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Business valuation during the Covid-19 pandemic

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Business valuation during the Covid-19 pandemic

This article considers the challenges of valuing private companies for the purposes of litigation during the Coronavirus crisis.

Whenever accountancy expert witnesses express opinions about the value of businesses, they are effectively estimating what they think a hypothetical buyer would pay to acquire them. Such buyers are either acquiring assets or, more commonly, a future stream of profits. One of the critical aspects of business valuation is therefore the estimation of what those future profits might be and seldom has predicting the future been as difficult as it is now, in the wake of what we hope has been the peak of the Covid-19 pandemic.

A conspicuous feature of the economic landscape in recent months has been the enormous variation in the way in which different sectors have been affected by the restrictions of social distancing and government lockdowns. Some sectors, albeit relatively few, have flourished, notable among which are online platforms such as Zoom and Amazon. By contrast many more businesses have faced a collapse in sales or have had to close completely.

Against this backdrop, it is perhaps not surprising that there is anecdotal evidence that the volume of business sales has also plummeted. We expect that buyers are likely to discount the prices that they are willing to pay to acquire businesses to a level that is lower than sellers are willing to accept. Arguably, if a business cannot be sold, it is difficult to ascribe any positive value to it above that which could be achieved on a break-up basis.

Undoubtedly the best way to achieve certainty would be for litigants to put their differences “on hold” for a year to two by which time the prevailing economic climate might have become more stable. However, that is unlikely to be a practical or even a desirable option and therefore thought needs to be given to how best to deal with the current circumstances.

Our recommendation is therefore that the best approach to business valuation is as follows:

1. To recognise that the most appropriate starting point is to establish the value of the business immediately before it started to be affected by Covid-19.
2. To assess the degree to which it has already been affected by the pandemic.
3. To assess the extent of ongoing effects on a month by month basis.
4. To assess the degree to which the business is likely to be capable of “bouncing back” and both the degree and timescale of its likely recovery.
5. To estimate the extent of any one-off costs that may be incurred such as restructuring or redundancy costs.
6. To assess what would be the value of the business on a break-up basis, this being likely to be the lowest possible valuation.
7. To consider the degree to which the valuation is reliant on future earnings compared with underlying asset values, recognising that even asset values may be affected by such issues as:
   - The depletion of cash deposits to fund losses or working capital increases during the crisis;
   - increased bad debts arising from the insolvent failure of customers;
   - reduction in stock values arising from obsolescence caused by periods during which trade might have been suspended;
   - reductions in the values of freehold properties.
8. To consider the pre-Covid-19 valuation in light of the forgoing factors and to discount that valuation accordingly, if appropriate.

If this approach is taken it ought to be possible to suggest a range of values albeit that the ranges may well be greater than would have been the case before the inception of the pandemic.

In the most extreme cases, the discount that is applied to the pre-Covid valuation might be so large as to reduce the value to that which would be achieved on a break-up basis. However, many businesses will be able to avail themselves of government support packages and will weather the financial storm. They may be battered by it but they will probably survive.

Specific issues arising in divorce cases

Covid-19 has raised two specific issues in the context of dealing with family businesses in divorces. The first is whether, in relation to cases that have already been concluded, the pandemic qualifies as a so-called “Barder Event”. Such an event is one that occurred since the making of the order, which invalidate the basis, or fundamental assumption, upon which the order was made.

We are already starting to see applications on these grounds in which business-owners are seeking to have the terms of their divorces set aside or revisited. Similarly, we expect to see an increase in applications for reductions in maintenance by business-owners who cite falls in earnings caused by the effects of Covid-19 restrictions.

The second issue is the question as to whether, if the value of a family business has been reduced to net asset value, it should be treated as being just as secure as the value of other family assets such as pension funds or former matrimonial homes.

Typically, a business is viewed as being an asset of relatively high risk. It therefore tends to be given less weight than assets that are perceived to be safer for the purposes of achieving a fair division of assets between spouses.

However, if a business is valued on the basis of what could be achieved on a break-up basis, there is an argument to say that it has effectively been “de-risked”. To discount it further for the purposes of comparing it with other matrimonial assets, could then be seen as double-counting.

STOP PRESS: Remember to check that any asset valuations on which your clients are relying have been updated to reflect the reduction announced in the Budget, whereby the Lifetime Limit for Entrepreneurs' Relief has gone down from £10 million to £1 million.

Proceeds of Crime Act applies to those never convicted of any wrongdoing

In November 2019, the Davies family from Bath had their assets seized despite never having been found guilty of a crime. We consider how this was possible in a country where most people believe they will be deemed innocent unless proved guilty?

The Davies family was unable to explain adequately how a £8.1 million property empire had been acquired. Some had been funded from rental income and capital profits built up over a period of time, but it was unclear from where money had come to pay for the initial acquisition of the property portfolio.

The allegation by the National Crime Agency ("NCA") was that it had been generated from mortgage fraud and the sale of controlled drugs but the prosecution had insufficient evidence to pursue an action through the criminal courts so it decided to take civil proceedings under the Proceeds of Crime Act ("POCA").

This type of civil action without a criminal conviction follows on from the NCA's stated aim at the start of 2019 that it was looking at upwards of 100 possible targets for Unexplained Wealth Orders ("UWO").

Individuals facing UWOs have to prove that they acquired their assets legitimately and if they fail to do so they are likely to have them confiscated.

By contrast, civil recovery proceedings under POCA, require the NCA to prove **on the balance of probability**, that assets or property have been acquired through unlawful conduct. This test requires a much lower threshold than that applied in criminal proceedings in which guilt has to be demonstrated beyond all reasonable doubt.

UWOs were introduced in February 2018 and, so far, we have seen UWOs against the wife of an Azerbaijani banker, people with connections to the Northern Irish paramilitary and other undisclosed individuals.

Whilst the stated aim for this UWO is to combat corruption, another benefit for the prosecuting authority is that it gets to keep a share of any proceeds that are recovered.

In our experience the financial investigations undertaken by the NCA and SFO are almost always capable of being challenged but this area of forensic accountancy is not for the faint-hearted so, if you have a client facing a UWO or POCA proceedings here are our top tips:

1. **Don't panic**. In our experience claims are often overstated.
2. **Get us in early**. If your client is legally aided, you will need prior approval for the fees of a forensic accountant.
3. **Obtain as much documentation as possible**. This will include getting the bank statements from the prosecution along with the analysis of the sums being claimed but we will also need as much documentation as possible from the client.
4. **Arrange for us to meet your client**, whether that's at your office or in prison.
5. **Ensure your clients appreciate that the onus is on them** to prove the legitimacy of the means by which they acquired their assets, not on the prosecution to prove that they were obtained unlawfully.

Our prediction is that the number of civil POCA proceedings and UWOs are set to rise with a concentration on higher value claims than we saw when POCA was first introduced.

How to challenge contentious valuations

It is common in business valuations for there to be a debate about whether it is more appropriate to apply a discounted cashflow ("DCF") technique or to apply a multiple to expected future earnings.

In theory both approaches should lead to the same result but each approach has pros and cons, some of which are summarised below.

When faced with a business valuation that applies one approach or the other, it is often worth getting your client's advising accountant's view on whether the approach taken is appropriate. Sometimes, it can even be worthwhile to ask for a valuation to be done using the other approach as a test for reasonableness.

Arithmetically it ought to be possible to reconcile the two approaches for simple businesses in a stable state. For example, suppose a company generates £500k per annum and is worth £2.5 million. That would imply it should be valued on the basis of a multiple of five. However it also implies a discount rate of 20%[1].

In the author's experience it is surprising how often valuers can be shown to have been inconsistent in their approach by showing that their DCF calculations cannot be reconciled with their multiples.

1 Simplicity

Applying a multiple to future earnings has the significant advantage of simplicity. It involves only two figures, the future earnings and the multiple. By contrast a DCF calculation is much more complicated and involves the use of numerous variables including a risk-free rate of return, cost of equity, cost of debt, a so-called "market beta", to name but a few.

2 Subjectivity

The choice of multiple is often criticised as being subjective. Indeed, that criticism has some justification and is a reason why the choice of multiple is often a matter of expert evidence. Although it is usually based on a review of multiples that apply to comparable quoted companies, truly comparable businesses are often almost impossible to find and, even if a true comparable can be found the resulting valuation will by definition be one that is relative to those companies with which the index business is being compared.

3 Availability of data

It may seem trite to say that a DCF calculation can only be undertaken if cash flow forecasts have been prepared but all too often it is simply impossible to adopt a DCF approach because few owner-managed businesses prepare sufficiently detailed or far-forward looking financial projections.

Even where such projections have been produced, in the context of contentious litigation, there is often a suspicion that they may have been "massaged" to paint an unduly rosy or bleak picture depending on the vested interests of whoever has prepared them.

For that reason, it is sometimes deemed safer to predict the future based on what have been the historic results of the business. Although past performance is no guarantee of what may happen in the future, historic results tend to be considered to be more objective than future projections.

4 Growing or declining businesses

One of the most significant advantages of the DCF approach is that it allows a valuer to model changes in earnings resulting, for example, from anticipated growth. By contrast the simpler multiple approach relies on a single estimated figure for the business' long-term average earnings.

4 "Terminal value"

Even if a company has prepared cashflow forecasts for the next three or five years, there will come a point in time at which the forecast runs out. For valuation purposes the DCF approach requires valuers to extrapolate the earnings for the final year into perpetuity by use of a so-called "terminal value" adjustment. Often this can represent more than half of the total value of the business and small changes to the underlying assumptions and discount rates can give rise to very large changes to the terminal value and therefore to the ultimate valuation.

Consequently, although DCF valuations are often said to be more objective than those which apply a multiple to average future earnings, many of the elements that are used to build up a DCF valuation can themselves by highly subjective.

[1] Being one divided by the multiple or the "inverse" of the multiple.

Important restrictions to Principal Private Residence Relief

Principal Private Residence Relief, or PPR, is a well-known exemption used by homeowners that typically means that they can avoid a tax liability arising on the sale of their homes.

Until recently, homeowners were deemed to have occupied the property for a period of 18 months prior to its sale regardless of whether or not they actually lived in it.

This is particularly important in the context of family breakdown and divorce, where it is frequently the case that one spouse moves out of the family home months before a financial division of assets is agreed.

With effect from 6 April 2020, the 18-month exemption period was reduced to a mere nine months.

The Government judges that *"for the majority of individuals, a nine-month final period exemption strikes the right balance between being long enough to provide relief whilst they go through the process of selling their home, but not so long that they are able to accrue large amounts of relief on two properties simultaneously, or on homes that are no longer used as their main residence".* [1]

" Tax will have to be paid within 30 days "

It is likely that a consequence of this change will be that more divorcing couples will incur a taxable gain on the sale of the Former Matrimonial Home ("FMH") and, if the gain exceeds the annual allowance of £12,000, not only will Capital Gains Tax ("CGT") be payable but the tax will have to be paid within 30 days of the date of completion of the sale.

Under the previous rules taxpayers had up to 22 months to pay the CGT on the sale of residential property because it was paid under the ordinary self-assessment regime.

To illustrate the effect of the new rules consider the example of Mr and Mrs Smith whose FMH has been valued for FDR purposes at £975,000 and had an original purchase price of £577,000. The gain during the period of ownership is therefore £398,000, split evenly between the parties, £199,000 each. Assuming Mrs Smith remained in occupation until the property was sold, she would be able to claim PPR for the whole period of eight years thereby avoiding a tax liability entirely. However, suppose that Mr Smith left the FMH two years before the sale. That would mean that 2/8ths of the gain would, under the old rules, have been subject to taxation as follows:

Mr Smith	Period of ownership	Gain
FMH	6 years	£149,250
Final period relief	18 months	£37,313
Period subject to taxation	6 months	£12,438
	8 years	£199,000

This means that Mr Smith would have needed to have paid CGT on £438 of his gain, after his annual allowance of £12,000 and assuming no other chargeable gains in the year.

By contrast, let's consider the situation that would arise if the FMH were to be sold or transferred after 6 April 2020. In that scenario Mr Smith will be taxed on 15/96ths[2] of the gain as follows:

Mr Smith	Period of ownership	Gain
FMH	6 years	£149,250
Final period relief	9 months	£18,656
Period subject to taxation	15 months	£31,094
	8 years	£199,000

Therefore, this change in legislation will increase Mr Smith's chargeable gain from £12,438 to £31,094. CGT will now be payable on a net gain £19,094 after deduction of the annual allowance of £12,000 and assuming no other gains.

The new rules may also effect the tax payable on the sale of Mr Smith's new home if he has acquired one.

As can be seen from the figures in the illustration above the change in the rules is likely to have a significant impact. Not only will tax be payable under the new rules in cases in which it would not have been payable under the old rules but that due date for payment will be much earlier.

[1] assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/816107/CGT_PRR_summary_of_responses.pdf

[2] Mr Smith left two years ago and can gain final period exemption on nine months, meaning 15 months will be subject to taxation. Eight years = 96 months.

Separated... or not?

Assessing the date of separation can often be far from straightforward.

The restrictions to PPR Relief are likely to bring into sharp focus the often thorny question as to when, for tax purposes, a couple has separated. This is of vital importance because transfers of assets between spouses can be undertaken without incurring tax up until the end of the tax year of separation.

HMRC recognises that separation is a matter that has to be seen in the light of all the relevant circumstances. An individual who is happily married to a spouse who spends large amounts of time working abroad is clearly not separated (despite living apart) whereas a couple who spend 365 days a year under the same roof could, for example, be deemed to have intended to separate permanently if they are leading separate lives and have an agreed intention to divorce. The position is far less clear when couples have had periods of reconciliation or, as happened in one recent case, where one party was petitioning for a divorce in circumstances in which the other was adamant that the marriage wasn't over and was resisting the petition. There is currently a dearth of reported tax cases on the issue but this may well change as more and more divorcing couples are at risk of being taxed on the sale of their FMH.

The risks of late night drafting

The recent case of Abberley v Abberley [2019] EWHC 1564 (Ch) serves as a timely reminder of the risks of drafting mediation agreements at the end of a long day.

Litigators frequently debate the pros and cons of having Counsel in attendance at a mediation but one clear advantage is that it means that there are at least two pairs of eyes on hand to draft what can sometimes be complex mediation settlement agreements.

Understandably, if agreement has been reached in a mediation, the parties will be keen to reduce it to writing there and then to avoid the risk of one of them reneging overnight. However, lawyers are often reluctant to start drafting agreements or even heads of agreement late in the evening. Their reticence is well justified in the light of the Abberley case in which the court considered the status of handwritten "heads of terms" signed by all the parties at the end of a long day's mediation.

One of the parties applied to the court, arguing that he should not be bound by the document because, as was accepted by all parties, the intention had been that the manuscript document would in due course be superseded by more formal documentation. However the judge disagreed and held that the document constituted a binding agreement.

Of course, if the dispute involves complex financial issues that may have tax implications it would also do no harm to ask a forensic accountant to provide input to the settlement agreement if one is in attendance at the mediation.

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