

Viewpoint on Value



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Economic bust, litigation boom

In good times, companies typically operate harmoniously with their shareholders, employees, suppliers and customers. But the likelihood of conflict may increase when a company's performance falls short of stakeholders' expectations. The sluggish economy might not be the only scapegoat for lackluster performance. Civil wrongdoings — such as breach of contract or negligence — also cause businesses to lose money.

Many relevant factors

Compensatory damages awards attempt to make plaintiffs “whole” again. The starting point for estimating damages is a succinct damages theory. For example: *If Ms. Einstein had not infringed our patent, ABC Company would have earned more money.* From here, the expert refines the damages theory based on the evidence.



In such cases, the financial expert needs to fully explain the appropriate damages theory and underlying financial assumptions to avoid undermining the attorney's case.

One party's unfair gain is sometimes used as a proxy of the other side's loss.

Factors the expert considers when filtering through financial data include:

Financial projections. The plaintiff or defendant might have projected profits before entering into a contract. For example, financial projections often are used to obtain financing — or internally, to assess an investment's feasibility. They can provide insight into where the company might be “but for” the damaging act, especially if prepared before the dispute arose.

Comparable data. When assessing damages, an expert typically looks at industry averages and competitor performance using data from a reputable source, making sure to measure the financial metrics consistently between the comparables and the subject company.

Defendant's subsequent gains. One party's unfair gain is sometimes used as a proxy of the other side's loss. A defendant's gains might be relevant if the plaintiff alleges unfair competition, a breach of a noncompete agreement or a breach of an exclusivity contract.

Discount rate. The traditional approach to quantifying damages is a discounted cash flow analysis in which the appraiser calculates lost profits over a finite time period and then discounts the cash flow stream to its net present value. The appropriate discount rate is subjective, however, and depends on case specifics. Courts offer little guidance. But experts agree that the discount rate should incorporate the perceived risk of achieving the expected profits and the plaintiff's use of funds.

Accepted methods for quantifying damages

The number of valuation challenges in federal and state courts has been on the rise. Accepted methods for quantifying economic damages include:

Before-and-after method. An expert might, for example, analyze the company's operating history and then show how the defendant's actions caused an aberration in these trends. Damages equal the difference between actual performance and expected performance based on historic trends.

Yardstick method. Another approach is to benchmark the plaintiff's performance against competitors or industry averages. If the expert can establish a clear relationship between the performance of the company and its peers, this external data can support an economic damages claim.

Sales projection method. Some experts predict how a plaintiff might have fared based on financial projections prepared for financing or other external purposes before the defendant's wrongdoing. This method is often reserved for startups and companies with limited operating history.

Quantifying damages is an inexact science — no single method works in all cases.



Damages duration. Most calculations assume that damages occur over a finite period of time, such as a contract's term or a product's useful life. But some losses are permanent. In such cases, economic damages equal the difference between the value of the company before and after the damaging act.

Taxes. Generally, experts calculate damages on a pretax basis, because plaintiffs owe state and federal taxes on most compensatory damages awards. If this is the case, the discount rate the expert applies to lost profits also should be a pretax rate.

Most jurisdictions expect plaintiffs to minimize continued losses.

Other factors. Before arriving at the final damages amount, an experienced expert will ask two more questions:

1. What external factors — such as the loss of a key employee or economic recession — could have lowered profits? After all, the defendant can be blamed only for the loss it caused.

2. Did the plaintiff take steps to mitigate losses? Most jurisdictions expect plaintiffs to minimize continued losses. This includes finding other suppliers or customers.

Remember: The burden of proof for showing that a plaintiff failed to mitigate damages lies with the defendant.

The right person for the job

Economic damages cases draw on many of the same skills required for business valuations, including accounting, financial analysis, benchmarking and discounted cash flow techniques. But economic damages calculations and valuations do differ in some ways.

One key difference is that damages experts enjoy the benefit of hindsight. For example, they may consider how the industry and subject company actually performed during the damages period. But in valuations, subsequent events are taboo unless they were known or reasonably foreseeable on the valuation date.

In any case, an expert with previous experience in damages cases and a thorough understanding of relevant case law and accepted technical methods can make all the difference in whether the case is won — or lost. ●

Rules of thumb are no substitute for the real thing

Rules of thumb are simplified formulas that may be published in trade journals or passed along by word of mouth. These equations vary from industry to industry, but common examples include one times revenues (for CPA firms) or five times earnings (for small manufacturers). Because of their simplicity, rules of thumb often appeal to business owners seeking a quick way to determine their business's worth. But it's that very simplicity that can cause problems.

Use formulas with caution

Rule-of-thumb formulas fall short for many reasons, including:

Oversimplification. Valuation is rarely as simple as a mathematical relationship between price and another financial variable — such as revenues, earnings or net assets. Valuers adjust for the specific characteristics of a company, including its discretionary and nonrecurring expenses, differences in accounting practices, contingent liabilities, and nonoperating assets. Rules of thumb also fail to address transaction details, such as earnouts and noncompete agreements.

Poor definition. Some formulas can be simplistic. They don't specifically identify what's being valued (stock or equity) and what's included or excluded in the sales price. And terminology can be ambiguous. For example, do "earnings" include items such as taxes, interest and depreciation? Moreover, some rules of thumb provide a range of possible values without explaining how to determine where the subject company might fall within that range.

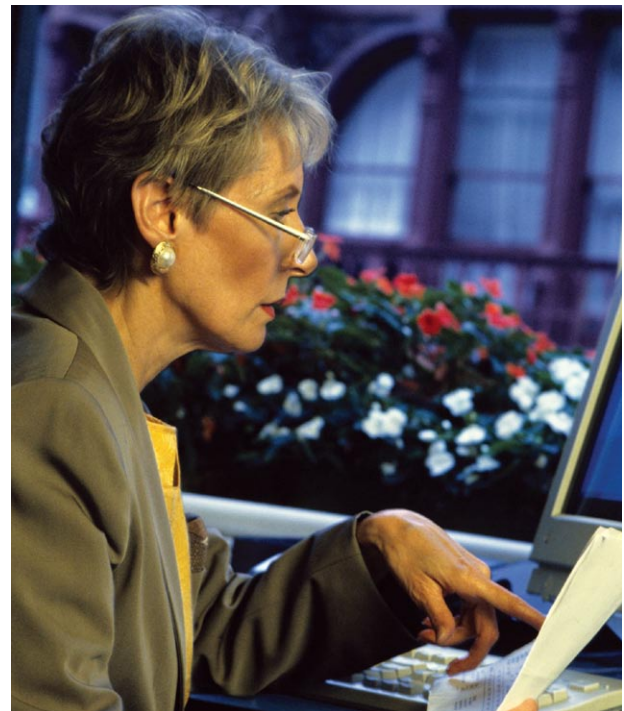
Irrelevance. The turbulent economy has proven that market conditions can change quickly. One day you might be on top of the world, only to have the rug pulled out from under you the next day. Rules of thumb popularized during industry rollups or in the midst of an M&A frenzy may be less relevant when the market fizzles out — and vice versa.

Learn from another's misfortune

To illustrate the perils of relying on rules of thumb as the sole method of valuation, consider the manufacturer who relied on the formula "five times earnings" when buying a competitor. The buyer (Carl) hoped to expand his existing business by acquiring a competitor's shop space, machinery, trained machinists and a work order backlog.

Carl performed minimal acquisition due diligence. He toured the facility and shook hands with the machinists. He read the financial statements, but accepted them at face value. Using the rule of thumb, Carl paid \$1 million in cash for the business, including a 10-year note from the bank for \$800,000.

A year later, Carl had the sinking feeling he'd overpaid. A friend referred him to a business appraiser, who estimated that the fair market value had been



only \$700,000 on the acquisition date, based on comparable transactions. Some reasons for the discrepancy included:

Deferred repairs and maintenance. The seller boosted earnings by deferring repairs and maintenance expense. Much of the acquired equipment was in need of repair and some was replaced after closing.

Valuation is rarely as simple as a mathematical relationship between price and another financial variable.

Renegotiated lease terms. The seller's lease expired within a month of closing. The landlord, a friend of the seller's family, raised the rent to market rates for the new tenant. Previously, the company had paid below-market rental rates, which had the effect of overstating earnings.

Loss of a key employee. The lead machinist retired shortly after the deal closed. The valuator estimated the machinist had generated 15% of the company's output last year.

Loss of a major customer. A financially distressed retailer accounted for 30% of last year's earnings. The retailer liquidated six months after closing and defaulted on \$125,000 of outstanding invoices. The seller had booked no allowance for bad debts.

Employment contracts with key employees and earnouts — in which a portion of the selling price is contingent upon future performance — are common in many transactions involving small manufacturers. These terms of sale might have helped protect Carl's financial interests.

More important, though, a valuation professional could have helped Carl look beyond the oversimplified industry rule of thumb — considering the business's unique risk factors and conducting more in-depth acquisition due diligence.

Look beyond the obvious

Rules of thumb can serve as a reasonableness check when an appraiser has determined a company's value using accepted valuation methods.

But valuing a business is a science that requires specialized training, years of business experience and hours of analysis. It may be tempting to sidestep the valuation process to save time and money. But relying solely on industry rules of thumb to value business interests can often backfire. ●

Fine-tuning the value estimate

The importance of valuation adjustments

Appraisers often make adjustments to normalize companies' earnings. By removing all unusual, nonrecurring events from a company's financial statements, an appraiser uncovers a clearer picture of the company's normal operations and helps ensure the numbers better reflect reality.

But what's normal? It depends. For instance, the appraiser may have to adjust a company's historical

results so those results better represent the anticipated and representative benefits that an investor may expect.

Revising the income stream

When applying the income approach or the market approach, an appraiser derives a company's value from its earnings using capitalization (or discount) rates or pricing multiples, respectively. But before jumping headfirst into this basic math, he or she steps

back and asks whether a company's past earnings represent its future earnings potential to a hypothetical buyer. If it doesn't, the valuator considers revising the company's income stream to better reflect the future cash flow a prospective buyer could generate from its operations.

Discretionary adjustments are the first subset of income stream adjustments. These modifications are intended to bring a company's expenses in line with industry norms. Discretionary costs that commonly require adjustment include an owner's compensation and perks and related-party transactions.

In addition to changing the expenses a current owner controls, the valuator asks whether the current income stream includes any extraordinary or nonrecurring expenses, such as startup costs or legal fees associated with a pending lawsuit. Because these items aren't expected to continue in the future, the valuator removes them from the company's earnings.

Both discretionary and extraordinary adjustments may be appropriate to achieve a reasonably accurate estimate of the subject company's value, depending on the circumstances.

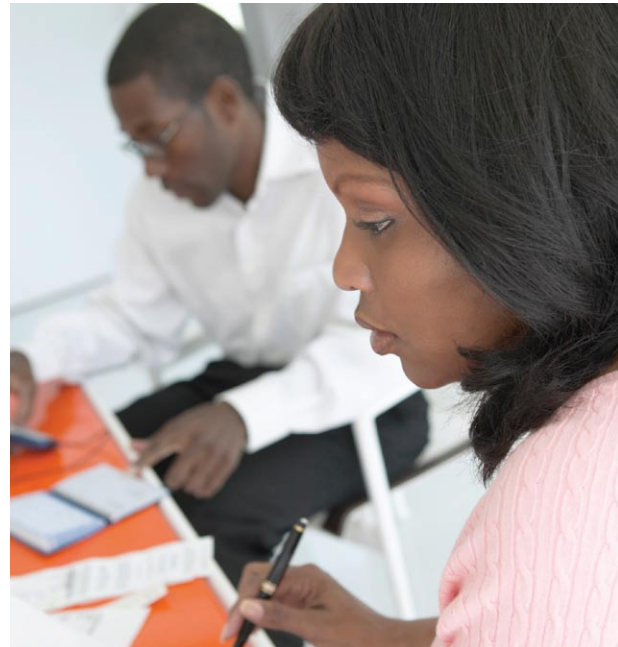
Fine-tuning the result

After a valuator makes a preliminary estimate of a company's value, he or she considers additional fine-tuning. Before finalizing the conclusion, the valuator assesses exactly what the preliminary value estimate includes. If anything is missing, the valuator makes a last-minute alteration.

Common last-minute alterations include changes to:

- Excess/deficit working capital (compared with the company's operational needs),
- Contingent or unrecorded assets and liabilities,
- Nonoperating assets, and
- Real estate (if most industry participants rent their facilities).

When making last-minute adjustments, a valuator also adjusts the earnings for any income or expenses



these assets or liabilities generate, including any tax benefits or consequences.

Quantifying discounts

Among the most common valuation discounts are minority interest and lack of marketability. Minority interest discounts reduce an interest's value to reflect its inability to control the company's management and policies. When quantifying this discount, a valuator considers several factors — such as levels of control and associated benefits, distribution of the other shares, and contractual agreements among the owners.

On the other hand, lack of marketability discounts reflect the relative difficulty (in terms of liquidity, time and transaction costs) an investor in a private company would have selling his or her shares. Factors that affect an interest's marketability include transfer restrictions, dividend-paying policy and financial performance.

The flip side of discounts is valuation premiums. Rather than reduce a company's value, premiums increase its value. The two most common are the control premium and the swing vote premium. The former is the mathematical inverse of the minority interest discount, and it's designed to increase a minority basis value to a controlling basis value, considering the economic value of benefits

to be recognized through the elements of control. The control premium is especially relevant in merger-and-acquisition valuations.

A swing vote premium reflects the ability of a minority shareholder to side with another owner to affect decision-making. For instance, a 2% interest might be subject to this premium if two other individuals equally owned the remaining shares.

Analyzing the details

Normalizing a company's earnings involves more than merely reading the company's financial statements. It requires detailed analysis as well as an understanding of the company's current and future operations.

Because it requires a valuator to exercise his or her professional judgment, a valuation adjustment may become contentious between parties and even lead to a lawsuit — so it's important for business owners and attorneys to understand its ins and outs. ●

Tiered valuation discounts: How low can you go?

Valuation discounts can substantially lower the fair market value of gifted business interests. But business interest owners often inquire whether additional discounts apply when multiple layers of ownership exist — for example, if a family limited partnership (FLP) owns a minority interest in a real estate holding company.

The answer is, maybe — if each entity exists for a bona fide business purpose. Multiple ownership layers shouldn't be fabricated merely to avoid gift and estate tax. It also helps if each tier owns some substantive level of assets.

Case in point

One landmark case in which the Tax Court embraced tiered discounts is *Astleford v. Commissioner*. Here, Astleford Family Limited Partnership (AFLP) owned a 50% general partner interest in Pine Bend Development Company (Pine Bend), which owned 3,000 acres of land, including 1,187 acres of farmland (the Rosemont Property). Mrs. Astleford gifted limited partner interests to her heirs, and the IRS contested the values claimed on her gift tax return.

After hearing testimony from six valuation experts, the court permitted a 20% market absorption discount on the Rosemont Property because the large, unique parcel would "flood" the local market. Then it granted Mrs. Astleford combined discounts for lack of control and marketability of 30% at the Pine Bend level and 35% at the AFLP level. The combined effect of these discounts was a 64% discount on the net asset value of the Rosemont Property. (Discounts are multiplicative, not additive.)

Rigor and reasonableness

Astleford is one of many cases involving tiered discounts. Others include *Estate of Piper v. Commissioner*, *Janda v. Commissioner*, *Gow v. Commissioner* and *Gallun v. Commissioner*. These cases demonstrate that courts recognize properly structured tiered discounts, which can add up quickly.

