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Expert Analysis

Valuation as Art and Science: The Story Behind the Numbers

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Litigation and transactional attorneys frequently require a valuation, which is a broad term used to describe an appraisal. It can involve determining the worth of tangible assets such as machinery and equipment, but in the context of legal professionals, it more likely involves real estate and in most instances the equity of a business—also known as the stock ownership of a company or a business valuation. Financial expert witnesses have defined appraisals in their reports, and many articles regarding how to value a company have already been published for the benefit of the legal professional.

These work-products are typically instructional in nature, providing a foundation to certain concepts, such as the methodology or tools that an appraiser uses in conducting his or her analysis. However, the intention of this article is to demonstrate that great care is required in applying the information provided from one's valuation tutorial. Models developed to determine "the price of an equity interest" can be sensitive to certain variables and assumptions are best supported by market evidence.

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Standard Methodologies

Prior to providing suggestions to refine one's understanding of business valuation, the standard methodologies are briefly summarized below:

> The business valuation expert's responsibility is to make the complex simple and to unravel the mystery of valuation.

- **The Asset Approach.** This approach calculates value based on the cost of reproducing or replacing the asset, less depreciation from physical deterioration and functional and economic obsolescence, if present and measurable.
- **The Market Approach.** This estimates value through an analysis of recent sales of comparable companies as a ratio to an earnings parameter (also known as the Transaction Method) or from the determination of market value ratios of publicly traded companies, which are based on the market price of the security to an earnings parameter (also known as the Guideline Company Method). These ratios, such as the price-to-earnings ratio, are commonly referred to as "market multiples."
- **The Income Approach.** This approach involves performing a projection of anticipated benefits, which are then discounted by a rate of return that is commensurate with the risk of achieving those benefits. Methods under this approach include the capitalization of earnings (also known as the single period model) and the discounted cash flow method (a multi-period model).

From these definitions it is apparent that business valuation involves a certain degree of math in either developing a market multiple (a ratio) or calculating the present value of future benefits. In fact, years ago, a colleague once stated that "he is a simple guy and [business valuation] is just math."

At the time, it became clear that once one understands and accepts the science of business valuation, simple multiplication and addition is foundational. However, the finance professional's promotion to a seasoned testifying expert is how well he or she recognizes the "art" of business valuation, which involves financial analysis.

Business valuation may appear as simple math on the surface, but what lies beneath is a series of judgments grounded in market evidence, logic and experience. Thus, blindly calculating the median from a group of market multiples of comparable companies and applying this median to the subject company's earnings is a disservice to the reader of the business valuation report.

Financial Analysis

In reviewing the reports of other experts, attorneys should be aware that the financial analysis—or lack thereof—is fertile ground for cross-examination questions. Business valuation is not simply math but should be a documented outline of the finance professional's thought process. A story exists behind the numbers, and an effective appraiser translates the market evidence. The analysis of business valuation can be illustrated by two examples, in which public filings (such as 10Ks, earnings announcements and press releases) were used to assess the validity of an opposing expert's assumptions in a litigation matter.

- **Example 1:** In using the Guideline Company Method, an opposing expert discounted the market multiple that was applied to the subject company's earnings because of customer concentration, but the management discussion and analysis letter for each guideline company also reported customer concentration. Thus, the market price of the guideline companies already reflected this factor, and by further discounting the multiple, the opposing expert was double-counting the risk. In this example, the opposing expert failed to research and justify the discount claimed as well as understand the industry dynamic.

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- **Example 2:** In a dispute between shareholders, the parties disagreed with the company's projected profitability, which was significantly higher than that of the industry. Failing to investigate the reason for the difference, the opposing expert claimed that "the good times can't continue." In contrast, the press releases and company's earnings announcements provided statements from the company's CEO, in which he stated an effective advertising strategy and a unique distribution network contributed to its competitive advantage. In this example, the opposing expert did not adequately analyze the deviation in the market evidence or attempt to logically explain the projections used in the Discounted Cash Flow Method.

As these two examples demonstrate, it is the quality of the financial analysis that distinguishes the professionals. However, cases have occurred where counsel has referred the business valuation expert to a buy-sell or operating agreement to perform the appraisal that substantially reduces the opportunity for a well-thought-out financial analysis.

For example, the agreement may have a provision that states no minority interest discount is to be applied or the company must be valued using the last three years Earnings Before Interest Taxes Depreciation & Amortization (EBITDA) or a multiple of 10 times EBITDA is the appropriate market multiple. Each of these provisions benefits one party to the detriment of another, and it is important to understand the implications of each of these provisions from a valuation perspective as these types of agreements are drafted or litigated.

As such, there are four points to consider:

- **Avoid References to Discounts and Adjustments.** The various methodologies or tools that finance professionals use to calculate value generate either a controlling or minority interest indication of value and depending upon the interest being valued, either a minority or control position, an adjustment may be required. As an example, consider a scenario in which one represents a controlling shareholder and the finance professional relied upon transaction multiples, namely the prices paid to acquire similar companies that yield a control value.

If the client were to redeem the minority shareholder's shares without applying a minority interest discount, then that client will over-pay. Since valuation indications may be calculated on a different basis, this scenario is analogous to having the financial professional adding meters and feet to obtain total length, which cannot be calculated without adjusting one of the metrics.

• **Avoid Pre-Determined Business Valuation Formulas or Calculations.** Agreements exist which state that the value of the business will be determined by multiplying the company's EBITDA or three-year average EBITDA by a multiple of 10. As in the case of valuing other assets such as real estate, value changes over time, and relying upon a single data point without any additional context prevents the finance professional from performing an adequate financial analysis. In fact, the profitability and/or growth prospects of the subject interest may be very different from the growth and profitability of a company that would transact at a multiple of 10.

For example, the financial professional needs to consider whether any business divorce planning was occurring in the year in which earnings are to be relied upon. In other words, the instructions to the finance professional should not conflict with economic reality, and that is often the case when formulas are presented or referenced in these kinds of agreements. This is akin to requiring the financial professional to sum up the numbers "1" and "2" but prohibiting the use of the number "3" in his or her analysis.

• **Introduce Multiple Data Points.** Typically, agreements will reference a liquidity event or a provision that describes the rules governing the transfer of stock. In these references, the agreements will invoke a valuation to be performed. However, it is recommended that an interim procedure occur in connection with an annual review of the company's finances or the annual meeting with the stockholders. By adding a provision that a valuation be conducted on a regular basis, the company will have a reference point for transactions in its stock. If they are already prepared regularly, then they should insist the finance professional explain and document the change in value.

Again, the objective is to present the financial analysis to understand the basis for the valuation. The annual valuations should also be performed by a financial professional who complies with the Uniform Standards of Professional Appraisal Practice (USPAP). This qualifier will ensure that the financial analysis will be addressed and the reader of the report will understand the evidence considered. If price is an issue, the financial professional may instead conduct a limited scope appraisal, which also presents an indication of value. Accumulating evidence assists in preventing surprises when a particular shareholder wants to redeem his or her shares.

• **Include a Protocol for Disputes.** If a third party is required to mediate or settle a dispute, outline a protocol for selecting that party. In a recent valuation dispute between shareholders, the language in the agreement was vague regarding the selection of the third party, who was engaged to critique the valuations of the two other parties and submit a third opinion.

Unfortunately, in high-net-worth matters, one of the parties may exert a certain underlying influence because of stature in the community. The third party may be independent to the subject interest, but obtaining an opinion may be best served by searching for someone outside the particular market to avoid any potential bias. In the matter referenced above, one of the shareholder's experts and the third party operated too closely, referring work to each other when conflicts arose. This pre-existing relationship tested the role of a true advisor, the ultimate goal.

Conclusion

Discount rates and capitalization rates, discounts and premiums, and present value factors do sound esoteric to the non-financial professional. In efforts to reduce the complexity, it is reasonable to attempt to automate the process such as when the banking industry introduced visual software to the ATM machine. A number of complex commands are behind a simple screen menu that eliminates the need for human interaction and thought. However, this technological advancement for a number of industries is not appropriate for business valuation.

The thought process involved in an appraisal cannot be simplified to a brief outline of procedures or commands. It is true that a standardization exists and a framework is followed regarding the approach, but the financial analysis requires intellect and experience. The business valuation expert's responsibility is to make the complex simple and to unravel the mystery of valuation. Using the science of valuation, we are also artists who know how to evaluate what is relevant among copious documents in a litigation matter in order to present a concise and persuasive argument based upon reasonable and supportable assumptions.

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