Thought Leadership Series: COVID-19 Impact on cash flow and business valuation

Financial Advisory Services

Cash is king – back to basic

Whilst the Covid-19 situation is unprecedented, experience of past economic disruption, such as the 2008 financial crisis, does provide some insight into what is likely to happen in terms of Cash Flow. However, the impact is not uniform.

How to protect **cash flow** in your business?

1 **Tax Payment**

Biggest and important cash flow in business

Tax payments in one of the biggest cash-flows in any business. Significant cash flow positive results can be created in a wide range of ways with some of the most well-known being 1. R&D tax credit, 2. VAT Planning 3. Payroll or benefits planning 4. Time to Pay arrangements 5. Management of quarterly instalment payments and 5. Credit tax losses from a fall in asset values.

2 **New risks and risk management**

New unforeseen risks arise due to the situation and mitigate action should be ready

Businesses will be dealing with new areas of risk and risk management, which may mean their structures need to be adapted, debt restructured, investment plans altered, or supply chains modified. Inexorably, all of these issues will have a significant tax dimension and impact

3 **Positioning for the future**

Possible upcoming future opportunities due to this situation

In any economic disruption once the immediate steps are taken to protect the business, and to cover risk, there are generally opportunities to prepare or improve the business for the aftermath of the crisis. A fall in share prices will mean stock options or other incentives are 'underwater' having lost their incentive effect. They can be reset to retain and incentivize key staff at no cash cost and get a tax deduction along the way in some cases. Supply chains may need to be changed or rebuilt or there may be opportunities to accelerate business transformations which were already underway.

At a personal level, falls in the value of assets may provide an opportunity for passing assets down through generations.

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COVID-19 has serious impact different economic sectors which without a doubt impacted the M&A transactions (M&A and private equity) with a scenario where the difficulty in defining the value of business, in a context of high uncertainty, can cause price formation to be governed by other criteria (the need to buy or sell, strategic aspects, gaining market share, etc.) or that simply that decisions concerning investment are delayed or cancelled.

Focus going forward:

1 Generation of cash flow

As in any financial crisis the impact is going to be different according to the business sector we are talking about, but also to each company's own characteristics: the level of previous indebtedness, geographical diversification, client or supplier dependency, size, cost flexibility etc. However, in the current situation, other variables exist outside the company structure itself that may determine significantly the start of crisis recovery, mainly companies' access to new financing (equity and/or debt) and the effective deployment of policies implemented due to the crisis by central banks and governments (tax, labour, etc.).

But in our opinion, the fundamental variable that determines the ability to generate cash flow and, therefore, for companies to create value, is going to be time. How long can companies and businesses endure the current situation? And, more importantly, what condition will they be in once all this is over?

2 Variable growth

Variable growth, in valuation, refers to the expected growth of generated cash flow, to which we referred in the previous section. The higher the expected growth, therefore, the higher value expected.

Data has recently been published regarding the fall in retail consumption in China due to the Coronavirus crisis, that dropped by 20% in February, when the last few years showed an annual growth of over 8%, following 20 years of continued growth. This is without doubt alarming data that one way or another will become apparent in Europe and other regions.

Just as worrying is the standstill in investment in China that has, without doubt, caused the growth. The saver, the investor that has resources, the companies themselves prefer to wait until there is a greater visibility concerning the future and reserve their funds or they allocate them to assets that have no related risk. What we saw in financial markets is transferred to the real economy, to individuals and to companies.

3 Risk

Lastly, we have the variable risk, understood as uncertainty, volatility or variability expected in the cash flow generated. In valuation, we reflect this concept via the rate of discount or of the valuation multiple. The higher the risk, the lower the value or multiple.

In the current situation, industries such as those related to tourism, travel and oil, tend to easily be placed in the same basket of high risk sectors, at least occasionally, and other recent ones such as online sales, remote telecommunication systems, online courses, or as classic as supermarkets or general food as industries with a low risk profile.

COVID-19 Impact on business valuation

Covid-19 is posting challenges to businesses given ambiguity on the duration and extent of the virus pandemic. The longer-term impacts remain unknown. The virus pandemic is likely having an impact on business valuation. There are several factors to be considered in business valuation.

1	**Date of valuation**	Value of business is based on what is known as at a valuation date. The development of virus pandemic changes dramatically day-to-day; and therefore, the events or circumstances that exist as at a valuation date should be carefully assessed.
2	**Cost of equity**	Consideration of whether risk-free rate is indeed "risk-free" involves assessment as to whether the rate is default-free. The financial health of a business is one of the critical considerations when building up a discount rate.
3	**Double-counting on risk?**	The preparation basis of cash flows projection of a business should be matched with the basis of determining the corresponding discount rate. Business-related risk factors should be carefully incorporated into cash flows projection and/or discount rate, ensuring no double-counting of the risks in business valuation.
4	**Discount for lack of marketability (DLOM)**	Depend on how a DLOM is determined, extreme volatility of the market may signal a higher DLOM. A prolonged volatile market will be affecting the DLOMs. Although there is insufficient empirical data to quantify the increased DLOMs due to virus pandemic, its impact should be considered using a defendable approach for business valuation.
5	**Governmental support and incentives**	Some businesses affected by the virus pandemic may eligible for governmental support and incentives. The impact of such governmental support or incentives should be thoroughly assessed and considered in a business valuation.

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