COVID-19 impact

on valuing short term management rights

For almost as long as management rights businesses have been bought and sold valuers have based their valuation of the business on the nett profit of the business for the prior 12-month period, the assumption being that such nett profit was sustainable in the future. That compares to other business valuations where it is common to have regard to three years of trading.

An accountant preparing an income verification report, or a valuer carrying out a valuation, would only make anything other than a minor adjustment to the prior 12 months nett profit if there was a one-off event not likely to recur where the nett profit may have increased or decreased as a result of that event (the Commonwealth Games on the Gold Coast being an example). In those circumstances the "usual" nett profit for the period of that event would be assumed, in place of the nett profit actually received during that period.

So, how and why is the impact of COVID-19 going to change the landscape of valuations moving forward for short term businesses? The current answer is that it is not yet clear, and it is a topic being routinely discussed among accountants, valuers, brokers and all other stakeholders with an interest in the short-term accommodation market. This article does not attempt to answer that question, much smarter minds than mine are still working on it, rather, I will provide an overview of where those discussions are heading.

The "why" in the question above is simpler to answer than the "how", so I will start there! COVID-19 is different to other one-off events for a number of reasons, some of which are:

It goes without saying that the financial performance of every short-term accommodation business has been affected by COVID-19 to some extent and we don't yet know the full impact it will have.

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Different geographical areas are experiencing different impacts and even within a single geographical area, the impact is different even amongst businesses in that area.

Different business types, i.e., motels, short term apartments, resorts and caravan parks are being impacted differently. And if I haven't already mentioned this, it isn't over! Unfortunately, the impact of COVID-19 is likely to be with us for some time, at least until the international borders are open once again and confidence in international travel gets back to what it once was, if ever.

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So now we turn to the "how" accountants and valuers will negotiate this minefield and work out not only the nett profit of a business as at the date of contract, but the sustainability of that nett profit which after all should form the basis of a valuation. A number of suggestions have been posited, which are:

1. Use the traditional method of reviewing the previous 12 months and ignore the impact of COVID-19. This approach will naturally be specific to the business and the actual impact on that business during the prior 12-month period.
2. Take an average of the previous three years nett profit, which is a common way of evaluating businesses that aren't management rights businesses.
3. Or a projection of the prior and future nett profit based on a combination of items 1 and 2 and an estimation of what will happen in the future.

Some valuers are expressing a preference for the third method above and to my layman's accounting brain, this makes sense. Another method being considered in the industry, where the income of the business has been affected by COVID-19 and is likely to continue to be affected, is to start with the nett profit for the prior 12 months, excluding the impact of COVID-19 (as in option 1 above), then apply the typical multiplier to that figure to arrive at a value. The next step is to look at the likely reduction in the assumed nett profit figure adopted over the next three years then deduct the total of those "reductions" from the value arrived at.

For example, let's assume the nett profit of a business for the previous 12 months, after excluding the negative impact of COVID-10, was $550,000 and a multiplier of 5.5 was adopted to arrive at a "normalised" sale price of $3M. Over the next three years, it is projected that the ongoing impact of COVID-19 would reduce that nett profit by $100,000 in year one, $50,000 in year two and $25,000 in year three, being a total reduction of $175,000. That would mean the sale of $3M would be reduced by $175,000 to $2.825M.

At the time of writing there has been no formal adoption of any specific method, it is still in the discussion and analysis phase. Unlike the "old" method of verifying the nett profit of the business for the prior 12-month period, whichever method is used, valuers and accountants will need to drill down into the specifics of the impact COVID-19 had and will continue to have, on that business. This analysis, together with careful consideration of all the factors relevant to the specific business, will assist in determining the sustainability and appropriate multiplier for that business.

From what we have seen, some businesses that were dramatically affected by COVID-19 have recovered to pre-COVID-19 levels or better, due to the influx of tourists from Queensland who may previously have holidayed overseas or interstate. Now that the Australian borders are mostly open, occupancy rates are predicted to improve further.

Reports show that Australians travelling overseas spend more overseas than international tourists spend in Australia. While the international borders remain closed, it stands to reason that domestic spend on travel will increase with (hopefully) much of the money previously spent overseas being spent at home.

We can only hope that when the international borders open there will be a balanced transition from domestic to international visitors and that occupancy rates will remain stable. What we all wouldn't give for a crystal ball, but as things stand today, valuations are more reliant on projections and assumptions than ever.

In summary, watch this space! ■