Benefits from Collaboration

Determining Fair Market Value During Uncertain Times

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The onset of COVID-19 and the resulting public health emergency moved the country and, indeed, the entire world, into a period of significant uncertainty. The US Government has taken significant actions as a result of this uncertainty to aid the economy; however, the date and levels of economic recovery are uncertain. With this backdrop, appraisers must still perform their work to determine value. Company management can play an important role in helping appraisers determine value.

Uncertainty Results in Unprecedented Governmental Action

The Congressional Budget Office identified several factors impacting its economic projections, including how the pandemic will unfold during the remainder of 2020 and into 2021, how social distancing will impact the economy and how recent policy actions by the government will affect the economy. Government actions have included the Coronavirus Preparedness and Response Supplemental Appropriations Act, the Family First Coronavirus Response Act, the Coronavirus Aid, Relief and Economic Security (CARES) Act, and the Paycheck Protection Program and Health Care Enhancement Act. Through the CARES Act, the Federal Reserve (the Fed) has taken unique action.[1]

The Fed takes an active role in monetary policy; however, for the first time in history, it purchased corporate bonds with the stated purpose of ensuring that the market functions properly. As a result of these actions, interest rates have been impacted. Appraisers use interest rates in their analysis as one component of risk. Generally, as interest rates decline, all else being equal (which rarely or never actually happens) value would increase. However, interest rates are only one component of the overall assessment of risk. Uncertainty, measured in the market as volatility, is another of many factors.

The Fear Index

For investors, a definition that includes purchasers of businesses, an increase in volatility equals an increase in risk. Thus for all investments, as risk increases, value declines proportionally. The Chicago Board Options Exchange (CBOE) created the Volatility Index (VIX) as a measure of expected future market volatility. It provides a look into how the market and investors perceive risk. As illustrated in the 2020 year to date VIX chart below, market expectations for volatility increased significantly with the onset of COVID-19 and have remained higher than recent historical levels.

FIGURE 1: VIX "FEAR INDEX"

Appraisers use data and other observations, including market volatility, as inputs to determine value. However, the risks associated with public markets are often different than the risks associated with non-public entities. Although appraisers consider economics and market volatility as factors of their analysis, the risks for an individual company may be different.

Premise of Value in Uncertain Times

The role of appraisers is to express an opinion of the value of a business based on a given standard of value and a given premise of value. The standard of value can be thought of as the way the business is measured. One can think of this as a ruler with inches on one side and centimeters on the other; it is a way of measuring something under a different scale. Businesses are most often valued under a fair market value standard.

One can think of the premise of value as describing how the business is viewed for the valuation. Typically, this is either as a going concern or under a liquidation scenario, where operations are not expected to continue. Under a liquidation scenario, the value of individual assets is greater than the entity's ongoing operations. Some healthcare entities may not survive, given the recent impact of COVID-19 on the economy. For every valuation, the appropriate premise of value will have to be determined.

Approaches to Value

A qualified appraiser seeks to issue an opinion that appropriately reflects the value of the entity as of a specified date. The appraiser will look at various approaches (e.g., asset, market, and income) to determine value. One method under the market approach uses multiples from prior transactions applied to operating statistics of the subject company to determine value. It is generally less applicable during times of significant economic uncertainty. Historical multiples are likely to be less representative of the market today. Valuators can use this approach; however, significant adjustments will likely need to be made. These adjustments are akin to a discounted cash flow method or litigation assignment. For more specific information about these types of adjustments, contact an experienced appraiser.

The asset approach will remain in use, whether due to healthcare regulatory constraints or because the asset basis best expresses the value of the business. At least for the near term, we recommend using an income approach using a discounted cash flow methodology. Under this methodology, detailed estimates of revenue and expense line items are explicitly projected into the future. The resulting future economic benefit is expressed as of a given date by reflecting an estimated cost of capital (i.e., a discount rate). The cost of capital is a composite measure of risk reflecting several different risk factors. Currently, uncertainty and volatility are high, lowering values. As detailed assumptions about the future are inputs for a valuation, management should collaborate with appraisers about their understanding of these assumptions.

Collaborating with an Appraiser

It is important to remember that the deliverable generated by an appraiser is an opinion. Experience, research, data, analysis, and communication inform the opinion. Although all these elements are critical to a valuation, during periods of uncertainty, effective communication with business management is essential. Classic thinking (cited by appraisers) is that no one understands a business better than those in it. A classic axiom, often recited by those in healthcare, is "all healthcare is local." In recent years and more recently, as a result of COVID-19, telehealth has expanded, allowing for care in non-local markets.

As appraisers seek to tell the story of an entity's value, management should take an active role in communicating with the appraiser to determine value appropriately. Although the appraiser will be independent, management should help the appraiser understand the short- and long-term outlooks for the business, its market, and the local economy.

The following is a suggested list of topics entity management should ensure an appraiser's understanding of:

- Dates and extent of social distancing, remain at home directives, and reopening phases.
- Dates when elective surgeries were paused and resumed in the service market.
- Historical volume trends, including a comparison to the same period during prior years.
- Referral patterns, identification of major sources of patients, and the financial and operational health of those referral sources.
- Use of Paycheck Protection Program funds and loan forgiveness requirements, Medicare accelerated payments and other healthcare-specific funding sources.
- Changes in day to day operations, including staffing, services provided (e.g., the introduction of telehealth) and expense reduction efforts.
- Information known about competitor operations in the market.
- Key factors entity management considers relevant to develop worst, most likely, and best-case scenario financial projections.

Management should also consider inquiries regarding approaches and considerations employed by the appraiser in performing the valuation. These can include the following:

- What are the appraiser's expectations regarding economic recovery?
- Which premise of value is the appraiser assuming?
- What valuation approaches is the appraiser using?
- If using a market approach, did the appraiser adjust historical multiples?
- If multiples were adjusted, what economic and business factors of the entity's service market did the appraiser consider?
- How will the appraiser account for COVID-19 risk in the analysis? Without that risk, to what extent might the value be different?

The current environment is unprecedented, and the future is uncertain. Generally, uncertainty lowers value due to an increase in perceived risk. However, through communication, management can help appraisers understand entity-specific risks to determine value appropriately.

Endnotes

1 CONGRESSIONAL BUDGET OFFICE. 2020. INTERIM ECONOMIC PROJECTIONS FOR 2020 AND 2021. MAY. ACCESSED JUNE 25, 2020. HTTPS://WWW.CBO.GOV/PUBLICATION/56368.

For a discussion of the impacts of telemedicine on healthcare entity value, request a copy of Richard's upcoming peer-reviewed article in *The Value Examiner* from the National Association of Certified Valuation Analysts.