

Business Valuations During COVID-19

Jake: Thanks for tuning in to the Texas family law podcast, where we provide you tips and insight to help you navigate divorce and child custody situations.

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Jake: And I'm Jake Gilbreath. We are the managing partners at Walter's Gilbreath PLLC with offices in Houston, Austin, and Dallas. And we're both board certified in family law by the Texas board of legal specialization.

Sarah: Your hosts are broadcasting from the lone star, state of Texas, where both have earned a reputation as fierce and effective advocates, both inside and outside the courtroom.

Jake: Alright. So this week Brian and I were talking and continuing on the topic of business valuations we thought that we should specifically talk about business valuations during the time of the pandemic. We decided to do this topic because I've actually had it come up in two separate cases.

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Just recently in a deposition on Friday, we were talking to the vice president of a business that was being evaluated. We had our experts our deposition, the other side had their experts who came with depositions. We quickly saw the effect the pandemic had on the evaluation of the businesses, along with the effect that the federal stimulus package and the various different funds that the business was getting from the stimulus package and how that affects the overall valuation.

So Brian and I thought that we would talk about that. I guess I'll start off by talking about what I'm hearing from all the experts in our cases, which is essentially "We don't know how this is going to affect business valuations. We don't know how, this is going to affect projecting income into the future."

If you remember from our last podcast, we were talking about valuing businesses as an ongoing concern (that's the income approach to valuing businesses.)

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That's probably the most common thing that we see of the divorce is that we value a business, not just as if it was being liquidated today, but rather, as an ongoing concern where we take the income of business and apply a multiplier. I say, "we" but the experts do this and then apply various discounts on it.

I think Brian would be the first one to say along with me that it is typical to see during a divorce that the business owner all of a sudden starts screaming and hollering about income being down and the sky is falling in the business isn't really what everybody thinks that it is.

And that's not an uncommon thing. I guess I'll ask you, Brian, is that, is that something that before COVID-19 you were seeing as an area of dispute in business valuations as to what the recent income is, as opposed to looking at what historical figures were showing everybody.

Brian: That's right. I mean, that's always been kind of a dynamic and in a lot of these cases when the divorce starts, they know the person who's going to end up with the business.

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Typically the founder owner is tempted to say that the valuation is less and things are going to be bad and income is down. Not all of them do, but I mean, that's certainly a temptation. And on top of that, we actually have a lot of businesses having a lot of troubles right now.

Jake: Yeah. It's like it's legitimate for the first time. Sometimes it is actually legitimate. Sometimes there really is an economic downturn or it really does make logical sense that the business is not doing as well as it has historically.

I do remember though, as being a first year associate being taught by my boss at the time, Jim Piper who's actually our Of Counsel at our firm now, but Jim kind of sat me down during the first six months and said "You know, Jake, you'll never hear the business owner's lawyer pick up the phone and call the other side and say, I've got great news. The business is doing great. We're printing money. There's more than enough money to go around for everybody. I just want to share that with everybody."

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You'll never hear that. What you always hear is it's gloom and doom and the business's crashing and burning. So when you take that into account for business valuation, the CPAs who do the business evaluations have a phrase for it that you sometimes hear tossed around humorously.

It's called raids, spelt R a I D S, which stands for a "recently acquired income deficiency syndrome." You go through a divorce and all of a sudden the business owner is motivated to say this business is not doing as well as you guys think it is.

If you remember from our previous discussions, the whole point of getting a business valuation is to get a number. Like we talked about last time, somebody is most likely going to get the business at the end of it. And so he or she that's gained the business is motivated to drive down the value while the spouse that's not getting the business is motivated to drive it up.

So whoever's getting it, is more inclined to say, it's not doing so great.

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And you know, sometimes it's legit and sometimes it's not, or sometimes it's in between. But like Brian was saying, this is kind of the first time I think, in my career and probably in your career where everybody takes that really seriously, it doesn't just get met with a bunch of skepticism.

A lot of businesses really are down. I think the question is, is this temporary or is this something long term? And the interesting thing is there's no really historical data where an evaluator can say, well, this type of business and this type of industry recovers, or it's going to take X amount of months to recover.

And so we're going to kind of bake that into our business valuation. I think on top of that adding to the complication of it all there's these various stimulus packages that are coming out. Even if a business is down, it may be saved by a federal stimulus package where it really is not going to have an effect.

Oh, I think Brian and I were talking even before we started this podcast, that there could be businesses where a federal stimulus can be a windfall where they're actually not affected by COVID-19. but at the same time, they're getting federal stimulus money because the stimulus money isn't properly segregated to those who are actually harmed.

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It's kind of a shotgun effect. If it goes to all small businesses then there's going to be small businesses out there that actually benefit. As kind of 'bizarre' as it is to say there's going to be some businesses to actually benefit from the pandemic and the federal stimulus. So backing way up, we were talking at my deposition on Friday about the PVP loan, the small business had gone to PPP loan, but Brian, can you explain this because I know you handled this for our business.

Brian: Yeah, it was, an idea put together in Washington in a couple of days. About 600 or 700 billion with a 'B' dollars that were distributed to mostly small businesses in the United States. PPP just means Paycheck Protection Plan.

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This is part of the cares act. The idea was they would pay companies to keep people on payroll. In other words, you know, at that time right when the curtain was coming down on the economy, companies, especially those in the really hard hit areas, we're just laying off everybody right and left.

The restaurant industry was typically laying off 90% of their staff, essentially overnight for most restaurants, for example. And so this incentivizes the business owner to keep folks on payroll basically for two months. And as long as you do that, you get essentially to keep the payroll, this simplifies it quite a bit, that you would have a, that you paid those folks, and it is taxable at this point. And so it's not in your pocket, every penny of it, but you get, let's say 60 or 70% of it.

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That's the general concept of it and it, and it's a windfall in a couple of different ways. One is that if you just tread water, then you get to keep it. There are a lot of businesses that probably wouldn't have laid off anybody or, not many people, especially for in the short term. So for those companies, this really is a windfall in the true sense of the word. That brings up a lot of questions. You know, , how do we treat this? Is this something that we

should look at as part of their long term income, because it's going to kind of show up that way or is this just a one time thing?

Then there's also other uncertainty, as there may be more of this kind of thing coming down the pipeline. So it opens a lot of questions and, well, you know, I don't think everybody's got a real clear answer to it at the moment.

Jake: Yeah. I think what I keep hearing from both business owners and evaluators is “we don't know.”

Even Brian and I are looking at this as small business owners, wondering how is this gonna affect our business long term?

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We just don't know. I spent a bunch of time in my deposition on Friday, for example, talking to the vice president of this business and asking them things like how's COVID-19 affected business? How's it affected new business coming in? How's it affected ongoing business? How's it affected jobs that y'all are doing as a new construction company? How are the jobs that you're doing? Have you laid off employees? Things like this, this and that.

He didn't know it, and I don't think he was being purposefully invasive. He was kind of a neutral witness anyways as the vice president, not the one going through divorce. He said, yeah, we don't know.

When you sit there and you go “what business have you lost because of COVID-19” there's not a whole lot of businesses that are sophisticated enough to say, well, “we've lost X percent of our new business because of COVID-19.”

You know, Brian and I, for example. I know we spent a lot of time looking at projections and how much business is coming into the business because we've got overhead. You know, we have employees, we have a business to keep going. We have an ongoing concern. But all of that's pretty sophisticated for a small business.

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There's a lot of small businesses. If he asked him kind of, what's your three months projections of new business, you're going to get a shoulder shrug of, well, we don't know. Well, where should you be at as far as new business? How many new clients did you bring in each month? They don't know. This is a lot of business owners and that's not a criticism.

They just don't have that data. So I think a lot of people are looking at these business valuations and going, we don't know, we have zero data. We're flying blind as to what COVID-19 is going to do our business. So it's interesting when you get you doing a divorce through COVID-19. Does looking at 2019 numbers to value this business really make sense? Even if you go look at three years of history, you know, 2017, 2018 and 2019 for business, is that really a fair way to value this business? Because nobody knows what the world looks like moving forward. And you know, again, we talked about last time, businesses are valued

as the way a motivated buyer's going to buy from a motivated seller with, essentially, no strings attached.

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So what's that mean? With this new pandemic when nobody really knows what's going on, if it's interesting. We're kind of getting consistently people saying we don't know how it's going to be. So it's going to be argued from both sides.

Brian have you started seeing people distinguish that maybe this type of business will be affected by COVID-19 and maybe this type of business won't be affected by it? Or do you think the business valuers are getting sophisticated enough or having enough data yet to start making those types of judgment calls?

Brian: I think it's really hard. I think there's some relatively easy ones to say. If you're a restaurant, or if you're in the travel industry, airline industry, I think there's a real high probability that those types of businesses are going to be either permanently affected or at least really, really long term affected.

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We can overlay this with the fact that there's an ongoing oil, energy sector crisis going on top of this, which is particularly impactful to certain companies. I'm in the middle of an international company valuation, and we've got to deal with the economic situation here, in Pakistan, and elsewhere the middle East. It's three regions that they operate in each, and they're affected differently in each area.

It's quite the, quite the thing. This is really unprecedented. You know, we had a brief, short and sharp recession in 2001 with 9/11. We had another one in early 1991-92 with the Iraq war. We remember both of those, but they were short and sharp and they were remounted pretty quickly.

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There was a long and serious one in Texas, well, nationally in 2008-2010, but Texas sort of was almost immune to it, especially the bigger cities and Austin in particular, but the other big cities as well.

And so, now we have Great Depression levels of unemployment, but it took four years to get to that level of unemployment in the Great Depression. It took COVID four weeks, so it's just really, really hard to know what's going to happen and how to value this. I think it may be five years from now, before we can look back and really understand what happened and where we're going to go from it.

It's, it's really tricky. I think that business valuations right now are probably the hardest they've ever been because of. Because of these factors you may see more disagreement between experts than you've seen because of some assumptions they make. It's really hard to make them. I think most of the time you have two good experts with the business, with some kind of history and good numbers.

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You're going to come out with the valuation with numbers pretty close between the two experts, but right now is really, really hard to say.

Jake: Yeah. And how do you say my way is right and your way is wrong? If one expert says this is long term, this is going to affect this business long term. And the other one says, no, it's not. We really don't know.

Again, this is the purpose of the income method where you evaluate businesses as an ongoing concern. You look at historical data trying to predict what the future looks like, but there is no historical data for a business in COVID-19.

We've got a case right now where there's a dental practice. They own several dental practices and everything, and it's probably fair to say when the country opens back up it's not like people are gonna stop having their kids' dental checkups. I mean, if anything, you could argue that has no effect because it's not like it's going away.

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Hey, you know, even if people aren't going to the dental office right now, they're going to go, eventually once the country opens back up, but that also assumes that there's not going to be another outbreak.

You have to bake that into the business valuation that there could be another outbreak, there could be fear of a spike. If that's the case the business will take a hit. It's interesting the way it's going to be argued on both sides of it. People don't know. Experts don't know, but it kind of goes back to at the end of the day, this is going to be all about advocacy.

Convincing a judge or jury that this business is either worth X or this business is worth Y and this is what you should consider. This is why you should listen to my expert, and not listen to the other side's expert. I think this is, for a practitioner, a really interesting time because you get to spend a lot more time discussing judgment calls and a lot more time discussing an individual business rather than a wide paintbrush of how all these businesses operate. You really do have to drill down and see how each individual business is dealing with the pandemic.

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As an example, You know, me and my wife recently bought a house right before the pandemic hit. Great timing. But, something new that we had to do before buying a house is when we applied for a loan we got a questionnaire from the bank saying, how has COVID-19 affected you and your business?

Right? Obviously the bank wants to know if me and Brian are going down in flames, versus it being brighter. They want to see if we're thriving during this time when they were deciding whether or not to do a loan for this house. And it was interesting to read it cause they asked things like have you laid the employees off? What's your projections look like? Do you see a drop in business? Do you see a drop in collections, that type of stuff. And we were

essentially kind of walking through this vice president at the same questionnaire. You know, what do you see in your business? Are you seeing jobs going away? Are you laying off employees?

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Yeah, you're taking on new business. Are you having to tap into a line of credit? Are you looking for capital one way or the other? You know, kind of knowing to ask those questions? Because at the end of the day, the business owner is the one who ultimately probably knows best as far as the health of the business, even with a global pandemic.

They'll know what projections are in the future, or at least he or she knows better than anybody else does. So knowing to be able to drill down and find that information about what the health of this is really is even during a pandemic is something that's going to kind of take a unique skill set.

It's exciting to me. I know it's exciting to you, Brian, and exciting to our experts. Exciting may be an interesting word, but it is kind of a new time and a new skill set that we haven't seen before in the practice. You know, it's interesting to me.

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I know it's interesting to you and I'm interested to see how all this plays out on both sides of the aisle, as far as trying to figure out business valuations moving forward. So, you know, maybe in a few weeks or a few months, we'll be talking about it from different perspectives, but Hey, you can kind of wrap it up with a big, "we don't know."

Above all else, you have to have a good advocate in your corner, no matter what. These numbers really can swing one way or the other. So, do you have anything else to add to that, Brian, before we wrap up?

Brian: Well, you know, this brings to mind another option, which is that your expert may not or the other expert may not be able to with reasonable certainty, come up with evaluation right now.

You might be able to say the other expert shouldn't be allowed to give an opinion or they're not ready to give an opinion and go to the judge. Somebody could go to the judge and say, we can't go to trial. We can't resolve this because nobody knows where we are right now. Which, you know, tactically, there's always usually one side that wants to drag their feet.

So that's, a situation we haven't seen before either. So I think we are in uncharted waters for sure.

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It'd be interesting if somebody shows up and says, you know, let's not have a divorce, let's wait a few months and sort of see all this plays out because you could see numbers varying wildly just over a couple of months time.

Jake: So yeah. We'll see how it plays out. I'm sure we'll be talking about it in a future podcast, but that's where we see it right now. So I guess with that, we'll wrap up and we'll see everybody next time.

Brian: Sounds good.