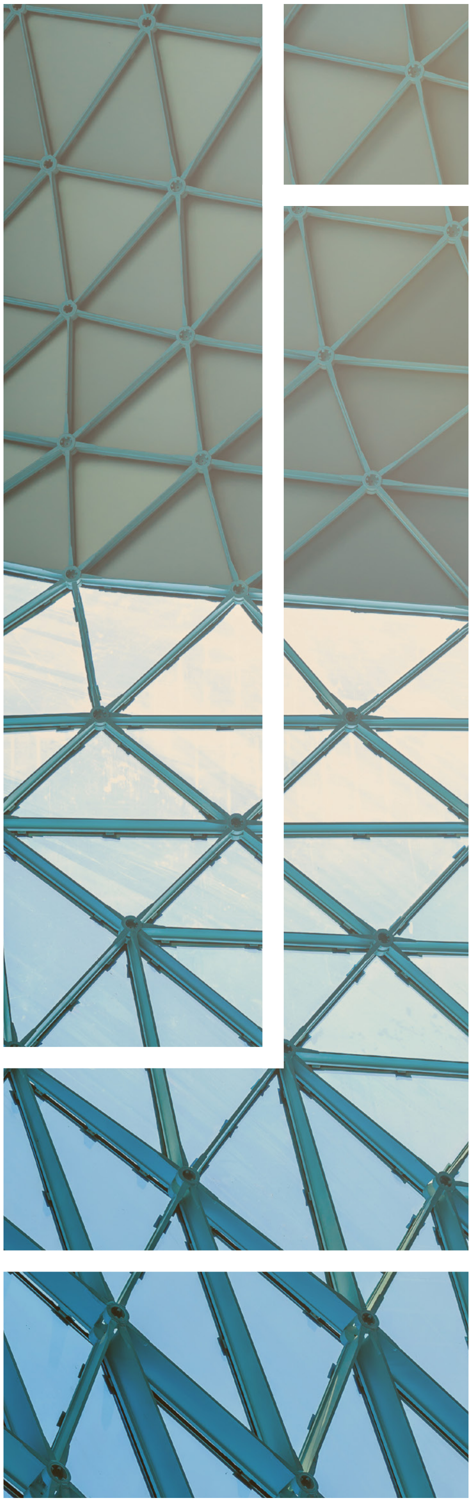
Despite Gains in Hard-Hit Sectors, Be Realistic on Valuations



The outlook across sectors is better than expected, but forecasts must be achievable

When the pandemic began, CFOs tended to be conservative in their budgeting—bracing for the worst. But an elongated market correction, like the one we saw in 2008, never materialized.

Rather, many industries that faced a demand disruption experienced a V-shaped recovery in which business snapped back to pre-COVID levels, making up for earlier losses. Much of the recovery was driven by steadfast support from private equity sponsors and lenders along with federal stimulus.

As we look ahead, the positive sentiment on the performance of private companies continues: 70% of participants in a webinar hosted by the valuations and opinions group of Lincoln International, where I serve as a managing director, said they expect enterprise valuation multiples to increase or remain flat in 2021 despite closing at an already all-time high.

In addition, optimism levels are growing as vaccination rates increase, lockdown restrictions ease, and the government infuses more capital into the economy.

These positive signs, coupled with better-than-expected 2020 performance and compartmentalization of the pandemic and its effects, has led CFOs in many industries to forecast double digit EBITDA growth in 2021.

Positive predictions

As indicated by a Lincoln analysis conducted across its 1,700-private-company database, average annual EBITDA growth is in the low to mid-single digits.

For reference, growth averaged 2.5% in 2019 amid the bull run and 5% in 2020. Yet, today—in the midst of a global pandemic—2021 EBITDA growth is forecasted to be almost 10%.

Digging deeper to examine individual industries, we're seeing a rubber-band effect of the V-shaped recovery; companies are moving from surviving to thriving, even in some of the most COVID-impacted sectors.

You can see this clearly in two industries heavily impacted by the pandemic: consumer and industrials.

On average, consumer businesses' EBITDA declined 1.7% in 2020, according to Lincoln's private company analysis. Unsurprisingly, growth was dragged by COVID-hit restaurant and retail, which declined 27.7%. In 2021, expectations are wiping out losses with 17.6% and 11.3% revenue and EBITDA growth predicted, respectively.

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This forecasted growth outpaces trends seen before COVID-19 disrupted the sector. The estimated private company revenue growth is almost twice that of the estimate from S&P Global Market Intelligence's consumer product and consumer services segments, which is predominately based on public companies.

In the industrials sector, at the height of the pandemic, factories worldwide were forced to close and had difficulty procuring supplies.

All in all, based on Lincoln's analysis, the industrial sector experienced stable earnings in 2020 as compared to 2019. However, forecasts show that businesses expect an equally steep snapback of 10.1% and 8.3% revenue and EBITDA growth, respectively, in 2021, as the sector returns to pre-COVID operational levels.

Interestingly, the revenue estimates align closely with the S&P Global Market Intelligence's expectations for several of its industrial subsectors.

In contrast, technology experienced a huge spike in demand, fueled by the shift to e-commerce and a need for technological improvements in all businesses.

Moreover, software-as-a-service (SaaS) was particularly resilient, experiencing 24.7% EBITDA growth in 2020. It's expected that the industry will maintain this growth trajectory into 2021.

Budget questions

With highly impacted sectors expecting robust growth, CFOs should anticipate difficult questions in their budgeting about achievability. Despite positive indicators, the pandemic is not over.

The uncertainty of 2020 led to leniency in the evaluation of budgets. But this year, as valuations are performed on companies, CFOs will need to be prepared to address how budgets will be reached and substantiate the magnitude of revenue and EBITDA growth anticipated.

Here are some of the questions valuation professionals will be asking:

1. *Have projected revenue levels been achieved before?*
2. *How much of forecasted growth is attributable to contracted revenue?*
3. *Are cost-cutting measures put in place during the pandemic temporary or permanent? And have these measures hampered the ability to scale and achieve future revenue targets?*
4. *How does the forecast compare to industry peers?*
5. *When does the budget assume the economy will be fully reopened and does the current state of reopenings modify the outlook?*

Buyers and sellers will value a business based on the achievability of their forecast—and will haircut a forecast that cannot be substantiated.

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