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COVID-19 Insights

Smart Strategies in a Lower Valuation World

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Executive Summary:
Smart Strategies in a Lower Valuation World

The COVID-19 pandemic has resulted in significant public market losses and substantially impacted volatility and uncertainty in the economic marketplace. The value of private companies, assets and debt have been disproportionately affected by the turbulence as it has decreased investor appetite for riskier, illiquid investments. For High Net Worth families and individuals, as well as Companies, certain strategies that are put in place now can yield significant benefits to provide material long-term gains as holdings appreciate in value over the coming years.

COVID-19 is a "material event" which disrupts the assumption that historical data points are presumptively the foundation of the future. This triggers the need for a fresh look to consider the value of a company in light of its prospects in current and future economic circumstances.

Factors that Are Impacting Valuation

- *Cash crunch: Increasing risks and delays around access to needed capital*
- *Outlook: Near, medium and longer-term changes in forecasts and growth rates*
- *Exit Delay: Material delay in planned exits, existing M&A deals in greater jeopardy*
- *Higher Market Risk: Risk-adjustments have been affected on a sector by sector basis.*

Strategies

High-Net Worth Families & Individuals

Make Gift & Estate Planning Moves – Use it or Lose it

- *Intentionally Defective Grantor Trust (GT)*
- *Grantor Retained Annuity Trust (GRAT)*
- *Gift*
- *Intra-family loans*

Companies

- *Make Equity Grants/Restructure & Rebalance Ownership*
- *Reprice Underwater Options or Units*
- *Execute Corporate Conversions*
- *Handle Spin-offs/Carve-outs*

COVID-19 Insight:

Smart Strategies in a Lower Valuation World

The coronavirus (COVID-19) has resulted in significant public market losses, as reflected in daily stock market gyrations and volatility. Private companies, asset and debt values have equally been affected by the pandemic. For High Net Worth individuals and companies, certain strategies can provide a silver lining amidst the tough news and provide **long-term benefits when valuations rise again**.

For many private holdings, COVID-19 will provide some downward impact on value. This can result from significant disruption in operations, revenue/margin drop off, challenges in accessing capital, slower growth and delayed exit timelines. Certain direct impacts can already be seen as the market for secondary sales has started to shrink. Another immediate impact is revision of near and medium-term cashflow projections.

What's Different?
COVID-19 is a "Material Disintermediating Event"

For valuation purposes, we often consider past performance when looking at value. This can include recent financing rounds or historical financial performance of a company and market transactions/sales of companies. However, COVID-19 is a "material event" which can disrupt the assumption that historical data points are presumptively the foundation of the future. This triggers the need for a fresh look to consider the value of a company in light of its prospects in current and future economic circumstances.

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Factors that Are Impacting Valuation

There are few companies that have escaped any impact from the current economic conditions and uncertainty, even if operations have not yet been directly affected. Some key factors that are driving shifts in Value include:

- Cash crunch: Increasing risks and delays around access to needed capital and possibly company survival
- Outlook: Near, medium and longer-term changes in forecasts and growth rates; in some cases, a major rethink of a company's business model and prospects
- Exit Delay: Material delay in planned exits, existing M&A deals in greater jeopardy
- Higher Market Risk: Public markets have demonstrated not only a drop in value, but also significant volatility, and risk-adjustments have been affected on a sector by sector basis. This affects investor appetite for riskier private assets and affects the risk-adjusted value of private companies, assets and debt.

How to Estimate Forward-Looking Performance?

We have worked with dozens of clients already to revise forecasts and make risk adjustments to their cash flows and working capital requirements. In other cases, more substantial, structural and longer-term changes are involved, completely altering the previously held performance trajectory. One of the best approaches to navigating material future uncertainty is deploying scenario-based and probability-weighting strategies, with a clear thesis around each scenario and a basis for the changes to key metrics. Don't fall into unsupported bias, in either direction, which cannot withstand scrutiny in the future when the chaos recedes. **It's extremely important that valuations undertaken in this period are well supported, utilize sound methodologies, and will prove to be fully defensible to an IRS or SEC review.**

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While COVID-19 has caused significant economic turmoil, there are a few smart strategies that HNW individuals and companies can take in the current environment to optimize their and their staff's positions that can drive longer-term gain value when valuations rise again.

Strategies for High-Net Worth Families & Individuals

- Make Gift & Estate Planning Moves – Use it or Lose it
  - Intentionally Defective Grantor Trust (GT)
  - Grantor Retained Annuity Trust (GRAT)
  - Gift
  - Intra-family loans

Strategies for Companies:

- Reprice Underwater Options or Units
- Make Equity Grants/Restructure & Rebalance
- OwnershipExecute Corporate Conversions
- Handle Spin-offs/Carve-outs/Restructure Individuals

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High Net Worth Individuals:
Time for Gift & Estate Planning Moves

Make a Gift or Transfer shares or property into a trust.

Context

- Gift tax generally is imposed on larger non-charitable gifts (i.e. non-charitable gifts in excess of $15,000 annually per donor per donee) that, in sum, exceed one's lifetime exclusion (currently $11.58M, $23.16M for a married couple; individual exclusion scheduled to be reduced on Jan. 1, 2026 to $5M, adjusted for inflation).
    - There is speculation that the exemption could be reduced sooner, depending on the 2020 election
    - Treasury regulations have clarified that a gift that uses the current exemption will not be affected later upon death of the donor if the exemption amount is later reduced
    - As result there is a "use it or lose it" element to current planning for HNW individuals with taxable estates

Challenge

- Any such transfers must be recorded at their fair market value at the time of the transaction, and counts against annual and lifetime exclusion limits – which are subject to change in 2026
- Anything that is beyond the exclusion limits is subject to significant tax

Why Act Now?

- **The current environment of depressed asset values, low interest** rates and a high exemption amount opens up critical planning opportunities.
- Due to COVID-19 impacts, the IRS has issued very low interest rates applicable to intra-family transactions undertaken in May 2020.

- Additionally, the value of private companies/holdings and real estate holdings have been severely impacted by the volatility
- This represents a unique opportunity for HNW individuals and families to achieve extraordinary wealth transfer tax savings now
- The current lower values present an opportunity to make gifts of shares or property that are expected to appreciate substantially in the future and use less of the lifetime exclusion. This property also could be sold to family members at the current low values. Furthermore, intra-family loans can be made at extremely low current minimum interest rates.

What to Do?

Top Strategies include:

- Sales to an Intentionally **Defective Grantor Trust** (**GT**): A grantor could sell assets to an GT in exchange for a promissory note bearing interest at the Applicable Federal Rate (AFR). For May, that rate is 0.25% with maturity dates under 3 years, 0.58% for 3-9 yrs, and 1.15% for 9+ yrs. No gain is recognized on the sale and interest payments to the grantor are not subject to income tax. Any income/appreciation on the asset (beyond the AFR) pass to the beneficiaries free of gift tax, estate tax and generation-skipping transfer tax.
- **GRATs**: a grantor retained annuity trust (GRAT) returns to the grantor the value of the initial contribution plus a certain rate of return (the "Section 7520 Rate"; "S7R") over a set period of time (typically two years) and transfer to the beneficiaries all income & appreciation on the trust assets in excess of S7R free of gift tax. For May, the Section 7520 Rate is 0.8%. This rate, combined with current depressed asset values create optimal conditions for a GRAT strategy to successfully transfer wealth. A GRAT strategy can also be used by those who have used up their lifetime exemption amounts, as it is typically structured such that the gift tax value is zero.

- **Gifts:** for anyone who has not used their full exemption, this is an opportune moment to act now. It can save significant wealth transfer tax as all future appreciation will be excluded from the transferor's taxable estate.

Who Benefits?

- Donor and donee in executing an optimal transfer of wealth and maximizing the value of what's transferred by minimizing the tax impact

Reprice Underwater Options or Units

Why?

- Typically, companies will commission a valuation annually, or in conjunction with funding rounds, to set the strike price of options, profits interests, phantom stock and other equity incentive units

Challenge

- Many units may now be “underwater” (the strike price is above the stock price) killing their incentive and retention value
- New hires equally, will require a strike price for their options/units, and using a pre-COVID-19 valuation may vastly overstate that strike price

What to Do Now?

- With a new valuation, you can execute a repricing or exchange of previously issued options; often valuations can be 20-40% lower
- The strategy we see most commonly and easily executed is where companies cancel prior options and reissue new ones at the lower strike price, but hold vesting conditions the same; this is typically comparatively quick and inexpensive to executive, with immediate and clear benefits
- Other strategies can include swapping options for other incentive units (e.g. options for restricted stock awards or RSUs), repricing existing options directly, or cash buyouts -- all of these options need close review to understand their interplay with plan documents and applicable laws

Who Benefits?

- Future Staff: with units that will motivate them;
- Current Staff: Otherwise stuck with underwater options & at a higher strike price than new staff
- Company — re-establishing incentive functions of their equity awards

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Make Equity Grants / Restructure & Rebalance Ownership

Why?

- Similar to the repricing options, this can be a good moment to make a grant of equity and/or profits interests in your company; many owners/founders have key principals they want to bring into the business, or that have been with them for some time, and for whom they want to give a direct ownership stake
- Equally, this may be a time to rebalance or restructure ownership arrangements between existing co-owners / founders -- sometimes this can be family members in a family-owned business

Challenge

- The challenge in many of these rebalancing exercises is often that value of the shares is high, and a **tax liability is triggered**; Direct grants of stock or capital interests have immediate tax consequences
- Any person receiving new equity in a business must either pay income tax on those shares or otherwise declare a taxable gain, depending on the structure
- The hurdle rate for profits interests is based on the value of the company at the time the units are granted

What to Do Now?

- If your goal is to maximize the incentive / motivation of the grant, and/or to minimize tax liability, the new lower valuation environment can provide a good moment to get these issuances done and out the door; equally restructuring/rebalancing transactions can be optimized for all parties

Who Benefits?

- Recipients: will benefit from the reduced tax hit in the immediate moment and from long-term value gains if the shares appreciate in the future
- Company: Benefits from a smoother negotiation and may have flexibility to offer greater units in the moment at the lower valuation

Keep track of Equity Transactions

The current market challenges have led to significant reductions in workforce and changes in process and procedures with employees working from home. In this context, it's very important that records of equity transactions are kept closely tracked. This can include:

- Records of vested and unvested equity awards at the time of employment separation, which are critical for understanding the separated employee's rights and options
- Equally, it's important to be clear on provisions in plan documents and equity awards related to when a recipient changes employment status (furlough, leave of absence, full-time/part-time transition, voluntary or involuntary termination)
- New Grants, strike prices, hurdle rates, termination provisions and other key aspects of grants need to be effectively captured
- All equity information should be current, accurate and completely accessible remotely

We've launched a key software tool and concierge service that can help make sure you are always able to handle these events with confidence; we do the heavy lifting for you and you don't need to hefty external advisory fees to get it done right.

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Execute Corporate Conversions

Why?

- The 2017 Tax Cuts & Jobs Act (TCJA) stirred the debate as to whether to operate in corporate or LLC/S-corp form by changing tax provisions
- Corporate earnings are taxed twice (at corporate level and then again at shareholder level); LLC/S-corp earnings are taxed once
- There may be advantages to converting from a C-corporation to either an LLC or S-corporation now to take advantage of TCJA changes
- Conversely, converting from an S-corp/LLC to a C-corporation may be advantageous where it affords access to s.1202 benefits (Qualified Small Business), enabling tax-free gains on a sale of the company where exit plans make it worthwhile

Challenge

- Moving from a C-corporation to LLC form is considered a deemed tax liquidation event: the corporation is taxed on any appreciation built-into its assets ("BIG" – built-in gain) and its shareholders are taxed on the deemed liquidation distribution
- Moving from a C-corporation to an S-corp also triggers tax on corporate asset built-in gain; the gain is taxed at the corporate level if the asset is disposed of within 5 years
- For s.1202, it's required that the gross assets of the company at the time fall below a certain valuation threshold in order to for the shares to qualify

What to Do Now?

- When valuations are reduced, both the corporate gain (if any) generated on the deemed liquidation and shareholder tax (if any) that arises on any assets deemed distributed will be minimized; thus you can execute the conversion and pay materially reduced taxes
- For s.1202, a good time to make this move is when asset values are depressed

Who Benefits?

- Company & Shareholders with improved tax positions

Handle Spin-offs/ Carve-outs/Restructure

Why?

- Spin-outs of business units & assets from an existing company can be an key strategic move to unleash the value of the captive unit/assets
- A corporate parent can dispose of a subsidiary or technology; many private companies start with a services model but incubate a technology, they ultimately spin that technology out of the business – this allows new investment to happen for the spin-out, and for staff to be given share/option incentive compensation for the spin-out alone
- Keeping the value of that spin-out as low as possible is often critical to both the parent company and to NewCo to optimize the transaction
- This can also be relevant where a company is seeking preferential s.1202 treatment for NewCo (as noted above)

Challenge

- Many spin-outs cannot be executed under the tax-free spin-off provisions of the relevant jurisdiction, thus driving two levels of taxation: corporate gain on the distribution, as well as tax on the distribution to stockholders
- Distributing the stock of a subsidiary/NewCo when value is low will reduce the tax exposure in all cases

What to Do Now?

- Take your business unit/subsidiary/"incubated" business line or technology and effect a spin-out
- Make sure you select an optimal effective dateIf circumstances warrant, a Fairness Opinion may be needed to ensure the
- Board can effectively discharge its fiduciary duties to all shareholders

Who Benefits:

- Company, shareholders of Parent / OldCo. shareholders of NewCo, and ultimately employees of NewCo

Conclusions

Overall, this may be an opportune moment to either reset a prior valuation or to get a new valuation commissioned. In many cases, it may be prudent to consider/review whether the value calibrates in another 6-8 months as things settle down and greater visibility reveals itself as to COVID-19 impact and forward-looking performance. But whatever you do, make sure your actions are well documented and defensible in light of financial and valuation principles. The one lesson of any downturn is that, when the dust clears, all of these actions are reviewed in a different world and often subject to fierce challenge. If you are a company that is angling towards an exit or an IPO, rest assured that buyers' diligence team and the SEC review stock awards closely.

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Our Team is Here to Help

If you are a current Oxford client, we recommend that you reach out to discuss whether you or your company can benefit from any of these strategies. If you are not currently a client, we are more than happy to discuss this with you and help you in thinking through the best path forward.

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