BIZEQUITY®
ALGORITHM UPDATE

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BizEquity Algorithm Update: Q1 2020

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Introduction

As of April 1st, 2020, what seemed to be the cruelest imaginable "April Fool's Day" joke had become a stark reality for virtually every nation in the world. Despite our highly productive economy and vast amounts of wealth, the **United States has shouldered its fair share of the sickness, grief and economic despair that is forever linked to the "Coronavirus"** or more specifically the disease known as "COVID-19" (hereafter referred to as "CV-19").

April 1st, 2020 also happened to be the first day that BizEquity customers will be able to enter financial figures for the current fiscal or calendar year of 2020. As it turns out, this is an extremely important development in terms of allowing financial advisors and business owners to most accurately assess the probable fair market value of their businesses in the midst of the CV-19 outbreak across the country.

In response to the evolving dynamics of the US economy and the values of companies therein, we have undertaken a **comprehensive analysis involving the steps needed to adapt our patented algorithm to accurately adjust the business value estimates** generated by our thousands of users. In short, these changes include:

Major Algorithm Adjustments Due to COVID-19 Events

1) The entry of expected 2020 financial performance (income statement) and position (balance sheet) will play a major role in adjusting business values to the "new normal" of the CV-19 era.

2) All industries are mapped to the Russell 2000 Index to create daily but minor changes to portfolio companies valued via BizEquity.

3) There is an across the board "Corona Factor" adjustment to account for the universal impact of uncertainty in crisis conditions such as these.

4) Winners and losers from the CV crisis have been identified with corresponding percentage adjustments implemented over time.

Background Analysis

Anyone who owns a business or serves the owners of private businesses instinctively knows that:

> **The valuation environment is dramatically different than it was only two short months earlier.**

As the gravity of the virus and its many implications increased, we witnessed **unprecedented volatility in public firm share prices** and a collective loss in the trillions of dollars (including the staggering loss of $6 trillion in value from global markets and $4 trillion from US markets in only six days towards the end of February, 2020).

The **2020 stock market crash began on February 20th** after the DJIA, S&P 500 and NASDAQ Composit all finished at **record highs on February 12th of 2020.** Volatility throughout March was extreme including another "Black Monday" followed by a "Black Thursday" when stocks across Europe and North America dropped by more than 9%. As of March, 2020, global stocks have seen a drop of at least 25% and around 30% in most G-20 nations.

On March 31st, the Dow Jones industrial average plunged 410 points, or 1.9% to cap the most dismal first quarter of its 135-year history. The blue-chip index ended the day at 21,917.16 — a full 23% below its January start and 26% off the record high it set on February 12th at 29,551.

> **As of April 1st, 2020, the DJIA closed at around 20,943 or around 8,608 points and 29% lower than the historic high. It is a logical question to ask if private companies are also now collectively worth 29% less than they were in February.**

Although there is a general correlation between public firm stock values and private firm values, history has shown us that:

> **Private firm multiples vary much less than their public counterparts.**

Our published analysis confirms this and includes the important premise that the primary factors which drive business valuation multiples upward in the private sector revolve around growth (or contraction) in company revenues, profits and cash flows. The so-called "size effect" has been documented in many ways by many professionals and holds that:

> **As revenues, profits and cash flows increase, so too do the pertinent average multiples.**

At the same time, it is arguable that a **large swath of main street companies have become more or less "unmarketable" at the present time** – with a corresponding ***value of close to zero*** (or at best some measure of "liquidation value"). This fact goes to the extremely unique nature of recent events as compared to the typical post WWII economic disruptions or recessions. In a period of weeks, the:

> **US economy went from its strongest position in 50 years to its weakest position in 50 years.**

The unique nature of today's events goes beyond the dramatic decline in business activity and public firm share values to include the notion that:

> **The rebound should be far quicker than average and hopefully stronger than average.**

The aforementioned economic strength before CV-19 will make a big difference with respect to the inevitable turnaround. While some prognosticators are expected a year or even two to pass before we return to recent activity levels, ***BizEquity is on the optimistic side of this equation*** and believe that it should not take more than a year to return to "normal".

> **The strength of corporate and main street America prior to CV-19 coupled with an unprecedented and targeted/phased response to the economic crisis should prove to be the "saving grace" as it were.**

Things Will Get Better, But……

Despite our belief that the economy and business values will rebound steadily and substantially after the downside of the CV-19 curve is reached, the reality is that the value of virtually every business in the US is less today than it was two months earlier.

> **Excluding all other factors, the mere presence of high levels of anxiety and uncertainty has alone shaved large amounts of value from all businesses, small and large, private and public, strong or weak, etc.**

The determination of the magnitude of this drop in business value is of course situation-specific. As we know, there have even been "winners" emerging from this tragedy due to the changing behavior of consumers, businesses and governmental entities around the country. At the most basic level, these winners exist because the quantity and quality of their earnings are higher now than they were pre-COVID.

> **This in fact is the essence of business valuation, i.e. it is a function of the expected future net cash inflows accruing to the ownership interest and the risk profile of these cash flows**.

Some businesses are generating higher profits and cash flows with greater certainty today than two months ago, e.g. grocery chains, online work platforms, etc.

On the flip side (and the more common outcome), ***businesses with lower profits and cash flows and increased risk will be worth less today.*** Hence the significance of the April 1st change in the BizEquity algorithm to include the expected financial results for fiscal and calendar year 2020.

Whether the expected revenues and profits are higher or lower than last year,

> **The user of the BizEquity online tool MUST take the time to gauge the impact of recent events on any given company's expected 2020 financial performance (income statement entries) and position (balance sheet).**

The process of developing such estimates can vary from extremely detailed to extremely basic. In every case, however, this evaluation and estimate is essential for generating a credible estimate of the firm's value as of April 1st , 2020 and thereafter.

BizEquity has also undertaken a comprehensive review of the impact of the virus on deal making and their newly emerging multiples. Not surprisingly, the **number of deals taking place has plummeted due the uncertainty at play.** Although there is a rising presence of "virtual deal making," many scheduled closings have been deferred or even cancelled. Xerox ended its hostile bid to takeover HP, Inc., citing the coronavirus. There is also a heightened discussion of the importance of **"material adverse change" clauses** in future acquisitions.

The impact on deals was muted during most of February as dealmakers expected another near record year, but the **impact in March has been stifling**. Once the volatility ceases, there should be a dramatic increase in the number of suitors (including cash rich private equity firms) seeking to **take advantage of softer valuations**. Another common outcome expected in future deals will be **"earnout structures"** which tie the actual price paid to eventual financial outcomes.

BizEquity Adjustments to Valuation Algorithm

The depth and breadth of "new" transaction data is very limited. Despite this constraint, we have evaluated each of the industries associated with the five digit NAICS codes utilized in our algorithm and have **identified "winners and losers".**

Based on this analysis, we have updated the multiples in our database to reflect these recent changes. Beginning in early April, we are implementing these changes over time so as to reflect the general trends associated with each industry.

Some industries will see larger changes than others, either on the upside or the downside.

In addition to the industry-specific changes, it is noteworthy that our **algorithm already includes a daily but minor impact from changes to the Russell 2000 Index** (includes the smallest of publicly-traded firms which are most similar to the typical private company).

On top of these other changes:

We are implementing a "Corona Factor" adjustment which is universally downward and reflects the non-discriminatory impact of uncertainty across all industries and business values.

As a result, we now have layers of adjustments which will serve to most accurately assess the probable fair market value of your business or your clients' businesses.

1) The entry of expected 2020 financial performance (income statement) and position (balance sheet) will play a major role in adjusting business values to the "new normal" of the CV era.
2) All industries are mapped to the Russell 2000 Index to create daily but minor changes to portfolio companies valued via BizEquity.
3) There is an across the board "Corona Factor" adjustment to account for the universal impact of uncertainty in crisis conditions such as these.
4) Winners and losers from the CV crisis have been identified with corresponding percentage adjustments implemented over time.

Each of these elements are important, but it is the first item which is most "company-specific" and could have the greatest impact on current estimates of business value.

If credible annualized data is entered for 2020 which reflects the "most likely" impact of the crisis on any given business, then this alone will have a material and even substantial impact on the value of any company (most will be lower).

This is especially important given our statistical belief that the ***primary force behind higher multiples in a recovery is higher revenues and higher earnings/cash flow, i.e. the size effect.*** The same applies during a recession, only the multiples decline because revenues and earnings are smaller. It is also the case that the equity and enterprise values will also be affected by the incurrence of new debt to stay alive during conditions of depressed demand.

Importantly:

Many of the changes referenced above will be reversed as conditions improve.

BizEquity is taking its responsibility to serve business owners around the country by the democratization of business valuation access and knowledge. Under the leadership of Mike Carter, the personnel at BizEquity have undertaken the following steps recently to uphold this responsibility:

1) **Provided clients with unlimited access to prospecting data and extra reports.**
2) **Created the Coronavirus and Business Valuation Continuity white paper.**
3) **Distributed the Business Owner Survival Guide.**
4) **Hosted a webinar on the impact of the pandemic on public markets and private company valuations.**
5) **Made select donations to various charities and non-profit organizations assisting those in need.**