interface & electronic signatures etc.*
  - *Facetime videos becoming very common to best protect tenants and buyers. Making the due diligence process time and cost effective*
  - *Lender & Escrow issues overcome by remote transaction, nearly 98% of contracts executed via electronic signatures as of today*
  - *Employees*

23

Identification of the Lasting Impact on Real Estate Sales and the Way the Marketplace Transacts Business

- **INITIAL IMPACTS**
  - Fear & uncertainty being the enemy of sales
    - Show by dramatic fall in Stock market evaporation of confidence in the marketplace
- **CURRENT SITUATION**
  - Much like the rebound in the Stock Market, Commercial & Residential sales saw returned, with a large spike in transactions in 2021. In 2022, the markets have changed almost on a dime due to the four (4) interest rate rises.
  - Increasing & pent-up demand - in volume of sales & transactions in general much like the stock market.
    - *The four (4) Interest rates* increases *in 2022 have had a negative effect on the Real Estate Market. Buyer's longer-term mindset of the economy has changed their mindset to a more conservative approach to underwriting and long-term upside profits.*

24

- Multifamily assets: as shown by institutional buyers requiring a half to one full point increase in cap rates which in turn lowers their offering price.
  - *For example, on multifamily sales Braun International is representing, including transactions already under contract, a roughly to a 6 to 10% discount from the PRE-RATE Hike market.*
  - Industrial Assets: we have seen an increase in buyer demand, though with softening in prices.
  - Retail Assets: this asset class is continuing to be under pressure and will likely not return to pre-COVID pricing.
    - *Braun International and Premiere Estates Realty Organization has seen a 1000% increase in our Bankruptcy, Receivership and Lender transactions since last August. We expect this sector to see continued stress in the next two years.*

25

- Land: Agricultural land sales are dipped only slightly, international buyers have continued to be reliable buyers.
- Residential Land: Is under pressure with continued slowing in buyer demand, developers have severely curtailed purchases or are asking for substantial price reductions. Construction and labor costs have increased nearly 35% to 40%.
- Hospitality: Mid tier and Economy flagged properties are selling for up to 35% discount from Pre-COVID sales.

26

Explanation & Differences in Brokerage & Auctions

- **BROKERAGE**
  - What is Traditional Brokerage?
  - Do you really know what a broker does to market the property?
  - How does the broker negotiate with multiple buyers?
  - Why is it common they leave money on the table!
- **AUCTIONS**
  - Types of Auctions & How Why work
  - Bankruptcy Auctions – We offer a public auction platform with a court overbid auction. In some situations, we have convinced the court to require only confirmation and NOT overbid in court when employing a Public Auction.

Why? – because buyer's may not see the need to participate in the public auction if a court overbid auction is occurring. "Why not just wait and bid in court".

27

Explanation & Differences in Brokerage & Auctions - Continued

- **FUTURE TRENDS**
  - Forecasts & Predictions Moving Forward
  - Lasting Impacts on sales & ongoing businesses

What is a Hybrid Brokerage?

- Simple, it give seller's, trustees, advisors control.
- Hybrid Brokerage uses all of our international marketing, property preparation and transactions tools with a listing price and seller dictated sales terms.
- If the property does not sell by the seller's timeline via brokerage, the seller has the option to flip the property to our Worldbid Auction platform.
- Flipping the property to our Worldbid auction platform guarantees the property is sold by the date the seller requires with the terms of sale determined by the seller, NOT the buyer.
- Complete control.

28

Take Away Points

29

QUESTIONS

30

Articles Concerning Post-COVID Valuations

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BUSINESS VALUATION UPDATE
TIMELY NEWS, ANALYSIS, AND RESOURCES FOR DEFENSIBLE VALUATIONS

The Valuation Paradigm of COVID-19: Using the Discounted Cash Flow Method After an Economic Crisis

By Craig Jacobson, Dan Korczyk, and Richard Peil (GlassRatner, a B. Riley Financial Company)

As we write this article, the short-term financial impact of COVID-19 on the United States' economy has been dramatic and historically unprecedented. The immediate stoppage of our normal dynamic society, coupled with the "overnight" closures of most consumer-oriented businesses, has led to mass layoffs and temporary furloughs for millions of workers throughout the country. This, in turn, has led to an extreme degree of uncertainty for employees, business owners, government officials, and financial market investors.

The three of us have been around long enough to have witnessed a number of other events that led to major economic and market disruptions, such as the OPEC oil embargo of the mid-1970s, the "Black Monday" stock market crash in 1987, the first Gulf War during 1990 and 1991, the "dot-com" market bubble and subsequent collapse of the late 1990s and early 2000s, the 9/11 terror attacks on the United States during September 2001, and, most recently, the 2008 housing market collapse that led to a multiyear economic downturn.

All of these examples, along with other lesser-profile domestic and international events, led to declines in consumer confidence, business sentiment, and investor confidence. Accordingly, these societal and economic shocks have required investors and valuation professionals to reassess the traditional approaches and inputs used to value operating companies and other assets. And, although panic often ensues by certain investor classes during periods of extreme market disruptions, the challenge is to revert back to the foundational elements of valuation and how to properly apply those "blocking and tackling" fundamentals during very untraditional times.

This article focuses on the income approach and specifically the use of forward-looking projections and risk-adjusted discount rates in the context of a discounted cash flow (DCF) analysis framework. However, the same rationale is also applicable to other income approach methods.

Start with the big picture. At the risk of stating the obvious, everything is now different. Since their peak during mid-February, U.S. equity markets have fallen by about a third to levels not seen since 2016. For example, the S&P 500 Index plunged from its high of 3,386 on February 18 to 2,236 by March 22. Within that period, the markets experienced both interday and intraday volatility of enormous proportions. Clearly, investors' market perceptions included a combination of lower short-term earnings guidance, low or negative future growth rates, and increasing market risk.

It is difficult to imagine today a company that is not impacted in terms of the three components of a DCF analysis: earnings, growth, and risk. In a vast majority of cases, the net short-term outcome has been a reduction in both enterprise and shareholder value, though there are noted exceptions. For example, since the U.S. government announced travel restrictions from China

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on January 31, the web-based video conferencing company Zoom Video Communications Inc. (NasdaqGS: ZM) has experienced a sharp increase in demand for its service offerings. Accordingly, its share price increased from $76 per share on January 31 to a high of $159 per share on March 23, an increase of 109.2% in less than two months.

This exception demonstrates the importance of considering all three variables and their interrelationships. While Zoom is not immune to current uncertainties, including whether consumers will continue recent usage levels as economic conditions evolve and return to a new normalcy, risk alone is likely not driving its stock price. Rather, Zoom has been able to capitalize on the opportunity to solve many longer-term "work from home" issues for its newfound customers that were unaware of the company less than three months ago.

The big picture should also consider that the impact of COVID-19 will vary significantly by industry. It is likely that, post-crisis, the world will have been permanently rearranged in terms of demand for different products and services. Some businesses will not successfully emerge from the current crisis. In other instances, a new "readiness" mantra will drive CEOs and government officials to invest differently, prioritize differently, and view the world through new strategic and policy lenses. Out of necessity, many companies will have operated in ways previously foreign to them, only to find that they have learned to better manage and diversify their operations. Others will have learned hard lessons pointing to the need for much more change down the road.

Just how strong will big-picture demand be down the road? Some believe GDP levels and growth rates will not return to those of the last few years. Others believe the human desire to return to a state of normalcy leads to pent-up demand and thus strong consumer spending—the segment of our economy that makes up 70% of GDP. To some degree, our economy and financial markets will face the old chicken-or-egg question, and valuations are likely to play a key role.

If equity markets react with great confidence and publicly traded valuations are robust, as they typically are coming out of an economic downturn, an aging society that controls the largest portion of saving base in the U.S. may be in the mood to start traveling, dining out, and generally spending. However, if equity markets behave sheepishly, then renewed demand may lag. Generally, the Federal Reserve has not directed its policymaking toward satisfying the equity markets; however, under the Trump administration, the connection between managing the economy and the stock market has come more front and center.

Economic recoveries don't happen overnight. Economic momentum increases as confidence builds, yet the COVID-19 pandemic has reinforced what prior viruses such as Ebola should have already taught us: that pandemics need to be added to the growing list of risky disrupters such as technology, politics, weather, terrorism, and war.

Projections and growth. The COVID-19 economic shock is unique since it has impacted both the supply and demand sides of the U.S. economy. On the supply side, the virus has caused extensive disruptions in many domestic and international supply chains, while the closure of most consumer businesses, mass layoffs, and furloughs at many U.S. companies have led to an immediate reduction in consumer demand. Most observers, at a minimum, expect the U.S. to experience a short-term recession, while more pessimistic economists have hinted at a deeper recession or even a longer-term depression, all of which needs to be factored into the key inputs of a DCF analysis.

We believe best practices will require valuation professionals to re-examine all three primary components of a DCF analysis: current earnings capacity, projected growth rates, and market risks that are translated into discount rates, rather than simply increasing the discount rate to account for the greater risk in today's markets.

Forward-looking projections of earnings and cash flows are the one key input that will require the most significant level of diligence and consideration. Clearly, most businesses are now expecting lower levels of revenue, earnings, and cash flow than earlier in 2020. While not all businesses are impacted the same way, it is safe to say that most projections that were prepared before the COVID-19 outbreak are no longer valid.

Therefore, the goal for valuation analysts is to work with the business owner and/or manager in order to assess the situation. While valuation practitioners often disagree on the level of scrutiny that management-prepared projections should receive, in these unusual times, it is especially important to understand management's thought processes and to possibly suggest modifications to projections, if appropriate.

The starting point for any set of forward-looking projections is a baseline. Historically, the baseline has been a fairly tangible measure such as the previous year's or quarter's financial results. However, in this time of economic upheaval, this measure may no longer be relevant, and the current baseline will be highly uncertain. We are only a few weeks into the crisis, and the long-term impact is not knowable. Therefore, a much more thorough reassessment of current earnings capacity is needed to establish a meaningful baseline to "drive" projected revenues and earnings into the future.

For many companies, the short-term prognosis is significantly different than even one year down the road. For example, the demand for air travel and hotel rooms are at such low levels that many planes are parked and many hotel properties are temporarily closed. Yet, it is reasonable to expect that, as society returns to more normal work and social activities, the demand for airlines and hotels will increase significantly from where they are right now. Other industries should similarly be analyzed from a very short-term and then longer-term perspective.

Once a new baseline is established, the next step is to estimate growth in revenue and potential changes in profitability. For revenue growth, one should review updated analyst and industry reports for the subject industry as well as for the economy as a whole.

If one is using the fair market value standard of value, the valuation analyst should consider that a "willing buyer" might be unwilling to pay a purchase price at this time that reflects expectations of high levels of growth and/or a fast economic recovery. Accordingly, given the expectation of a near-term economic downturn, it would seem prudent in many cases to assume tempered levels of growth, or even negative growth (again, this expectation can vary significantly by industry). While this, of course, lowers computed valuations, this seems to be in line with market expectations.

The contrarian might argue that the equity markets are not necessarily projecting slower future growth but rather that the markets are thoroughly confused at the present time. Markets don't like uncertainty. Said differently, risk levels are high right now. At some point, greater clarity will likely come into focus. If growth optimism sets in, this will bode well for increasing valuations. Of course, additional clarity in the other direction will lead to lower projections and more downward pressure on valuations.

Finally, changes in expenses and profit margins must be considered. As with growth rates, it is likely that many expense components will be permanently changed relative to precrisis levels.

Let's start with labor costs. Clearly, a major decline in economic activity will shift equilibriums in the labor markets. Left to their own volitions, the economic forces of supply and demand suggest a likely decline in market wages. However, this basic economic law must be considered in the context of the political environment. The push in some states and municipalities for a $15.00 minimum wage might change depending on economic and/or political factors that may vary significantly by industry and geographic area.

Other cost factors are likely to change due to both supply and demand pressure. Increased oil production by Saudi Arabia and Russia, coupled with lower global demand for gasoline, diesel fuel, and aviation fuel, have driven energy prices down to historical lows during the past few weeks. In addition, other commodities such as agricultural prices have been declining and are likely to experience continued abnormal volatility. Accordingly, the traditional process of comparing historical and projected profit margins will become more uncertain.

In many cases, valuation analysts will want to conduct granular "line-item" analyses of a target company's most critical and sensitive operating expenses to properly evaluate its cost structure and forward-looking profit margins. In making a comparison, it will be important to not only note the expected changes in these inputs, but also make sure that there's a story behind the changes and that they're consistent with reasonable expectations for the post-crisis world.

Finally, comprehensive financial projections will also need to look beyond the income statement because many companies will emerge from the current crisis with weaker balance sheets. Many companies will have less working capital because of declining cash and accounts receivable balances, along with increased accounts payables as financial executives managed their declining cash flows during the crisis. In addition, many companies will have sustained their operations by increasing debt.

Accordingly, analysts will need to properly evaluate future working capital needs in their projections of future free cash flows. Projected capital expenditures and depreciation will also have to be reconsidered. In addition, increased leverage will diminish equity valuations.

The discount rate. During periods of turmoil and great uncertainty, equity markets become much more volatile. For those who follow the markets closely, we have witnessed historic interday and intraday share price swings during the first few weeks of March. For example, the top-10 daily point changes in the history of the Dow Jones Industrial Average (DJIA) have occurred during March 2020, while six of the top-10 daily percentage changes in the DJIA have occurred so far during March 2020.

The extraordinary day-to-day price swings of the major U.S. equity markets indicates great uncertainty exists when it comes to the fundamental elements of valuation and that most analysts are observing key risk measurements with opaque lenses.

We believe this short-term element of risk is primarily a matter of clouded vision of the future—i.e., projection uncertainty. However, the value of a company, as derived under the DCF method, is largely tied to cash flows over many years, not just the next few weeks or quarters. Accordingly, over the long term, a properly managed company's return on investment expectations—relative to risk-free rates and other classes of investments—is more reasonably predictable.

Therefore, our perspective on discount rates is somewhat different than our perspective on projections (with an exception discussed below). While projections in general can vary significantly over time, particularly in times of crisis and economic disruption, discount rates are less likely to change significantly; this, of course, assumes that appropriate adjustments have been made to the projections to which the discount rate is applied.

Discount rate calculations are often based on data from public securities market returns going back approximately 100 years. While the last few weeks have experienced unprecedented movement in stock prices, this does not mean that long-term risk/reward considerations have changed that significantly. If major changes in securities prices are properly reflected in revised projections, it does not appear that significant changes in discount rates are required.

However, in certain cases, the discount rate calculation might warrant some modifications other than changing long-term required rates of return. For example, valuation analysts may want to consider applying multistage discount rates to the term structure of the projected cash flows. For example, the first year or two of projected cash flows may require a higher risk-adjusted discount rate than projected cash flows further out into the future.

The exception to this thinking relates to companies that have become distressed during the crisis. Investments in distressed companies are riskier and therefore often warrant higher discount rates than for healthy companies. In the case of companies that have become financially distressed, the analyst might consider the applicability of a higher discount rate to account for this risk, making sure that the assessed level of risk is consistent with the risk inherent in the projections.

Reconciliation with the market approach. While this article has focused on the DCF method, a thoroughly constructed valuation analysis should also reconcile the DCF indications of value with indications of value from one or more independent valuation methods. Therefore, the topics discussed in this article should also be considered in the context of the market approach.

Public-company multiples have, of course, declined significantly during the past six weeks. However, when multiples are based on precrisis reported financial results, they might not be relevant to post-crisis valuations depending on the similarity of the guideline companies and the subject company in terms of growth, profitability, and risk factors. Accordingly, without proper adjustments that reflect revised baseline earnings estimates, the use of public-company multiples will more likely than not result in flawed indications of value.

As companies report updated (and presumably mostly lower) quarterly financial results in the coming weeks and months, multiples might make up some of their lost ground. In addition, as macroeconomic conditions become clearer, pricing multiples should become more stable and predictable.

The analysis of comparable acquisitions is somewhat different. It is reasonable to assume that many transactions based on precrisis conditions are no longer relevant. While one can adjust precrisis multiples to consider changes in market multiples, this should be done with care since the impact of the market varies by sector. Finally, it is likely that there will be a slowdown in transactions during the foreseeable future, so it is likely we'll have to place greater emphasis on other indications of value for some time. Overall, we expect that the market approach will become more reliable with the passage of time as public markets stabilize and more post-crisis transactions reflect the new reality.

Summary and conclusion. As with so many other areas of life, COVID-19 has brought the valuation profession into uncharted territory. The public equities markets have sent a strong, unambiguous signal that values are sharply down due to supply and demand disruptions impacting cash flows in far greater magnitude than changes in long-term risk. Accordingly, to properly perform a valuation analysis in the current environment, valuation professionals should focus their attention on the quality of baseline earnings estimates and projected growth rates during the foreseeable future.

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BUSINESS VALUATION UPDATE

TIMELY NEWS, ANALYSIS, AND RESOURCES FOR DEFENSIBLE VALUATIONS

Price Versus Value: A Transaction and Litigation Perspective

By Craig A. Jacobson and Richard B. Peil, B. Riley Advisory Services (New York, N.Y., and Phoenix, Ariz., USA)

According to disciples of modern portfolio theory and its efficient market hypothesis, shares of public companies should always trade at a price equivalent to their economic value, making it impossible for investors to experience short-term arbitrage profits. In other words, an investor should be unable to purchase stock at a price below its fundamental value or sell those same shares at a price above their fundamental value.

However, explain that theory to any hedge fund manager or day trader who purchased or sold GameStop Corp. (NYSE:GME) common stock for $89 on Jan. 26, 2021, $380 on Jan. 27, 2021, $112 on Jan. 28, 2021, or $413 the following day on Jan. 29, 2021.[1] During those few days of trading, did GameStop's share price and fundamental value gyrate in tandem? Or was there some combination of external forces that created a disparity between the company's trading price and its fundamental value? We believe the answer is resoundingly the latter.

Although rare, GameStop is an extreme example of interday and intraday price fluctuations that opens the door to a broader discussion about differences between price and value. The price-versus-value topic is of particular interest to valuation professionals who are called on to value securities of privately held companies in connection with commercial litigation or bankruptcy disputes and/or prospective M&A transactions.

In a vacuum, the concept of efficient markets is an elegant theory for academic textbooks. However, in the real world of business valuation, the theory becomes very murky indeed. This article focuses on practical reasons why price and value are not always the same concepts and why they can diverge in real-world situations.

The Starting Point: Defining Price and Value?

The famous Wall Street investor, Warren Buffett, is well-known for one particular quote: "Price is what you pay, and value is what you get." It is an idea that largely described his investment philosophy and one that he used to achieve unparallel levels of success during his vaunted career. If the most prolific Wall Street investor of the 20th and 21st centuries recognized a difference between price and value, it is hard to dispute the notion.

Price seems to be the easiest concept of the two to understand. As Buffett so elegantly alluded to in his quote, price is the amount of consideration paid to acquire another asset. Price is established through the competing elements of supply and demand until an equilibrium amount is achieved in a market.

However, unless an investor purchases a $10 bill for another similar $10 bill, the concept of what the buyer received in return for that cash payment, i.e., value, can be up for debate, particularly when that buyer purchases shares in a privately owned company.

1 *Note: As we write this article on Feb. 2, 2021, GameStop's closing price has fallen to $90 per share.*

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In the context of business valuation, the term "value" can have multiple definitions. So, before the onset of any valuation assignment, a valuation professional must specify an appropriate "standard of value." Common standards of value include *fair market value, fair value,* and *investment value*. However, for simplicity, this article assumes fair market value will be the appropriate standard of value for our discussion about value. As a reminder, fair market value is commonly defined as:

> The cash equivalent amount at which property would change hands between a willing seller and willing buyer when neither party is under any compulsion to sell or buy and when both parties have reasonable knowledge of the relevant facts.

Furthering the Warren Buffett philosophy, value is arguably what a buyer expects to receive from the purchase of a business, which is primarily a function of risk-adjusted returns, including dividends, earnings, cash flows, and growth thereof.

So, now that we have placed some context on the terms "price" and "value," we can now explore potential reasons for the divergence of price and value in marketplace transactions.

Deal Price vs. Fair Market Value of an M&A Transaction

When valuation professionals are called on to derive indications of value for a business or its securities, one of the common methods is to analyze the amounts paid to acquire companies that are comparable in nature to the subject company to be valued. Known as the M&A transaction method, an analyst will investigate the purchase price relative to a set of common earnings metrics such as revenue, EBIT, EBITDA, or certain operating metrics such as the number of subscribers for a cable-TV business or the number of available annual room nights for a hotel business. The transaction multiples derived from those earnings and/or operating metrics can then be extrapolated to derive indications of value for the subject company.

One might argue this valuation method is best used to derive an estimated purchase price for the subject company rather than deriving an indication of its fundamental value. A key element, which is often not considered when using the M&A transaction method, is knowing the buyer's motivation for entering into the underlying transaction being analyzed. We've all heard the phrase "beauty is in the eye of the beholder." However, when it comes to a business, the same can be said about its value.

Business buyers can have many different motivations for purchasing another company, and those motivations may be specifically unique to that particular buyer. Common motivations may include, but are not limited to, the following:

- Financial synergies that can be achieved through the combination of two independent companies or more. Such synergies may include costs savings through the elimination of duplicate cost structures, revenue enhancements through the combination of sales and distribution channels, and better utilization of research and development projects.
- It is cheaper to grow the buyer's business or enter new markets through an acquisition rather than making the financial investments necessary to create organic growth.
- A defensive move by the buyer to fend off competition or preserve market share.
- Management's self-interest to grow the business at any cost.

All of the aforementioned reasons can lead a specific buyer to purchase a business at a price much higher than the value other buyers would place on the acquired business. In other words, value was in the eye of the beholder. But the value the particular buyer perceived was not the representative view of most potential buyers.

The same rationale can also be used to explain the extraordinary price fluctuations in GameStop. Although some observers believed the fundamental value of GameStop ranged somewhere between $20 and $30 per share, the actual trading price was far greater due to the confluence of competing motivations the buyers and sellers engaged in the GameStop feeding frenzy exhibited. Some GameStop buyers were simply motivated by the prospects of short-term profits, while other buyers were essentially forced to buy shares to close out short sale positions that were going to expire. Needless to say, the trading of GameStop shares violated a fundamental element of fair market value: Neither the buyers or sellers are compelled to buy or sell. However, GameStop's short sellers were compelled to buy shares at any price to cover their open positions.

Early-Stage Companies

Early-stage companies also present a particular valuation challenge. From a fundamental point of view, a company's value should reflect the present value of its expected future cash flows. However, early-stage investors generally make their investment decisions based on an expectation the company will go through a liquidity event, either in the form of a sale or IPO, after a certain duration of time.

The expected liquidity event represents the investor's expected payoff, or total return of investment. More times than not, the liquidity event, or exit price, is estimated on optimistic expectations of an obscure metric such as projected customer encounters, hits on a website, or a forward-looking revenue multiple. However, the underlying value of the business when based on sound revenue and earnings projections can derive a far different amount than an investor's purchase price.

Among the explanations given for an expected exit price, projected synergies are often near the top of the list. However, synergies often prove to be more elusive than initially assumed. Accordingly, a valuation professional should account for the risk of achieving projected synergies by adjusting the projected cash flows, the discount rate, or the selected multiple.

As an example, using the fairness opinion for a tech industry acquisition that we recently reviewed, the fairness opinion provider calculated the exit value as a multiple of forward revenue. However, two elements of this analysis suggest this metric represents a price rather than a value. First, the use of a revenue multiple, rather than an earnings or cash flow multiple, implied the company was not expected to reach a normalized level of profitability by the end of the multiyear projection period. Second, a forward-looking revenue multiple for an early-stage company often incorporates overly optimistic growth expectations for the subject company than for the underlying benchmark companies. Accordingly, this suggests the terminal value might represent a price the company can be sold for rather than a fundamental calculation of its value.

Litigation Disputes—Computing an Award Amount?

When the aggrieved party in a litigation dispute seeks an award in the form of lost business value, the proper measure of redress is the amount that would place the harmed party in the same position he or she would have been absent the perpetrator's alleged bad act. To determine this financial award as a measure of damages, two threshold questions must be considered:

1. What would have the aggrieved party received absent the alleged behavior?

2. Would the aggrieved party receive the value of an asset, or the price of the asset?

This difference can manifest itself several ways. Take the case of a shareholder dispute involving an early-stage company. The transaction price of an early-stage company might reflect considerations other than those generally used in a fundamental valuation analysis. If the company would have sold for an exit multiple that can't be justified from a valuation perspective, then fairness may dictate the aggrieved party receive an award or settlement commensurate with the price paid rather than the value received.

On the other hand, some disputes require estimating the value of the company, which might be different than a contemporaneous transaction price. For example, in a solvency analysis, the standard of value is often present fair salable value, which practitioners generally consider equivalent to fair market value. In this case, a proper estimate of value might be more relevant than a contemporaneous transaction price that doesn't represent value.

The Final Word

Valuation professionals and academics have spent years trying to resolve the occasional chasm between an asset's price and its value. Ultimately, the differences can come down to measurements arrived at by different means and perceptions.

Prices can be determined by certain quantitative means such as market trend lines, trading strategies, and technical analyses, along with other more subjective elements such as emotions, confidence levels (or lack thereof), and greed. Value, on the other hand, tends to be based on certain fundamental objective measurements such as projected revenue, earnings, cash flows, and growth.

The real estate collapse that led to the Great Recession perfectly demonstrated this principle. For example, many houses that had a particular value derived from the use of fundamental appraisal methods ultimately sold for substantially less money because that was the maximum amount buyers were willing to pay.

Price is what one pays, and value is in the eye of the beholder.

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Matt Foster is a managing director and founding partner of Sonoran Capital Advisors in Phoenix. Prior to founding Sonoran in 2017, he worked as a director for international insolvency firm KRYS Global, and before that he worked for another restructuring boutique, Odyssey Capital Group. Mr. Foster began his finance career in private equity working for Citizens Capital, Inc. (CCI), the private equity arm of RBS Citizens Bank. He oversaw CCI's interests in its private-equity portfolio consisting of investments in over a dozen private companies. Since that time, Mr. Foster has been involved in a wide range of restructuring engagements, including out-of-court restructurings, chapter 11 restructurings, litigation support and solvency. He has served in multiple CRO, CFO, financial advisor and investment banking positions across various industries. In the past two years, he's been engaged as the CRO of an oilfield services company, CRO of a cryptocurrency bank, and financial advisor to a land development and mining company. Mr. Foster received his B.S. in finance from the University of Utah and his M.B.A. from Northeastern University.

Hon. Mary Jo Heston is a U.S. Bankruptcy Judge for the Western District of Washington in Tacoma, appointed on Jan. 31, 2017. Previously, she was a shareholder in the Seattle and Portland, Ore., offices of Lane Powell PC, where her practice involved commercial litigation and transactional matters with an emphasis on business reorganizations, international insolvency and the acquisition of troubled businesses and assets. Between 1988 and 1993, Judge Heston served as the first Region 18 U.S. Trustee, overseeing bankruptcy cases and fiduciaries in Washington, Oregon, Idaho, Alaska and Montana. She also is a former law clerk to a federal district court judge and a bankruptcy judge and a former estate administrator of the federal bankruptcy court. Judge Heston taught bankruptcy courses for more than 21 years at Seattle University School of Law and two years at the University of Washington Law School. She is a 2001 Fellow of the American College of Bankruptcy and an active participant in both professional organizations and community service organizations, and she currently serves or has served in leadership positions for the National Conference of Bankruptcy Judges, ABI, INSOL International, the Washington State Bar Association's Debtor Creditor Section, the Turnaround Management Association, CARE and CENTS. Judge Heston is a frequent international, national and regional speaker and author on topics including creditors' rights issues, commercial, consumer and cross-border insolvency issues. Her recent community service efforts have focused on military and veterans' financial and bankruptcy-related issues through her service on the *Pro Bono* Committee of ABI's Veterans and Servicemembers Affairs Task Force. Judge Heston received her undergraduate degree *cum laude* from the University of Washington in 1975 and her J.D. *cum laude* from the Seattle University School of Law in 1980.

Craig A. Jacobson is a managing director with B. Riley Advisory Services in New York and has 30 years of experience in valuation, litigation support services and transactions consulting. Prior to joining B. Riley in 2014, he was a principal at a regional CPA firm providing valuation and litigation support services, and prior to that, he held a senior position with Willamette Management Associates. Mr. Jacobson began his career at a boutique investment banking and consulting firm, where he provided valuations, mergers and acquisitions, and litigation support services. His experience includes performing valuations for financial reporting, tax and corporate planning purposes; investment banking services including mergers, acquisitions and fairness opinions; pre-Initial Public Offering services, including valuations and assistance in the preparation of SEC filings; intellectual property valuation and litigation support services, including irreparable harm calculations; calculating economic damages, including lost profits and lost enterprise value; dissenting shareholder litigation and transactions; change-in-control disputes; failed real estate developments; and failed mergers and acquisitions litigation. Mr. Jacobson has testified as to his findings in deposition, arbitration, mediations and in court. He frequently writes and lectures on topics including fairness opinions, solvency opinions, intellectual property valuation and infringement damages, and valuation. Mr. Jacobson received his B.S. in economics and computer science from the State University of New York at Albany and his M.B.A. in finance from New York University's Stern School of Business.

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