COVID-19 Implication in Family Law Matters

July 8, 2020

Who We Are

- Columbus, OH
- Cincinnati, OH
- Indianapolis, IN
- Toledo, OH

Who We Are

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Agenda

- Where we were and are
- Valuation in family law
- How do we determine value
- Strategies in divorce
- Other financial considerations

Where Were We Before?

April 2020

- Ohio, Indiana, Kentucky – Stay At Home Orders
- Non-essential business were shut down
- Paycheck Protection Program Loan funding
- Unemployment 14.7% or 19.5% (depending on how “counted”)
- Tremendous uncertainty


Record 20.5 million American jobs lost in April.
Unemployment rate soars to 14.7%

Where Are We Now?

July 2020

- Economies are reopening
- PPP funding not exhausted, new rules for 100% forgiveness
- Discussion of additional legislative relief
- Unemployment 11.1%
- 38 states are experiencing spikes in COVID-19 Cases
- Continued uncertainty

Florida coronavirus cases hit
state adds over 40K cases in
days

Is Columbus the next coronavirus "hot spot"?

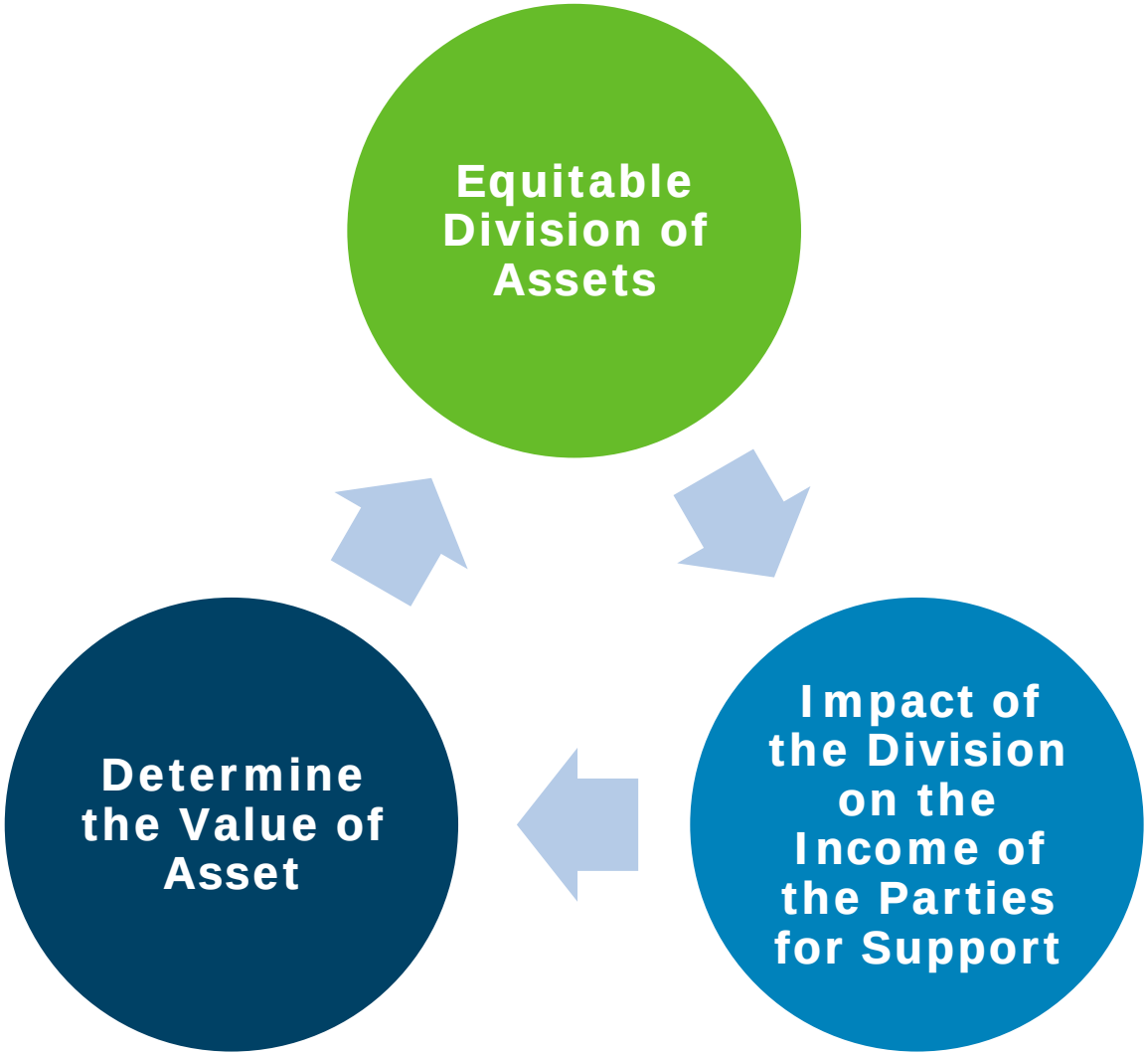
U.S. Added Nearly 5 Million Jobs in June

The Unemployment Rate Is Falling, But More People Are Losing Their Jobs Permanently

S&P 500

Purpose of Valuation in Family Law Matter

Value and Income



Significance of “Getting it Right” in Divorce

Trading assets that are particularly difficult to value currently with other assets that are not as difficult to value. Some may be depressed in value, but at least the value is more knowable.

How Do We Determine Value?

What Creates Value?

Creating, managing and maintaining a business is worthwhile only if doing so creates value because the benefit of the asset is greater than its cost

How Do We Determine Value?

Methods During COVID-19

Income Approach

Key Aspects:

- Value is based on the business' ability to generate future economic benefit (cash flows) for the owners.

- The value is based on the net present value of expected future income streams from the ownership of the asset.

- Two methods under this approach:
    - Capitalization of Cash Flows – Single period capitalization, typically historical performance is used to develop the single period, i.e. five-year average of cash flows or earnings
    - Discounted Cash Flows – Multi-period capitalization, generally future projects over three to five years.

- To each, a rate of return is applied to convert the cash flow into the value of the business

Income Approach

Challenges using the Income Approach during COVID

- **Capitalization of cash flows**
  - Predicated on the assumption that history = future
  - Is that true for the near term?
  - What about the long-term?

- **Discount Cash Flows**
  - Discrete projections
  - How do you project in the near term?
  - What about the long-term?
  - How far to project?
  - Considerations
    - Recovery timeline
    - Temporary and permanent changes to the workplace and consumer behavior that drives the markets and businesses

Income Approach

Potential solutions or alternatives for the Income Approach

- **Scenario Analysis**
  - May need to perform scenario analyses in order to try to better forecast how the business will do within the next 18-24 months
  - We don't know what the recovery will look like – U shaped, V shaped, W Shaped are all possibilities
- **Use of Historically Similar Data**
  - Does 2008 recession provide any insight as to how the company fared during that time period?
  - Lead the recession? Lagged the recession?
  - How did the industry compare to the overall economy then – can extrapolate to now?
- **Access to Capital/Cash Burn Rate**
  - Ability to survive will depend on access to capital
  - Valuations that do not consider a company's ability to withstand potential short-term cash flow issues come up short

Income Approach

- **Discount Rate**
  - Discount rates are used to present value the future cash flows
  - Representative of risk of achieving the cash flows
  - Significant unknowns increases the risk
  - Increase the discount rate or consider (on a DCF) using different discount rates for the short-term vs. the long-term

- **Industry Research**
  - Getting granular and very specific with the industry research becomes far more integral in developing projections
  - Drilling into industry resources for prediction of recovery

- **Some Businesses Will Profit**
  - It is important to remember that some businesses are counter-cyclical and will fare better in a downturned economy or because of the specific service or product that they are offering.

Market Approach

- The Market Approach establishes the business value by comparisons to historic sales involving similar businesses.
- Based on arms-length transactions of comparable assets.
- An asset is worth what other, similar assets are worth.

Market Approach

Challenges using the Market Approach during COVID

- **Historical Transactions**
  - Market transactions are generally historical in nature
  - Transactions during COVID-19 times
  - Important to understand what the M&A markets are doing now:
    - Still deals happening
    - More cautious and more strategic
    - Requires access to capital
    - More “skin in the game” by the seller
    - How does that compare to the historical? What about what we are measuring in family law?

Market Approach

Challenges using the Market Approach during COVID

- **Current Transactions**
  - More relevant because during COVID-19
  - Some industries' multiples are holding
  - However, the structure might be changing
  - Be wary of distressed transactions
  - Transactions based on pre-COVID results and pre-COVID motivation
  - May be far more contingencies in the pricing, less certainty and thus less ability to develop an accurate multiple
  - Availability - Still be some time before we see these transactions get reported

- **Valuator's challenge is how to adjust the multiples for the impact of COVID-19**

Market Approach

Potential solutions or alternatives for the Market Approach

- **Practical answer is that there may not be a solution if:**
  - Few number of transactions to begin with,
  - Dated and
  - Lack detail to adjust the multiples or the transactions

- **Sanity check**
  - May not be primary valuation methodology, but perhaps a sanity check

- **Adjust Multiples**
  - Requires detailed analysis
  - Weighting of transactions over others
  - Digging deep into the details
  - Taking an average and applying it could be garbage in/garbage out

Cost or Asset Approach

- The *Cost or Asset Approach* determines the business value based on the value of its assets. The idea is to determine the business value based on the fair market value of its assets less its liabilities.

- Based on the cost to replace or re-create the asset.

- A purchaser of the asset can avoid these costs by purchasing the asset instead of re-creating it.

Asset Approach

Challenges using the Asset Approach during COVID

- **Reliance on Other Professionals**
  - Primarily the asset approach is for holding entities, such as real estate holding, or entities that are not profitable
  - FMV Assets – FMV Liabilities
  - If the underlying asset is real estate, especially commercial real estate, facing same uncertainty and inability to accurately project future
  - Consider a commercial building that is highly retail?
  - Recent lawsuits from owners of real estate suing high profile retailers (Victoria Secrets sued by Easton)
  - Value of the entity is only as good as the underlying appraisal
  - Seen significant disclaimers on recent real estate appraisals

- **Costly to Appraise All Assets**
  - This has always been a challenge for the ANA. Appraise all machinery and equipment as well as real estate.
  - However, might not be economically feasible if the company is struggling

Asset Approach

Potential solutions or alternatives for the Asset Approach

- **Practical answer is that there may not be a solution if:**
  - Cannot obtain a reliable appraisal of the underlying assets
  - The parties cannot agree on the value or the method for valuing the underlying assets

- **Establishes a Floor**
  - The ANA does establish a floor value for the business
  - So even in the instance the parties cannot come to total agreement, the ANA can be helpful for establishing the lowest value for a company that is currently sustaining COVID-19 losses
  - May be worthwhile exercise to create a range from which to negotiate

Subsequent Events in Valuation

Subsequent Events

- "Known or Knowable"
  - Business valuations do not typically account for events occurring after the valuation date.

- Should COVID-19 be considered for a 12/31/19 valuation?
  - In general, courts prefer to see real world events incorporated
  - How do you do that if the valuation date is 12/31/2019
  - Additional disclosure or alternative valuation date?
  - Agree to push the valuation date to a later date

Subsequent Events

- AICPA's Standards on Valuation Services (SSVS No 1 VS Sec100.43)

- "The valuation date is as of the specific date…..
  - Generally, the valuation analyst should consider only circumstances existing at the valuation date and events occurring up to the valuation date.
  - Subsequent events are indicative of conditions that were not known or knowable at the valuation date, including conditions that arose subsequent to the valuation date. The valuation would not be updated to reflect those events or condition.
  - **In situations in which a valuation is meaningful to the intended user beyond the valuation date, the events may be of such nature and significance as to warrant disclosure in a separate section of the report in order to keep users informed.**

Language from Another Expert's 3/31/2020 Valuation Report

The World Health Organization declared COVID-19 a "pandemic" on March 11, 2020, approximately three weeks after the first death in the United States occurred. This was a crisis not yet fully understood, without a cure, any semblance of a duration or even an assessment of its long-term economic impact as of March 31, 2020. Information concerning those and other related matters specific to the pandemic continued to be assessed, evaluated and reported on subsequent to March 31, 2020.

Given our understanding of the implications of COVID-19 after the valuation date, the valuation of this Company does not take the full impact of the COVID-19 virus into consideration. Although the virus is significantly impacting regional, national and international economic conditions, its short and long-term impact on the Company and its operations is not determinable at this time. To the extent this information was known or knowable (but not yet available) as of the valuation date for this assignment, it is reflected in our analyses as disclosed in the body of this report.

Strategies in Divorce

Strategies to Consider

"If I had an hour to solve a problem I'd spend 55 minutes thinking about the problem and 5 minutes thinking about solutions."
— Albert Einstein

As professionals, we have to think differently as to how we solve some of these potential problems when we are negotiating a settlement. We have the power to get creative and craft a solution that meets the needs of the parties.

Strategies to Consider

Do Some Math

- Presumption that COVID-19 is having a negative impact is not always true or that it is a HUGE impact
- Get some information and do some math to determine just how impactful COVID-19 may be on the value
- Valuation uses multiple years to determine value and not just one.
- Doing some "math" as to alternative valuation dates can reveal the magnitude of the issue.
- Comparative financials year-over-year are tremendously important. They can give you insight as to the impact on the business thus far:
    - Financial statements, as detailed as possible, including income statement, balance sheet and if available, statement of cash flows for the following time periods:
        - 1/1/2020 – 3/31/2020 and 1/1/2019 – 3/31/2019
        - Year to date 2020 with a comparative 2019 for the same time period
        - Trailing twelve months for the most recent month completed (i.e if April 2020 then 5/1/2019 – 4/30/2020) and a comparative 2019 trailing twelve months (i.e. 5/1/2018 – 4/30/2019)

Strategies to Consider

- **Valuation Date**
  - Consider, to the extent able, extend the matter and the valuation date as far into the future as possible when the impact of COVID-19 may be more readily measurable.

- **Re-Valuation Date**
  - Have a “re-valuation” clause in a settlement, allowing for the ability to revalue the business at a later date. Have some parameters on what requires an adjustment. For example, plus or minus 15%.
  - Some businesses may not feel the impact until fourth quarter or 2021
  - Obviously this could create additional litigation if the valuator does not agree.
  - Consistency in valuation methods and inputs would be important.

Strategies to Consider

- **Spousal Support vs. Business Value**
  - Interplay between support and business value when it comes to officer/owner compensation.
  - Is there a manner in which you can shift more to compensation and thus shifting away from business value?
  - Results in higher support but, assuming support is modifiable, it is a method for the parties to share in the upside and potential downside
  - To that end, is there a formula you can put in place in order to protect each party from outcomes that differ from what is expected? As compared to endless litigation over modifications?

- **Staying in it Together (Last Resort!)**
  - Generally not our recommended approach with clients (and not yours either we are sure!), but to the extent the parties simply cannot agree, is there a way to "tie" their fates together?
  - Use a lower business value (to meet the business owners' concerns about the future), but the "out-spouse" continues to receive some benefit from the business or an upside in X years assuming performance (i.e. a kicker?)
  - Legal parameters and paperwork
  - Likely recipe for future litigation

Questions?

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Our Series Continues

- *July 15, 2020, 11:30 AM – 12:30 PM EDT*
  - Exploring The M&A Environment During Uncertain Times

- *July 22, 2020, 11:30 AM – 12:30 PM EDT*
  - Lost Profits in the Era of COVID-19

Each webinar qualifies for 1.0 hour of CPE based on Ohio CPE requirements and 1.0 hour of CLE pending approval by the Ohio Supreme Court and Kentucky Bar Association.

Visit our events page to see what else we have scheduled and view our past webinar recordings here.