Navigating “Company Value” in Times of Choppy Market Activity

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In the uncertainty of this social distancing economy and volatile equity and debt markets, how should business owners and professionals of private companies think about company value and the impact on estate planning and/or corporate planning initiatives? In this article, we consider the difference between “price” and “value” which may assist C-suite executives or business owners with internal planning efforts. In other words, it is next to impossible to try to “time the market” in making business or estate planning decisions. However, understanding how volatility, risk and business fundamentals affect company value can help managers make appropriate decisions.

In 2007 to 2009, we saw record oil prices, the S&P 500 top 1,500 points (amazing at the time), real estate values were peaking, and a high level of consumer sentiment. The subsequent declines in the equity markets hit nearly everyone by surprise as the sub-prime debt market collapsed and we came to grips with the realization that a severe economic recession and financial crisis was upon us. With widespread uncertainty around the future, markets experienced significant daily volatility. To some extent, the mental and emotional stresses resulting from the financial crisis and Great Recession (as well as shifts in the way broad industries now operate) continue to linger. As a society, we have some level of anxiety remaining from the pandemic and a looming recession, which is important to consider as we look to understand the current environment.

The last two years has the world again in an environment with a high level of uncertainty which at first led to a general panic across the globe. This panic manifested in the markets, with the S&P 500 retreating from topping 3,300 points in mid-February 2020 to less than 2,300 points in mid-March 2020. The S&P 500 has since rebounded, reaching an all-time high exceeding 4,800 in January 2022. This time, however, the uncertainty is different with many investors feeling that current pricing could exceed value. Further, volatility as measured by the CBOE Volatility Index remains well above its historical average and has begun to tick up again in late 2021 and early 2022. The daily ups and downs in the markets are often driven by the introduction of “good” and “bad” news, developments with government stimulus, commentary by government officials and the Fed, and, of course, the latest updates regarding COVID-19. Prices of individual companies are generally even more volatile. This market reaction is a natural, human response to uncertainty and is similar to what we observed in 2008 and 2009. To some degree, it is entirely possible that the level of volatility we see today is fueled in part by our relatively recent experiences during the Great Recession and financial crisis of 2008. Regardless, at any given time, the market may reflect pricing of equity securities and a shift away from business fundamentals (i.e., financial statement data and analysis, objective assessment of risk and future returns, quantitative and qualitative comparisons across industry players, etc.).

Without a doubt, company fundamentals have become much more uncertain since we do not know the extent of the economic impact caused by social distancing and the recent closures of many businesses.

This brings us to the point of how value is ultimately derived, which is an assessment of risk and return. In other words, the value of an investment is measured first by the return that the investor expects to receive whether via a future cash flow stream, future capital appreciation, or its expected utility. The second half of the equation is an assessment of the risk in achieving that return (which is typically measured by looking data deriving from the public markets). The higher the risk, the lower the value and vice versa. The idea of value is not always consistent with how companies are priced, particularly in times of crisis.

The concept of price vs. value can be analogized to a raft vs. a submarine in stormy waters. A raft, floating on the surface of the water, is at the mercy of the choppiness of the water and can be equated to current pricing behavior in the public markets. The massive swings that occur in equity prices (for example, volatility that coincides with the release of new information as the investing community searches desperately for some level of certainty) may not be indicative of a company's true value. On the other hand, value can be equated to the submarine, which, sitting beneath the surface of the water, will rise and fall as the currents change but will not necessarily see the same choppy movement as compared to the raft.

The concepts above are not intended to suggest that the values of businesses are immune to market volatility or the economic impacts of current events, but rather to convey that true value will generally not exhibit the same level of volatility from one day to the next. In a business valuation, the impact of factors such as COVID-19 and economic uncertainty can be measured (at least to some degree) via quantitative adjustments to expected future cash flows. Store closures, changes in demand and pricing for products or services, increasing operating costs, investment in additional equipment, and the like can be measured with some level of objectivity as a cash flow adjustment. These types of adjustments tend to remove some subjectivity in assessing business risk and the ability for a company to achieve expected cash flow returns. In this way, the value of an investment may fluctuate based on the fundamentals of the business. Short-term external conditions may be offset by the ability of a company to persevere in the long-term, which provides relative stability in value from one year to the next. Additional subjective considerations that may not be determinable from a cash flow perspective, but certainly impact business risk, may include broad changes in investor sentiment toward specific industries, changes in merger and acquisition activity in the markets, and potential changes in government regulation and incentives. The point is that a proper valuation will quantify as much as possible within the expected cash flows of a business to reduce the "guesswork" inherent to assessing future risk. This is what moves an analysis away from providing a price and back to value.

For business owners who may be thinking that the bottom is falling out from under their organization's value, or perhaps those who are concerned about volatility in pricing, it may be helpful to take a step back and think objectively about what drives value. Pricing in the markets,

while indicative of the direction in which value may be headed, does not singularly dictate current value. In addition to external pricing factors, the company's business fundamentals also have an important role in determining the direction of company value. Both external pricing indicators and the individual company's fundamentals need to be viewed in tandem when company value is a part of any business and/or estate planning decisions to be made on behalf of the company's business owners.

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