Coronavirus and Business Valuation Continuity Planning

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Introduction

Every ten years or so the world is subject to some sort of global crisis which tends to define a given era. March of 2020 will surely be a month that is remembered by citizens around the world as a uniquely trying set of circumstances which spawned tremendous uncertainty and pain and suffering in many countries. Sequoia Capital has already declared this disease to be the “Black Swan of 2020” due to its unforeseen and devastating consequences.

Although there are even “winning” industries or businesses in this complex and horrible happening (CLOROX; ZOOM; GOJO Industries), the fact is that virtually everyone and every company is being impacted by the virus in one way or another. It is also arguable that the value of most businesses is less today than it was one month ago due to the myriad effects of the virus on the global economy. Jen Kirby at Vox writes that the virus

> “…is unsettling supply chains, sapping sales of some products, throwing travel into chaos, freaking out the stock markets, and intensifying fears of a global recession.”

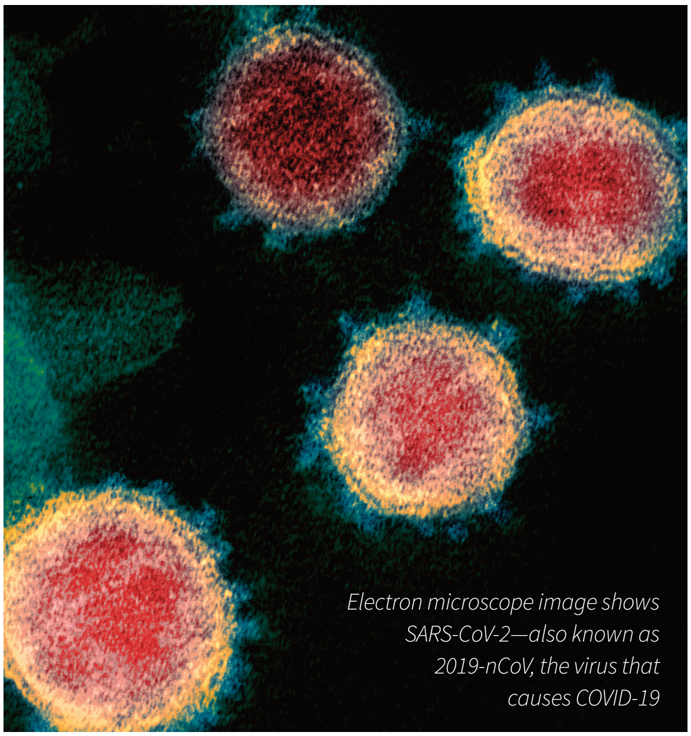
As we are still in the middle of the storm, nobody knows with certainty how this event will unfold over the remainder of what is a pivotal election year here in the United States. Given that business owners and their employees work daily to minimize uncertainty, it is not surprising to see a cottage industry of various experts weighing in on what will happen next and what can be done for protection in the meanwhile.

In the proverbial “big picture”, some of the primary “pools of thought” created by the Coronavirus include:

- Virus Containment and Eradication
- Political Repercussions
- Investor Reaction
- Business Preparations

The focus of this paper will be chiefly on “Business Preparations” and secondarily on “Investor Reaction” and the links between these two areas. The first two “pools” will be addressed briefly as a foundation to the investor and business implications. There are naturally overlapping considerations which are of great interest such as common sense steps that businesses can take to mitigate the spread and adverse effects of the virus.

Virus Containment and Eradication



Electron microscope image shows SARS-CoV-2—also known as 2019-nCoV, the virus that causes COVID-19

Coronaviruses are a large family of viruses that are common in humans and many different species of animals, including camels, cattle, cats, and bats. Rarely, animal coronaviruses can infect people and then spread between people, such as with MERS-CoV and SARS-CoV. Despite public familiarity with MERS and SARS, much remained unknown about the COVID-19 strains as of March 2020.

CDC Centers for Disease Control and Prevention

The CDC advice for containment by businesses and employers is available here:

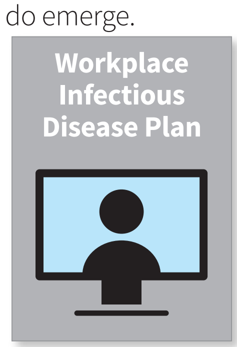
https://www.cdc.gov/coronavirus/2019-ncov/community/guidance-business-response.html

Current advice includes:

- Actively encourage sick employees to stay home
- Separate sick employees
- Emphasize staying home when sick, respiratory etiquette and hand hygiene
- Utilize technology in place of human contact
- Perform routine environmental cleaning
- Advise employees before traveling to take certain steps

One potentially large "silver lining" in the current catastrophe may be the development of a **workplace "infectious disease" plan. As one prognosticator opined "No one has a playbook for this".**

Although there have been flu scares in the past and attention has been paid developing proper responses, none have been as "real" as the current pandemic. The coronavirus is already embedded in the national consciousness and much can be learned to help prevent future scares and to contain those which do emerge.



Each business should have such a plan with clear objectives designed to:

- Reduce transmission
- Protect people at higher risk
- Maintain business operations
- Minimize adverse effects on other entities in the supply chain

More on this in the **"Business Preparations"** section.

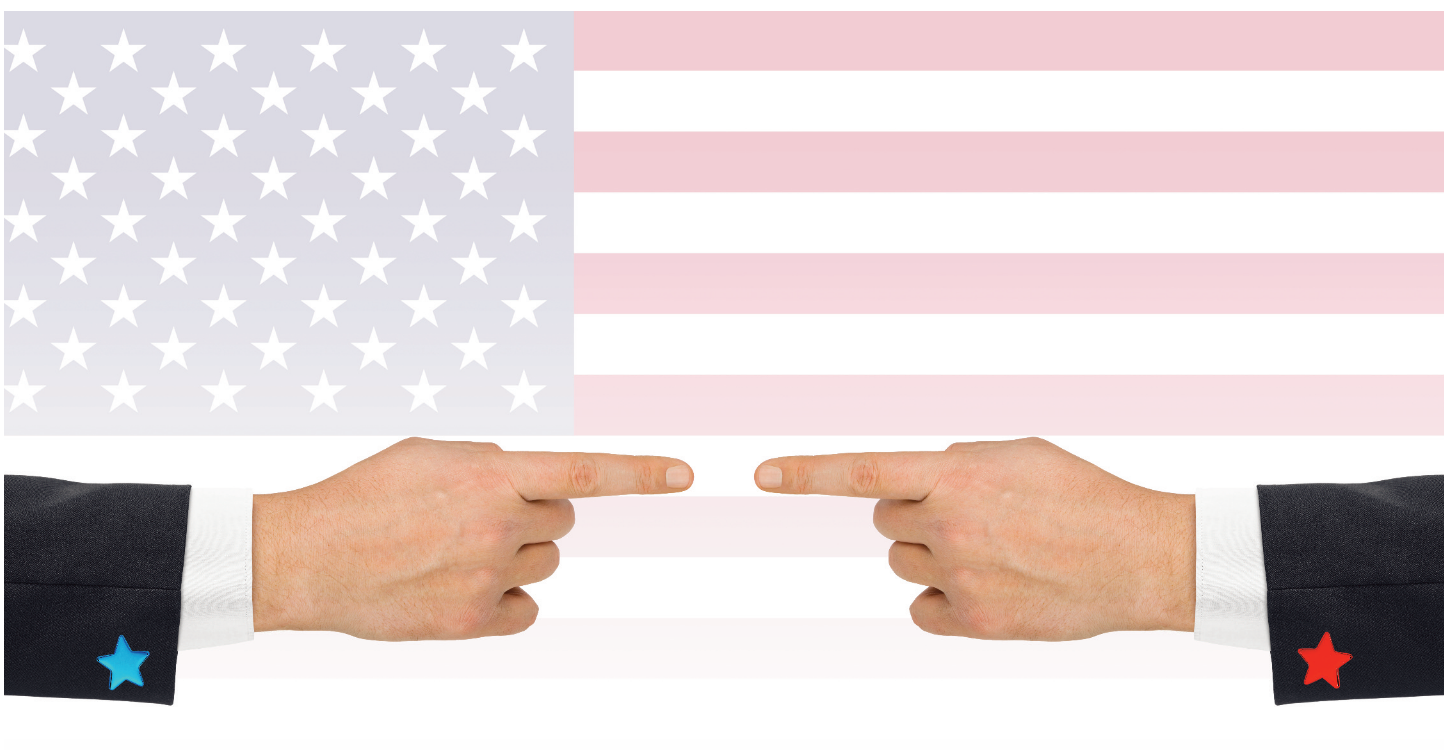
Political Repercussions

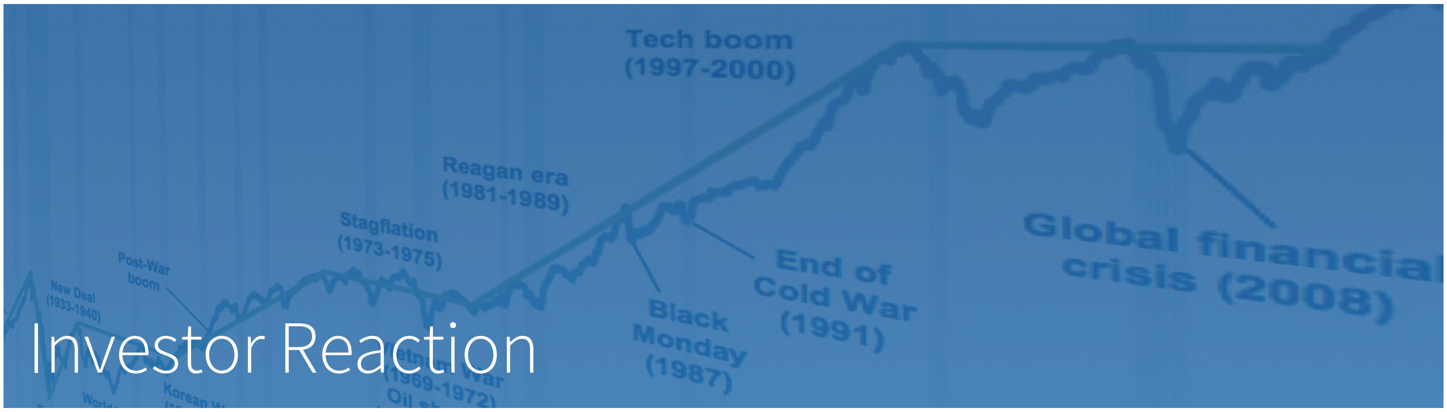
It is a sad commentary on US politics today that the public is legitimately concerned with the credibility of information regarding the virus that is

a) Provided by the administration and its departments and centers, e.g. CDC

b) Delivered by the main stream media in both print and television

Being in the middle of a presidential year election further muddies the waters with each side laying claim to their most favorable "spin". Suffice it to say that the public's ultimate perception of how the current administration handles this health crisis may "make or break" the re-election of a sitting president.





Investor Reaction

Gauged by the record level drop (in nominal terms) for the Dow Jones Industrial Average and steep declines in broader indices such as the S&P and the NASDAQ followed by a substantial rebound the following day, it is clear that the markets abhor uncertainty. Although the March 9th drop of more than 2,000 points was history-making, it was NOT the largest percentage decline which actually took place in 1987 when the index fell by nearly 23% (versus less than 8% on March 9th). Declines in 1929, 1987 and 2008 were all larger in relative terms.

The S&P 500 has dropped by nearly 19% from the record highs of last month, suggesting that we are only around 1% away from an "official" bear market – or the end of the current 11-year "bull market" which began in March of 2009. Selloffs are not new and they are even fairly recent as the S&P fell by nearly 20% in December of 2018 (and by a similar amount in 2011) and by more than 50% during the financial crisis which led to the "Great Recession" of 2008-2009.

Over the nine trading sessions between February 24th and March 5th, the Dow Jones Industrial Average registered its two **largest single-day point increases in history** (1,294 points and 1,173 points), as well as logged **five of its 10-largest single-session point declines** on record, ranging from 786 points to an all-time record 1,191 points. Motley Fool author Sean Williams reports that on March 2 and March 3, the Dow also recorded its respective third- and second-largest intraday point swings in its 123-year history. Though we're **only through roughly 10 weeks of 2020,** it's already the **most volatile year since 2011** in terms of 3% moves up or down on the Dow.

To be clear, the impact of coronavirus has the potential to be extreme in terms of employment and economic growth – at least for the short run. It is not clear, however, that Monday's carnage represented the "bottom" of this substantial decline – in a word, it is uncertainty which permeates the minds of investors and even their advisors. Monday's activity included an extra dose of uncertainty when Russia declined to follow the OPEC lead to slash production, which in turn caused a dramatic drop in the price of oil and the value of oil stocks.

It is our belief at BizEquity that the markets and the economy will begin their "real" recovery once it is clear that the number of new cases and deaths begins to decline and after investors have more thoroughly evaluated the winners and losers from the virus. In the meanwhile, both monetary policy (Fed) and fiscal policy (Congress and President) can step in to stabilize conditions through added liquidity (lower interest rates) and tax cuts (payroll tax cuts for now). Home mortgage rates have dipped into the 3% and even 2% range, triggering a deluge of refinancing requests while hopefully spurring new homeowners.

Although democrats have pushed back on the President's proposed payroll tax cuts to counter the economic impact of the virus, the rebound in stocks on Tuesday suggest that there is some merit to the proposal. The cut could amount to $40 billion per month, people briefed on the discussions said, which would make it quite substantial. Besides the payroll tax cuts, they are also discussing hourly wage earners' getting help so they can be in a position where they're not ever going to miss a paycheck." He said they'll "also be working on loans for small businesses" and working to help airlines and cruise lines, as well the hotel industry, which his company is involved in. Some lawmakers also discussed the idea of targeted infrastructure spending. Measures floated by Pelosi and other leaders in the democratic party included an expansion of unemployment insurance, food stamps and other public assistance programs as well as allowing for greater sick and family leave.

“The economy will be in very good shape a year from now. This is not like the financial crisis,” Treasury Secretary Steve Mnuchin said. "This is about providing proper tools of liquidity to go through the next few months."

“We need a detailed, pandemic-induced financial crisis plan, that forestalls bankruptcies and insolvencies where possible, without causing downstream crises,” writes John Cochrane, an economist at the University of Chicago. “Yes, you heard it here, judiciously targeted bailouts are really the only way I can think of to keep businesses and people from going bankrupt given the absence of pandemic insurance.” He adds that he does not know of any such plan.

Last Friday the **Coronavirus Preparedness and Response Supplemental Appropriations Act** (H.R. 6074) was signed by the President and became law. The legislation provides $8.3 billion in new funding to support public health services and businesses negatively impacted by the COVID-19 outbreak. In addition to providing public health agencies with $950 million, the new appropriations are estimated to **allow the SBA to provide $20 million in loans to small businesses.**

“For many American small businesses, the outbreak of coronavirus means fewer customers, gaps in supply chains, and workforce reductions,” says House Small Business Committee Chairwoman, Nydia M. Velázquez . “That is why [...] the House acted to open critical economic injury loans to small businesses dealing with the consequences of the coronavirus outbreak. These low-interest loans will inject much-needed capital into Main Street businesses as they recover from the hardship of operating during a public health crisis.”

The “winners” in economic terms go well beyond mortgage firms. According to data Vox received from Helium 10, a software suite for Amazon sellers, nine of the top 10 keywords being searched on Amazon.com are coronavirus-related. Shoppers are mostly searching for N95 respirators, medical face masks, and hand sanitizer. In Amazon’s health and household category as of March 5, top items included a three-pack of “anti-dust” masks, Clorox and Lysol Wipes, and “immune support” gummies.

Other **“winners”** include the following:

- E-commerce firms
- Cloud based communication firms
- Manufacturers of hand sanitizers, face masks and household disinfectants
- Medical supply firms
- Vaccine R&D firms
- Canned food and emergency food supply providers
- At-home entertainment companies
- Food and grocery delivery
- Grocery store sales of non-perishable goods
- Homebody industry products (video-conferencing, fitness equipment, tech companies)

On the **downside,** the phenomenon of "social distancing" and disruptions to the global supply chain are likely to have a strong impact on select industries

- Travel
- Air Transportation and Cruise Lines
- Conventions and Festivals
- Sporting Events
- Movie Theaters
- Restaurants (in particular Chinese)
- Olympics (fan-free)?
- All firms dependent on China-sourced supplies and products

Not surprisingly, stock analysts have changed their forecasts for earnings this year. For example, Goldman Sachs revised its earnings growth estimates to zero for US companies. "US companies will generate no earnings growth in 2020," Goldman Sachs's chief US equity strategist, David Kostin, said in a note to clients in February. "We have updated our earnings model to incorporate the likelihood that the virus becomes widespread."

Apple is one of those companies that has revised their projections for this quarter. Nike, too, is expected to have a grim quarter. Companies like Nike and Apple are unique in that they not only produce their products in China, they also sell a large volume of product to Chinese citizens. Apple and Starbucks closed their stores but have reopened more than half. Their employees may have been ill or in quarantine and face travel restrictions/delays in getting to work. Several cities were on full lockdown with retail sales nonexistent.

Our advice for investors is to consult with their financial advisors for investor-specific advice. Such advice should vary based on individual circumstances including age and portfolio value and the reality is that different advisors are following different strategies. As noted earlier, 2020 is already the most volatile year for stocks since 2011. Strategies suggested for consideration during this period of volatility by Sean Williams include:

- Stay Invested
- Buy Corrections and Use Limit Orders
- Do Not Use Margin to Buy Stocks
- Focus Efforts on Grabbing High Quality Dividend Stocks
- Think Long Term

One of the most common recommendations appears to be the "Stay Invested" philosophy due to the risks of seeking to "time" the market. Many studies have shown that "active investors" fare no better than "passive investors" and frequently do even worse. According to one Morningstar analysis, just one in four active funds beat the average returns provided by passive funds over a decade-long period, and that cheap-and-dumb funds were twice as successful as expensive-and-smart ones.

Time in the market beats timing the market.

In short:

- Wash your hands
- Ignore the markets
- Don't touch your face OR your stocks

Business Preparations

What can businesses do to counter the diverse forces emanating from the coronavirus? The responses fall into two different groupings:

1) Preventing Contamination and Spreading of the Virus

2) Business and Financial Measures

The first part of this article titled *"Virus Containment and Eradication"* addressed key steps which businesses can take to minimize the adverse effects of the virus on the health of employees including the establishment of an "Infectious Disease Plan" with clear objectives. The CDC refers to an "Infectious Disease Outbreak Response Plan" with detailed recommendations on how to create and implement such as plan. Please visit the webpage titled ***"Interim Guidance for Businesses and Employers"*** for more insights (link follows below):
https://www.cdc.gov/coronavirus/2019-ncov/community/guidance-business-response.html

A more concise set of recommendations from the World Economic Forum is presented here:

WORLD ECONOMIC FORUM
COMMITTED TO IMPROVING THE STATE OF THE WORLD

World Economic Forum Infectious Disease Recommendations

- Businesses must test home-working technology and review and prepare policies relating to remote working and sick pay;
- How and what employers communicate to their employees about coronavirus is critical;
- Global epidemic preparedness and response is underfunded – the business world needs to help fill this gap.

The company Facebook was one of the first to be affected directly by the virus outbreak in the Seattle area where all employees were told to work from home until March 31st. Alarm spread throughout the company – and many others just like it – prompting a variety of responses. Microsoft, Amazon, Ford, CNN, Citigroup and Twitter have executed work-from-home drills, dusted off emergency-response plans and ordered increasingly stringent safety measures to protect their workers. Amazon has since had it first affected employee along with HSBC and AT&T. Microsoft now has two affected employees.

Many corporate memos, including those from HSBC and Facebook, now mention deep cleaning of office spaces and self-quarantining. Face-to-face job interviews have been all but banned by some firms, in favor of interviews conducted by teleconference. The heightened anxiety in the workplace has forced executives to consider and implement procedures designed to help alleviate the uncertainty.

By March 10th, many companies had implemented work from home policies and tightened travel restrictions and going as far as suspending all nonessential travel. These measures may irrevocably affect workplace behavior as telecommuting becomes more ingrained. The use of digital tools for remote collaboration will also grow. The reality underlying this shift for the typical small business is not as glamorous as it first appears. Having employees stay home could in fact be devastating for some smaller businesses. Companies which must interact with the public will be hard hit, e.g. plumbing and HVAC firms and taxi firms. There are no currently effective contingency plans for such disruption.

From Virus Containment to Recession-Proofing Your Business

Moving beyond tactics to help against the spread of the virus and all of its negative consequences, it is also helpful to consider strategies as they relate to operating in conditions of economic recession. There is no doubt that this global virus has already been limiting production in a material fashion in China with other countries increasingly impacted. Falling production means falling incomes and falling employment. In a word – recession. It has been more than a decade since our last recession and it was special (known as the "Great Recession" in reference to the severity of the "Great Depression" in the 1930's).

The uncertainty surrounding the impact of the virus has a direct impact on expectations. Businesses operate and plan base on expectations and the business cycle unfolds somewhat like a snowball rolling down the hill, i.e. a small initial disruption can evolve into a gigantic disruption (and vice-versa on the upside).

What can businesses to do to prepare for the effects of a recession? As always, the answer is dependent on the size and type of company under discussion. Recommendations of this type can be very specific, but there are nonetheless some general recommendations which apply universally including:

1) Purchase "profit or business interruption insurance" coverage
2) Keep a vigilant eye on all operating and financial costs and keep all obligations "flexible"
3) Consider automation and efficiency-promoting software
4) Promote core values such as accountability, integrity, innovation and respect
5) Emphasize "product/service differentiation", i.e. elevate switching costs
6) Focus on how your firm can help others during downturns
7) Clean up your financials by eliminating "perks" and other "discretionary" outlays
8) Diversify revenue streams and reduce customer concentration
9) Build and utilize a team of advisors with "recession experience"
10) Create a "capital base" by retaining sufficient cash balances at all times

Overall, it is desirable to prepare and follow a strict financial management plan as part of a comprehensive business plan.

- Have your accounts properly audited at least every 12 months.
- Use professionally prepared management accounts to monitor your business.
- Prepare regular performance projections and cashflow forecasts.
- Regularly measure actual performance against the projections and forecasts.
- Monitor costs as closely as you do sales.
- Watch debtors and creditors closely.

There is no doubt that "an ounce of prevention is worth a pound of cure" when it comes to managing a business over the course of the business cycle.

Conclusion

It is now crystal clear that the coronavirus is having a material impact on business operations and business value and it is incumbent upon ownership to navigate this unchartered territory based on effective policy planning and implementation. With public markets losing close to 20% over the past several weeks, it is almost irrefutable that private firm values have also declined. As shown earlier, however, the impact is a function of the type and size of business (as well as the industry) being evaluated. At this point in time, the presence of mere uncertainty is the primary detriment to private firm values. As noted by republican Congressman Roger Williams of Texas “There is cash flow out there. I’m a main street business owner. Business is still very good. I think, though, if you focus on the employer and cut the payroll tax, along with the employee if you choose to do so, the money will get in the right hands. Business can still expand, businesses can hire, and I think that’s a good way to go if they choose to do that.”

He added, “The economy is good. I mean, I am a small business owner. It’s as good as I’ve ever seen it — I’ve been in business 50 years. So, I don’t think we need to try to tweak something that’s working. I think if we start … shoving more money in the economy, I’m not for bailouts. We don’t need that. The economy is good, the stock market will come back. Let the private sector begin to get it back. Confidence is good, so I wouldn’t overreact right now.

We agree with the Congressman and Secretary Mnuchin that this “recession” will be quite different from the “Great Recession” and most likely far more tame hopefully. For those thinking about selling their businesses, it might be prudent to wait out the current uncertainty so as to avoid any “coronavirus penalty”. Valuation multiples could remain at very attractive levels if the virus fizzles out with warmer weather and those victims who need assistance receive it in a timely manner over the next few months. Although private firm multiples have declined, we are hesitant to ascribe a similar 20% decline as seen in the public markets based on a preponderance of statistical evidence which shows that private firm multiples do NOT vary as much as public firm multiples. We remain cautiously optimistic for calendar year 2020 and assuming favorable election results a favorable 2021 and beyond.

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