John Martinka
Jessica Martinka
PO Box 3085
Kirkland, WA 98083

John - 425-576-1814
Jessica – 425-319-6984

john@johnmartinka.com
jessica@martinkaconsulting.com
martinkaconsulting.com

Valuations & Deals in a COVID World

I've been asked by quite a few people for my thoughts on business valuations and deals during the COVID-19 crisis. I've also been asked if there will be a lot of "good deals." Here are my thoughts, the first one being extremely important.

There will be no "deals" on good businesses, i.e. ones that survived or thrived during the virus crisis.

My second thought is almost as important:

Nobody really knows what's going to happen. If they say they do (know) watch out because the BS meter is in the red zone. We're in unchartered territory.

Good businesses include many essential businesses, especially those whose customers are essential, whose suppliers are essential, and can show their performance is sustainable, i.e. not a temporary spike. For businesses like this please keep in mind, the seller will control the deal.

Where will there be "deals?" They'll be on hurt businesses, which is the only time a buyer will control the deal. But who wants a hurt business? One with long-term damage? In my opinion, it will most likely be another company in the same or similar space. A company that can absorb overhead, create synergies, wants good employees, etc. Maybe even a job for the seller. And this is where the buyer can control the deal. Most financial buyers won't want a hurt company.

Before I get into valuation, here are some other things I expect we'll see:

- More seller financing, in fact banks are already indicating they want more seller financing.
- More buyer cash at closing, banks will shy away from the 10% down from the buyer (SBA loans) and want it at least 15-20% if not more.
- For businesses successful during the virus crisis, an emphasis of analysis will be on: is it a spike or a trend; who's creating the increased sales; what product mix is being bought; what type of customers, etc.?
- Expect business sellers to take longer than buyers and banks and CPAs to adjust to the new norm of deals, including that more patience will be needed as deals will take longer to close. Us intermediaries will adjust pretty fast; we're seeing firsthand what's going on in the market.
- More emphasis on current financial statements, meaning monthly statements with comparisons to the previous year.
- Buyers, banks, and intermediaries wanting to see a number of months back to normal or on the right track before committing.
- More COVID related due diligence (some banks have COVID questionnaires), more attention to intangibles, detailed diligence on any PPP funding; and industry experience will be a big plus for buyers.
- Banks will be running more and tougher stress tests on all loans (meaning, looking at more scenarios of debt coverage if sales and earnings decline).
- More earnouts, i.e. part of the price based on performance. Or, claw backs, which are a negative earnout if future numbers are not hit and which is how any variable pricing has to be handled for an SBA loan.

I started with statements about deals and forecasting. My third statement is about valuation:

It will be trickier than ever to value many businesses.

I'm regularly asked, "What's the multiple for this business?" or someone will say, "I'd pay X times EBITDA for that company." As I like to say, there is no set multiple for any business or industry. There's a typical range (different ranges for micro, small, mid-sized, lower middle market, etc.) and where in that range a business's value falls has to deal with the risk and reward factors, i.e. the non-financial factors, such as:

- Customer concentration or diversity
- Dependency on the owner or key employee
- Growth potential
- Regulations
- Suppliers
- Barriers to entry
- Competitive advantage

In 2020 we have to add:

- Government intervention (for example, essential or non-essential)
- Safety of employees and its cost
- Very recent history (months not years)
- The COVID affect, short, medium, and long term
- Customer demand for companies where in-person activity is required or suppliers to those firms – think airlines plus their effect on Boeing, Boeing suppliers, hospitality, recreation, etc.

In other words, there are a lot of unknowns. Historically, the first set of risk and reward factors above are known, or pretty much known. The second set are ambiguous and even the recent financial statements will need to have an analysis to see if recent performance is sustainable or a "V-shaped downturn and recovery" or a "long-term trough." An appraiser will be a bit more analytical with these new factors than a buyer (or seller) will be. Buyers will rely more on gut feel when it comes to the price they'll pay, and how they'll pay it (which is different than the value an appraiser comes up with). The seller's gut will still tell them their business is the greatest thing since cold beer, sliced bread, or whatever cliché you want to use. Bankers will be digging deeper than ever because, and this is obvious, they want to get paid back.

Appraisers use historical financial information and cashflow projections. If it was me, I'd be very cautious using projections and if I did, I'd want to see the projections the company had in their 2020 budget. I recently saw a valuation with a 10-year projection of revenue and profits. Ten years? It's hard to project 10 months. Heck, it's hard to project even 10 weeks. Based on surveys I've seen, about 75% of small to lower middle market firms have seen a sales decline this year. In other words, smart people will be comparing a company's projections to their past projections and performance.

Conclusion

There is no one size fits all answer. If the business has stayed on course or showed sustainable growth the value will increase, and the price paid will probably increase even more. If the business has suffered, watch out, the value will be a lot lower, buyers will be skittish, and even more skeptical than ever. For those in the middle, not growing but not suffering, maybe having slightly lower earnings, it's going to be "beauty is in the eye of the beholder." The same ranges of value will hold true with more companies on the lower end with earnouts allowing them to climb higher in that range. I wish there was a more clear-cut answer.