Viewpoint on Value

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Strategic investments

How valuators facilitate decision making

Some private business owners make major decisions by relying on gut instinct, rather than financial metrics. But investments made on a "hunch" often fall short of management's expectations.

Being strategic about strategy

There's more to capital budgeting than deciding which piece of equipment or real estate to purchase. Business owners also might want to ask:

- Should we launch a new product (or discontinue an unprofitable one)?
- Should we make a component in-house (or outsource production to a third party)?
- Should we buy our equipment (or lease)?
- Should we merge with a competitor (or possibly go with a joint venture)?

Ultimately, management is attempting to answer a simple question: If the company buys a given asset, will the asset's benefits be greater than its cost? In addition, they should determine which growth plans to pursue first and which to postpone until funds become available.

Often companies have limited funds and can't pursue every investment opportunity. When a financial professional helps an owner manage the decision-making process, department managers are less likely to claim that the owner made his or her choice based on favoritism or gut instinct. A more "scientific" approach improves the chances that others will buy in on the decision.

Financial metrics

Accounting payback is perhaps the most common — and basic — way to evaluate investment decisions. For example, a piece of equipment that costs $100,000 and generates an additional gross margin of $25,000 per year has an accounting payback period of four years ($100,000 divided by $25,000).

But this oversimplified metric ignores a key ingredient in the decision-making process: the time value of money. And accounting payback can be harder to calculate when cash flows vary over time.

Discounted cash flow (DCF) metrics solve these shortcomings. So valuators, who use DCF techniques regularly when appraising business interests, are the logical go-to advisors when evaluating investment decisions. (See "What's the business worth?" on page 3.)

Net present value (NPV) measures how much value a capital investment adds to the business. To estimate

NPV, valuators forecast how much cash inflow and outflow a project will generate over time. Then they discount each period's expected net cash flows to its current market value, using the company's cost of capital or a rate commensurate with the project's risk. In general, projects that generate an NPV greater than zero are worth pursuing.

Internal rate of return (IRR) is another metric that accounts for the time value of money. A valuator uses it to estimate a single rate of return that summarizes the investment opportunity. Most companies have a predetermined "hurdle rate" that an investment must exceed to justify pursuing it. Often the hurdle rate equals the company's overall cost of capital — but not always.

Other financial analyses

Valuators can dig deeper than accounting payback period, NPV and IRR. They also can perform sensitivity analyses to see how the outcome differs if key variables change. And they can project multiple scenarios — such as worst, best or most likely — to help management allocate investment funds.

In addition, because not all factors in decision-making are quantitative, presenting the alternatives in a decision matrix (see "Decision matrix" below) can be helpful. The matrix weighs both quantitative and qualitative factors that matter most to management and rates each project based on how well it achieves those priorities. The project with the highest weighted score is the better choice.

Value-added insight

Valuators can't guarantee that a project will succeed, but they *can* introduce discipline, objectivity and practicality to the decision-making process. In turn, this can help management rein in unrealistic projections and make optimal choices in today's volatile marketplace. ●

What's the business worth?

Aside from helping management decide where to spend its capital budget, valuators can help management understand how much the business is currently worth. Many owners have unrealistic expectations, especially since the latest recession disrupted many industries.

Knowing what the business is worth helps owners devise their long-term investment strategy. If their company isn't worth as much as they expected, investors may decide to hold on to their interests longer to give the market a chance to recuperate. Or they might decide to sell now, rather than allow business value to depreciate further, if management doesn't think things will turn around.

Sometimes owners want a formal appraisal. These can be valuable if owners have another purpose in mind, such as estate planning or revising a buy-sell agreement.

Other times owners prefer calculations, wherein valuators perform limited procedures or don't issue formal written reports. For example, management might ask for just a list of recent comparable transactions and a calculation of median pricing multiples to assess market value.

Decision matrix

		Investment A		Investment B	
Factors	Weight	Rate 1-5	Score	Rate 1-5	Score
Quantitative					
% Market share	20	2	40	4	80
Accounting payback	10	4	40	2	20
NPV	20	3	60	4	80
Qualitative					
Congruence with corporate strategy	10	4	40	3	30
Brand recognition	20	2	40	5	100
Owners' stress level	20	4	80	1	20
Total	**100**		**300**		**330**

Each factor is rated from 1 (highly unfavorable) to 5 (highly favorable). The more advantageous choice is the investment with the higher weighted score.

Taking a closer look at financial statement adjustments

Never take a company's financial statements at face value. Often, an appraiser needs to make adjustments to get a clearer picture of an investment's future economic benefits and to determine an objective value for the subject interest.

Consider Bon Appétit Café. When owners Joan and Jonah Jones were getting divorced, they couldn't agree on the value of this (hypothetical) French bistro. Both hired appraisers who agreed to use a 33% capitalization rate, based on the restaurant's condition, location and operating history. But they couldn't agree on the future economic benefits to capitalize.

Face value

Joan hired the company's tax preparer as her appraiser. He accepted the financial statements at face value and projected $150,000 of equity net cash flows for 2014, based on amounts reported on the 2013 financial statements. His value was approximately $455,000 ($150,000 divided by 33%). So, Joan asked Jonah to buy out her interest for $227,500 (one-half of $455,000).

So, should Jonah buy out her interest for $227,500? The answer depends on whether that number accurately reflects what a hypothetical prospective buyer could expect to earn from the bistro. But it's likely the number will change — based on necessary financial statement adjustments to account for that particular business's situation and circumstances.

Nonstandard accounting practices

An appraiser determines value by using pricing multiples and rates of return derived from comparables. Thus, if the business deviates from how the comparables generally report transactions, he or she may need to make adjustments. Examples of accounting practice adjustments include differences in inventory, depreciation or revenue recognition methods.

For instance, when customers pay, most restaurants record the transactions by crediting sales and debiting cash (or credit card receivables). But the Joneses had gotten into the occasional habit of pocketing cash receipts. While this inadvisable practice is illegal (because it understates taxable income), small restaurant owners do sometimes take this shortcut.

Based on documentation furnished by management, Jonah's expert estimated that the Joneses skim approximately $11,000 annually and increased the restaurant's 2014 projected cash flows accordingly.

Extraordinary items

Sometimes *future* performance deviates from *historic* performance. An appraiser might need to strip nonrecurring or extraordinary items from the financial statements to normalize the economic benefits stream. Examples of extraordinary income and expenses might include start-up fees, pending litigation, discontinued business lines or capital losses. The appraiser also adjusts for nonoperating assets and liabilities, such as marketable securities, real estate and shareholder loans.

In 2013, Bon Appétit Café was closed for remodeling for two of its slower months. Jonah's expert added $10,000 to reflect the incremental cash flows the bistro would have earned during its two-month hiatus. In addition, he added back $2,000 of nonrecurring remodeling expenses.

The requisite adjustments vary depending on the characteristics of the business, the business interest size and the valuation purpose.

Discretionary spending

Controlling owners make key decisions about discretionary spending items, such as hiring employees, choosing vendors and paying dividends. When valuing a controlling interest, the appraiser may need to adjust financial statements for discretionary spending to more accurately reflect the economic benefits to a prospective buyer.

Joan's parents own the strip mall where Bon Appétit Café has been located for ten years. No lease has ever been signed, and it's likely that Joan's parents will raise the rent after the divorce becomes final. So, Jonah's expert reduced the bistro's 2014 projected cash flows by $45,000 to reflect market rental rates (that is, fair rental value).

Net effect on value

The result of these adjustments — adding back $11,000 for unreported cash receipts and $12,000 for nonrecurring remodeling adjustments and subtracting $45,000 for below-market rent — is a projected net cash flow of $128,000 for 2014. This equates to a value of approximately $388,000 — about $67,000 less than that of Joan's expert. So, Jonah countered with an offer of $194,000.

Accurate value

This fictitious example shows that, while financial statements are excellent for accounting purposes, they don't necessarily accurately reflect value — as is. The requisite adjustments vary depending on the characteristics of the business, the business interest size and the valuation purpose. A credentialed, experienced valuator can help you make the right adjustments for your situation. ●

The early bird wins the case

Get appraisers involved in litigation sooner rather than later

Appraisers can be invaluable and essential expert witnesses, as you know. But they can help your case even more if you engage them from the beginning — as soon as deposition questioning starts. A qualified valuation expert can facilitate questioning both in deposition and at trial. Here's some advice on how to ensure you get the most out of your valuation experts.

Choose the best

When choosing a business valuator, you want the best, so you need to assess the expert's qualifications. Ask if he or she belongs to any business valuation professional organizations — and if so, whether he or she possesses business valuation credentials. It's also a good idea to ascertain the valuator's years of experience as well as his or her level of familiarity with the subject company's industry. Look for those who make valuation their top priority and have relevant courtroom experience.

In addition, ask whether your potential appraiser specializes in a particular valuation niche. For example,

someone who works primarily for nonmonied spouses in divorce cases might be perceived as a hired gun.

Ask the right questions

Every valuation assignment is unique, but attorneys can frame deposition and trial questions around certain common denominators. Your appraiser can help you look into any potential weaknesses in the opposing expert's background and expertise, such as:

Basic business valuation. The appraiser might suggest giving the opposing expert a pop quiz on valuation basics. Obviously, he or she should be able to define fair market value and know the three approaches (cost, market and income) to valuing a business.

Hesitation and mistakes may indicate that the expert is unprepared or unqualified. If the mistakes are significant enough, a *Daubert* challenge may be a viable option.

Valuation process. Determining whether an opposing expert followed all the routine steps required to value the business is key. For example, ask whether he or she conducted a site visit and interviewed management. If not, ask why. Some experts may sidestep these procedures to reduce expenses. In adversarial situations, experts sometimes simply assume controlling owners will deny access to the company's facilities or personnel — and, thus, fail to ask for it.

Assumptions and limiting conditions. Most appraisal reports contain an appendix that lists all of the valuator's major assumptions and limitations. Your valuation expert can help you scour this statement for any red flags, such as a scope limitation, overreliance on management-prepared spreadsheets, or the valuator's (or the valuation firm's) ongoing financial interest in the client's business. These elements may introduce an element of uncertainty in the expert's case or expose potential conflicts of interest.

Get a second opinion

For more help, consider hiring a second valuation expert to act as a consultant. Your primary valuation expert can't act as an advocate for a client's financial interests. To do so would compromise his or her perceived objectivity.

Most appraisal reports contain an appendix that lists all of the valuator's major assumptions and limitations.

But a disinterested consultant can review both experts' reports and help draft targeted deposition and trial questions. In addition, the second valuator can highlight the strengths and weaknesses in both reports. But the best part is that a consultant's work product is protected by attorney-client privilege, which means you're free to discuss and promote case strategy.

Catch the worm

The more information you have — and the earlier you have it — concerning your valuation expert (and the opposing expert), the better able you'll be to craft a winning strategy. Obtaining clarification up front can help you take full advantage of your valuators' expertise — and ensure a successful outcome. ●

A little bit of growth is a *big* deal

When valuators use the income approach, long-term sustainable growth is an important assumption. That's because a small difference in the projected growth rate can have a big impact on business value.

Why growth assumptions matter

Here's a simplified example of why long-term sustainable growth rates matter. Suppose an appraiser values a business at $6.5 million as of Dec. 31, 2013, using the capitalization of earnings method.

Let's look at the math underlying this value. The company's normalized cash flows were $1 million in 2013. The valuator estimates the cost of capital at 20% and the long-term sustainable growth rate at 4%. Using the Gordon Growth Model, expected cash flows in 2014 are $1.04 million ($1 million times 104%) and the capitalization rate is 16% (20% minus 4%). Therefore, the company's value is $6.5 million ($1.04 million divided by 16%).

But, what if the appraiser used a 3% long-term sustainable growth rate instead? Then the value would be approximately $6.1 million ($1.03 million divided by 17%). Here, a 1% difference in the long-term sustainable growth rate translates into a difference in business value of more than $400,000.

How growth rates measure up

One benchmark for long-term growth is *The Livingston Survey*, published by the Federal Reserve Bank of Philadelphia. As of June 2013, the survey reports that its long-term outlook for real gross domestic product (GDP) growth for the next ten years is 2.6%. The Consumer Price Index (CPI) is expected to grow by 2.5% over the same period.

When reviewing an appraisal, ask yourself: Does the valuator's assumption make sense in light of government statistics? Because inflation is factored into the cost of capital, valuators also include the rate of inflation in their long-term sustainable growth rates. If a company is expected to only keep pace with inflation into perpetuity, the long-term sustainable growth should theoretically equal the expected rate of inflation.

But if real growth is expected — beyond that of the overall market — the company may warrant a long-term sustainable growth rate above the GDP and CPI metrics the government publishes. But some companies in declining industries or generating income from wasting assets (such as oil, gas or coal reserves) may warrant a lower long-term sustainable growth rate.

What you can do

Whenever a valuator makes assumptions about expected growth, ask yourself whether it makes sense compared with other economic indicators. Companies typically can't sustain extremely high growth rates into perpetuity. ●

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John M. Leask II (Mac), CPA/ABV, CVA, values 25 to 50 businesses annually. Often, Mac's valuations, oral or written, are compiled in conjunction with the purchase or sale of a business, to assist shareholders prepare buy/sell agreements, or to set values when shareholders purchase the interest of a retiring shareholder. Here are examples:

- **Due Diligence & Assist with Purchase of a Business.** Mac has assisted purchasers of businesses by determining or reviewing the offer. He helps negotiate the price, perform due diligence prior to closing and/or helps structure and secure financing. Services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to future success, and helping management plan future operations.
- **Family Limited Liability Partnerships, Companies & Closely Held Businesses.** Mac regularly values various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuators.

Mac also helps business owners and their CPAs and/or lawyers in the following ways:

- Planning — prior to buying or selling the business
- Prepare valuation reports in conjunction with filing estate and gift tax returns
- Plan buy/sell agreements and suggest financing arrangements
- Expert witness in divorce & shareholder disputes
- Support charitable contributions
- Document value prior to sale of charitable entities
- Assist during IRS audits involving other valuators' reports
- Succession planning
- Prepare valuation reports in conjunction with pre-nuptial agreements
- Understanding firm operations & improving firm profitability

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More information about the firm's valuation services (including case studies) may be found at www.LeaskBV.com.

To schedule an individual consultation or to discuss any other points of interest, Mac may be reached at ***203 - 255 - 3805.***
The fax is ***203 - 380 - 1289****, and e-mail is* ***Mac@LeaskBV.Com****.*

If you have a business valuation problem, Mac is always available to discuss your options — at no charge.