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Estimating a COVID-19 Marketability Discount for Small Businesses

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The year 2020 has brought many challenges, making forward-looking business valuation more difficult. The biggest has been the COVID-19 virus outbreak and the social and economic effects that continue to wreak havoc with our ability to value businesses. This is magnified with micro and very small businesses[1] due to concentrations, poor financial information, and a lack of planning.

Much has been said about the need for management to provide detailed future projections and forecasts in the time of COVID-19. Yet owners and managers of most micro and small businesses cannot provide these data.[2] They could not provide it when the world appeared stable; they certainly cannot provide it now. That brings valuators back to using single-period capitalization of earnings methods and market methods. But clearly the risk of receiving future cash flows has increased. How can we adjust for this risk? The two tools we typically have as business valuators is to modify the cash flow and fine-tune the risk adjustment. This adjustment for this risk will likely show up in the company-specific risk for the capitalization of earnings method or a lowering of the multiplier in the market method.

The COVID-19 marketability discount. Another way to make this risk adjustment is to add a COVID-19 marketability discount on control interests.[3] After all, under both the income and market methods, the available data really do not reflect increased short-term risk to small and micro business.[4] In many situations, I favor the methodology of showing a separate COVID-19 marketability discount because it clearly shows the valuators thought process and the actual discount being applied for the current high level of uncertainty.[5]

The methodology is based on the weighing of factors such as those used in *Mandelbaum*[6]

1 I generally define "micro and very small businesses" as companies with revenues below $10 million.

2 One of the purposes of the book, *The Art of Business Valuation: Accurately Valuing a Small Business,* is to spur discussion of best practices of valuing these smaller businesses. This article is my opinion applying the principles of the book. As such, commentary, opinions, particularly implementable improvements, and alternatives are welcome. Please send to gcaruso@harvestbusiness.com. Relevant comments will be posted on the blog pages at theartofbusinessvaluation.com.

3 IRS engineers in the IRS DLOM Job Aid, pp. 8 and 9. "The controlling interest holder may not be able to sell the interest quickly or with certainty as to the ultimate sales price."

4 Market method data are almost exclusively pre-COVID-19. Under most buildup methods and data sources, the rate has dropped or only gone up a very small amount outside the company-specific risk, which is always a professional judgment call.

5 Clearly, this is a method that would be applied depending on the situation. The logic to develop a COVID-19 marketability discount can be applied to directly adjusting the multiplier, discount, or capitalization rate or applied as a separate discount for marketability. As with any discount, care must be exercised to not apply a discount for a risk that has already been fully accounted for.

6 *Mandelbaum v, Commissioner,* TC Memo 1995-255. In a landmark decision, Judge Laro provided a

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and the IRS DLOM Job Aid[7] but with categories modified to fit the current situation.[8] This process helps to organize thinking and provide support for professional judgment in these matters. Because this is an area with far more qualitative information than quantitative data, a high level of professional judgment[9] is required and there will always be a range of findings.

When applying a COVID-19 marketability discount, I value the subject company similar to how I would have prior to COVID-19-related issues becoming prevalent. In all cases, I adjust future cash flows to what I foresee as most likely. The marketability discount accounts for that increased risk from possible but not predictable economic or governmental action that could change those cash flows.

Consistent with *Mandelbaum* and the IRS DLOM Job Aid factors, I start from restricted stock studies, which show median discounts ranging

framework for evaluating discounts for lack of marketability in minority interest cases.

7 IRS DLOM Job Aid, pp. 8 and 9.

8 A logical next question is: When there is both COVID-19 marketability discount applied on a majority interest and then a marketability discount to be applied on a minority interest, how does one avoid double counting? The IRS Job Aid acknowledges that there can be a marketability discount on majority interests when the facts indicate that the majority interest will be unusually difficult to sell so that problem would arise anytime the facts justify a marketability discount of a majority interest. If I were valuing a minority interest, I would likely add the COVID-19 risk factors and risk measures to the basic *Mandelbaum* analysis for simplicity so as to not show two discounts. But, again, that would be very purpose-and-fact-pattern-dependent. I believe this is entirely consistent with the spirit of the Job Aid and *Mandelbaum* case based on the facts we are dealing with at this time.

9 One of the primary points of *The Art of Business Valuation: Accurately Valuing a Small Business* is that the valuation of micro and small businesses requires relying on qualitative or soft data and professional judgment more than the valuation of larger businesses due to the lack of quantitative data.

from 9% to 45%.[10] The Stout Restricted Stock Study data of 769 transactions shows a mean of 19.33% and a median of 15.05%.[11] Restricted stock studies are a fair starting point because one of the things they measure is the discount due to restrictions in selling the interest in the open market. While these are statutory restrictions as opposed to market restrictions, the concept of a reduction of value for reduced marketability holds. I use these statistics as a starting point indication of the likely range for the discount.

Looking at the data, the longer the restriction period, the higher the discount. Risk in business valuation is the perceived likelihood that a stated cash flow will not be received. Again, using a logical weighting process such as that provided in *Mandelbaum,* I believe the additional risk can be evaluated by review in the following areas: company factors, COVID-19 matters, risk measures, and economic issues, which also include industry information and our estimate of the length of time that the excessive uncertainty continues.

A sample completed summary form from a valuation of a cosmetic treatment and surgery center[12] is shown in the exhibit, which summarizes the factors. Many of the factors in the chart are dealt with in more detail in the main body of the report. Overall, the company is well positioned for the future, yet there remains high uncertainty as to future COVID-19 responses and the possible effects of a future economic downturn over possibly the next one to two years. Therefore, after reviewing the above factors due to the clear high level of risk shown by the risk measures and the economic outlook, I am selecting a COVID-19 marketability discount of 15%.[13]

The following is a review of the COVID-19 discount factors in the exhibit.

Company factors. This review centers on factors that may give a company more or less resiliency and more or less ability to survive difficulties and take full advantage of opportunities if they exist. Presumably, these areas have already been dealt with in detail in the body of most reports. Therefore, just a brief recap of major points would typically appear in the chart shown. I have broken them down into the following areas.

History and outlook. What adds or detracts from the company's risk in the current situation. Has the company survived unusual stress before? Overall, what is the outlook for the company at the time of the business valuation?

Financial factors, revenues, earnings, ratios. Clearly, these factors indicate whether there are high margins that allow reductions in revenue without a loss of all earnings. Strong balance sheets provide financial depth to bridge temporary cash-flow shortfalls. As an analyst, you are well versed in how to measure this category when we have sufficient data.

10 J.R. Hitchner, R.J. Alerding, J.B. Angell, and K.E. Morris (2017), Discount for Lack of Marketability Guide and Toolkit, Ventnor City, N.J., VPS, pp. 137-139.

11 Stout FMV Restricted Stock Study as of Dec. 31, 2019.

12 This was first used by me explicitly (I have been developing it since COVID-19 issues started, and I realized that my subject companies cannot give me a projection) for a valuation for an SBA loan. The company was shut down and appears to be fully recovered on a monthly cash-flow basis for the two months after reopening. Yet, there is still risk of another shutdown and economic issues for customers if a recession hits (At this point, I read a different view on that every day. Valuators, economists, and fortune tellers seem to have the same job in this environment.) Therefore, my basic capitalization rate (I used SDE for market method and after-tax cash flow for capitalization of earnings method on this valuation, and the two methods were very close) was a buildup for "normal times," which would include a normal company-specific risk that I further discounted by this amount.

13 Some analysts like to count the increase, decrease, and neutral results. I believe that a few measures are likely to be much more important and overriding; therefore, a "count" of results is inconclusive to misleading.

COVID-19 Marketability Discount Factors Example Summary Report				
COVID-19 Marketability Discount Factors	**Comments**	**Increase**	**Neutral**	**Decrease**
Company Factors				
History and outlook business	Steady business prior to events. Quick rebound. Appears well suited to continue forward.			xxx
Financial factors, revenues, earnings, and ratios	High historic profitability. Owner run.			xxx
Management	Technicians and surgeons staying. Management leaving. Change of management risk addressed in multiplier and cap rate.		xxx	
Systems/organization	Difficulties getting timely financials. Appear in reasonable order when received.	xxx		
Competitive position of products/company	Well positioned. Competitive pricing, monthly treatment club bring back steady customers.		xxx	
Covid-19 Matters				
Shutdown orders	Was shut down for two months.	xxx		
Effect of stay-home orders	Was shut down. Assessed above.		xxx	
Results since lifting	June 2020 and July 2020 monthly data provided show a complete monthly recovery and maybe a very small amount of recovery of lost revenues.			xxx
Employee issues	None reported.		xxx	
Supply chain issues	None reported.		xxx	
Management forecast	Forecast by buyer reflects stable operations.			xxx
PPP or other support	Received. It is believed it will be forgiven. Future support appears limited at this time.		xxx	
Risk Measures				
VIX index	Dec. 31, 2019 15; March 16, 2020 85 high; valuation date June 30, 2020 30; anything over 20 is interpreted as high volatility and risk. Risk perception remains high.	xxx		
FRED BofA CCC and lower debt	Dec. 31, 2020 last 20-day average, 10.46; valuation date June 30, 2020 13.79; Sept. 1, 2020 12.15%; rates of below-investment-grade bonds have gone up, indicating risk.	xxx		
BizBuySell Insight Recent Quarter Sales	2009 Quarterly Average 1100 2014 Quarterly Average 1900 2015 Quarterly Average 1800 2016 Quarterly Average 1960 2017 Quarterly Average 2500 2018 Quarterly Average 2600 2019 Quarterly Average 2400 2020 First Quarter 2225 2020 Second Quarter 1481 Sales drop shows it is harder to sell smaller businesses. This reflects increased risk. (The long-term data do not show material quarterly seasonality.)	xxx		
Economic Matters				
Economic outlook	Conference Board, best-case recovery by August 2021, likely sometime 2022.	xxx		
Industry outlook	Limited data found a study indicating no mid- or long-term effects.		xxx	
Cyclical industry	Medical, beauty, typically not viewed as cyclical.			xxx
Estimated length of time of excess uncertainty	This industry and company does not appear cyclical. I estimate 12 to 18 months as of the valuation date. This is an increase, but only a small/light increase.	xxx		

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Management. Quality management that provides leadership can greatly increase resiliency. Quality management encourages "continuous and forever improvement." Determining this can be very subjective due to limited contact with management and usually no contact with staff. Indications of quality management include high morale, timely production and delivery, inclusion of lower levels of management or staff in decision-making, etc.

Systems/organization. Quality management results in quality systems, so the two often go hand in hand. A system is high quality when "average people get extraordinary results every time." Usually companies that can get answers to questions quickly and can show you how they do things easily have quality systems. When company management always has a reason for a problem or delay, it often does not have quality systems in place.

Competitive position of products/company. This is operating on two levels in the current environment. The overall effect of COVID-19 on the industry, i.e., sit-down restaurants are in a poor position and then how the company and its products compare to competitors. If the company truly has barriers to entry from competitors (often licensing or permits for micro and small businesses), that reduces risk. If the company has reoccurring revenues, that reduces risk. On the other hand, concentrations, lumpy cash flows, a few large contracts, and the like can increase risk.

COVID-19 matters. In reporting COVID-19 matters, valuators are trying to address specifics due to COVID-19 and related government actions, customer or employee responses, or other impacts that may have affected the company.

Shutdown orders. Many companies were shut down if they were determined nonessential. The list of essential and nonessential varies from state to state and, in many states, by city or county. Clearly, the dates and impacts need to be noted.

Stay-home orders. Some businesses that were not shut down were still impacted because many of their customers were ordered to stay home. This, too, needs to be investigated and the outcomes noted.

Results since lifting. Clearly the results since the lifting or partial lifting of these types or restrictions needs to be noted. Several companies we have been asked to value had very clear recoveries. Others are catching up slowly. Others perhaps have a one-time loss they cannot improve on. A few may not be recovering yet or at all.

Employee issues. The private businesses I have been valuing have not reported a lot of employee issues, but certainly there are concerns among some workforces. Interplay of the American Disabilities Act (ADA) and COVID-19-related issues will be interesting to see develop.

Supply chain issues. Some companies are having supply chain problems. In addition, other companies may be stuck with seasonal or expiring inventory. The shift from commercial to residential goods is affecting other supply chains. Investigate and note any issues.

Management forecast. This could go here or up in the company factors. This should be a forecast developed since COVID-19 issues. Again, many micro and small companies cannot produce a forecast, so your "forecast" is likely to be a conversation with management where you summarize and estimate likely future outcomes based on all factors.

PPP or other support. Many companies received PPP loans that are likely to be forgiven. The SBA is paying loan principal and interest for six months or more this year on SBA-backed loans. Possibilities for business interruption insurance claims might be investigated. Others may have customers who received strong financial support through the coronavirus support checks and extra unemployment benefits. Still other companies cut or raised salaries of staff. These factors should be reviewed for impacts including the impact as these supports are reduced or ended.

Risk measures. Here is where the rubber meets the road. Measuring risk as perceived in the micro-and-small-business market is extremely difficult. Micro and small businesses tend to be riskier than larger businesses often because of all the concentrations they are subject to. There is also no quantifiable way to convert these data into an exact percentage discount or other adjustment. But I believe the three indicators below provide a clear indication of when the market perceives high risk to small business, which can create marketability issues, and the data can be regularly obtained and updated.

VIX index.[14] The Chicago Board Options Exchange (CBOE) tracks this index. It is a measure of the increase in price of 30-day stock options. A VIX above 20 indicates a high degree of risk.[15] The VIX can be overactive and is often call the fear index.[16] This certainly is a measure of perceived risk in the financial markets.

FRED BofA CCC and lower debt.[17] This is a measurement of the cost of below-investment-grade bonds, namely junk bonds. While many small businesses are more creditworthy than this, most small-business buyers (price is not value, but, at some point, the two need to be relatable) are risk takers seeking high returns as are investors in junk bonds.

BizBuySell Insight Recent Quarter Sales.[18] BizBuySell publishes quarterly data based on sales made through its online listing service. Coming from a brokerage background, I am convinced (but have not done quantitative studies) that small-business sales slow down during periods of high uncertainty. After all, the ability to sell when you want *is* the definition of marketability. When you combine concentration risks and other risks, small-business results can change quickly, so delays in selling can be costly. Finally, these really are micro and very small businesses, with the median sales prices being in the $280,000 range.[19]

Economic matters. Another major factor is the expected economic impacts of COVID-19 when people are afraid or unwilling to resume prior lives and government funding and other supports ends. While predictions vary, most call for some sort of recession appearing or reappearing by year-end 2020. A serious recession could impact many cyclical or B-to-B businesses with affected clients such as accountants that have avoided most of the impacts to date.

Economic outlook. I selected the economic summary provided by the Conference Board,[20] which is an association of large corporations. I would suggest its base-line projection. This appears reasonably middle of the road based on other economic indicators I have been reviewing. There are many sources of economic data, and you should use one you are comfortable with. Finally, at this point, you might even use several economic outlooks.

Industry outlook. Many data services are starting to have updates that reflect COVID-19-adjusted outlooks. In the meantime, or perhaps in addition, industry web articles and trade magazines are addressing current events and responses. While the point of view of the author or publisher (are they selling something?) needs to be factored into your analysis, currently, these provide relevant updates.

14 Charts and data also available from FRED fred.stlouisfed.org/series/VIXCLS.

15 Michael Williams, "VIX: What Is It, What Does It Mean, and How to Use It," Feb. 28, 2013, seekingalpha.com/article/1233251-vix-what-is-it-what-does-it-mean-and-how-to-use-it.

16 Ibid.

17 fred.stlouisfed.org/series/BAMLH0A3HYC.

18 bizbuysell.com/insight-report.

19 Ibid.

20 conference-board.org/research/us-forecast (I use the base case forecast).

Cyclical industry. Cyclical industries tend to be well known. That should be factored into a marketability weighting methodology because companies in cyclical industries often have periods lasting a few years when they are virtually unmarketable, often due to low profitability. This becomes a more important factor when an economic downturn is a likely forecast.

Estimated length of time of excess risk. Marketability discounts reflect the increase risk from an extended length of time to obtain a full cash price under a fair market value standard. In *Mandelbaum,* the length of time to a likely liquidity event is an important factor in determining a total discount. My personal framework for COVID-19 matters is that shutdown and customer fear factors are likely to continue for another nine to 18 months and, depending on the industry, customer base, etc., cyclical economic effects could continue for 12 to 36 months. But I have never spent so much time reading economic projections and seen so little agreement from month to month and source to source. I believe all things being equal (which is rarely the case, but we have to start somewhere) the likely time of the blockage is perhaps the most important factor in estimating a discount. Based on the Trugman[21] study and other studies, I have a rule-of-thumb starting point for a one-year blockage of 10% to 20%, a two-year blockage of 15% to 25%, and a three-year blockage of 20% up.

Synthesizing a COVID-19 marketability discount. As with many qualitative analyses, one or two measures may be so important as to override the other factors. In this case, some businesses are doing quite well and should continue to do so. They may not need this analysis at all. Others may have strong going-concern issues, reducing the need to do this type of analysis. But many businesses suffered various amounts from COVID-19 issues and may suffer more or less from what is considered likely in the foreseeable future. Those need to be assessed using this methodology or something similar.

The risk measures cannot be viewed in a void. All considerations on the worksheet are important, and they all interrelate as we try to develop a reasonable future cash flow and risk adjustment factor.

Overall, a well-managed business will always be less risky than a poorly managed business. How the business responded and its recovery from COVID-19 effects are extremely important. As the risk factors increase, the discount needs to increase. Cyclical businesses are always more risky than noncyclical businesses. In many cases, after preparing your analysis, talk it through with a colleague. This type of professional judgment can only be couched in the question, "Does this make sense?" If it does not, keep working on it.

Use these factors, or develop your own, but make sure you assess the increased risk from COVID-19 and the economic aftereffects. Finally, in many

21 Restricted Stock Studies appear to have higher discounts when the required holding period was longer. For instance, there are two Columbia Financial Advisors Studies. One was when the holding period was two years and generated an average DLOM of 21% and a median of 14%. The following year, the holding period dropped to one year and the average DLOM was 13% and the median was 9%. Also, see the original Trugman study and the Trugman Study 2007-2010 Update. In the original study, 136 transactions took place with the one-year holding period and had an average DLOM of 16.6% and a median of 14.3%. In the 2007-2010 study, 89 transactions occurred after the rule change to six months and they had average discount of 15.9% and median of 14.3%. The second study also looked at the average discount based on the days before registration that the interest was sold. Under 31 days showed a 12.22% average discount, 32 to 63 days showed a 15.31% average discount, 64 to 185 days showed a 16.27% discount, and over 185 days showed a 24.77% discount. Similar discounts were shown in the original study. (Original Study, William Harris, "Trugman Valuation Associates, Inc. (TVA), Restricted Stock Study," *Business Valuation Review,* Vol. 28, No. 3 (Fall, 2009) p. 138; 2007-2010 Update, William Harris, "Trugman Valuation Associates, Restricted Stock Study–An Update," *Business Valuation Review,* Vol. 30, No. 4 (Winder 2011), pp.132-139.)

cases, estimating and applying a COVID-19 marketability discount clarifies your thinking process on the impact of the current high level of uncertainty.

Gregory R. Caruso, *JD, C.P.A., CVA, is the author of* The Art of Business Valuation: Accurately Valuing a Small Business *(available at bvresources.com/products/guides-and-books). The book starts from the premise "does this make sense?" to get to the heart of the process to develop, review, or use credible business valuations. Mr. Caruso's firm, Harvest Business Advisors, has been involved in business valuation and business brokering within construction, engineering, and other fields for the past 20 years. He is the editor in chief of NACVA's* Around the Valuation World *and a member of NACVA's Ethics Oversight Board.*