Viewpoint on Value

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Coming to terms with the cost of capital

Small differences in the cost of capital between opposing experts can have a disproportionately big effect on business value. But the cost of capital can be one of the most difficult — and intimidating — ingredients of business valuation for judges, jurors, attorneys and business owners to understand. Because appraisers sometimes use different approaches to determine the cost of capital (also known as the discount rate), laypeople might perceive this piece of the valuation puzzle as highly subjective. In practice, however, the cost of capital is more straightforward than you might think.

The following questions provide a framework for understanding how the cost of capital functions in business valuation.

What is the cost of capital?

The *International Glossary of Business Valuation Terms* defines the cost of capital as "the expected rate of return that the market requires in order to attract funds to a particular investment."

In short, cost of capital measures risk or uncertainty. Riskier investments warrant a higher cost of capital than lower-risk ones. In turn, the higher a company's cost of capital (or risk) is, the lower its value. The marketplace determines the cost of capital based on the likelihood that an investor will realize the expected return from an investment.

When do appraisers use the cost of capital?

The cost of capital comes into play when an appraiser uses the income approach. One popular technique that falls under the income approach is the discounted cash flow method. Over the life of an investment, owners receive a stream of cash flows (dividends or distributions) and eventually sell their interests (providing either a gain or a loss). The income approach attempts to convert these future cash flows into a present single amount using a discount rate, which is based on the cost of capital.

Appraisers also may need to calculate the cost of capital when quantifying economic damages or evaluating capital investment decisions. The cost of capital is sometimes known as a "hurdle rate." As long as a capital investment will generate a total return above a predetermined hurdle rate, it makes sense to pursue it.

Which cost of capital is appropriate?

Businesses use two types of capital to finance operations: debt and equity. Valuators sometimes appraise equity directly. When discounting equity cash flows, the appropriate cost of capital is the cost of equity.

Demystifying capitalization rates

The discounted cash flow method (see main article) isn't the only method under the income approach where cost of capital comes into play; the capitalization of earnings method also involves the cost of capital. When using this method, valuators apply a capitalization rate, rather than a discount rate, to arrive at the net present value of future cash flows. Cap rates equal the appropriate cost of capital (cost of equity or weighted average cost of capital) minus long-term sustainable growth.

You could think of cap rates as the mathematical inverse of pricing multiples derived under the market approach. In other words, a cap rate of 20% equates with a price-to-cash-flows multiple of 5. This can provide a reasonable sanity check for the cost of capital.

When comparing cap rates and pricing multiples, appraisers use metrics that apply to the same earnings stream (such as equity or invested capital cash flows) for both — otherwise, the comparison will be apples-to-oranges. For example, you can't directly compare a cap rate on invested capital *cash flows* to a price-to-net-income multiple without adjustments to the underlying variables.

This is the required rate of return on equity investors expect to receive from their investments in the subject company. Two of the most common methods for quantifying the cost of equity are the capital asset pricing model (CAPM) and the build-up method.

The cost of equity is a function of the risk-free rate, systematic risk (based on expected public stock market returns) and unsystematic risks (based on size, industry and company-specific risks). To illustrate: A large, profitable, diversified and established public company typically has a lower cost of equity than a private start-up venture without a proven track record.

Sometimes valuators value *invested capital* — that is, the combination of both debt and equity capital. In this case, the appropriate cost of capital is weighted average cost of capital (WACC). WACC is a blend of the cost of equity and the cost of debt (which has tax benefits because interest expense is tax deductible).

In determining the value of a subject interest, an appraiser subtracts interest-bearing debt from the value of invested capital to arrive at the value of equity. An invested capital method may be more appropriate than an equity method when an appraiser is valuing a controlling interest and the subject company's capital structure varies from industry norms or a strategic buyer's preferred capital structure.

When discounting cash flows, it's important to match the right cash flow stream with the right discount rate. Equity cash flows are discounted using the cost of equity — invested capital cash flows are discounted using WACC.

Invested capital cash flows differ from equity cash flows in two ways. First, invested capital cash flows don't include changes in long-term debt. Second, invested capital cash flows are adjusted for interest expense (net of its tax benefits).

The right recipe

Valuing a business is similar to baking a cake: Although accepted methods exist, there is no single recipe that every cook follows. But knowing the menu of options and the underlying ingredients — such as cost of capital — can help you evaluate the quality of an appraiser's analyses. ●

Divvying up assets in divorce

In-kind distributions of stock may warrant valuation discounts

Divorce courts typically refrain from subtracting discounts for lack of control and marketability when divvying up marital estates that include private businesses. Instead, a spouse is generally entitled to the cash equivalent value of a pro rata share of the entire business.

But the Supreme Court of Rhode Island recently made a noteworthy exception in *McCulloch v. McCulloch*. Here, the court made an "in-kind" distribution of stock by awarding one spouse 25% minority interests in two privately held businesses that were controlled by her former husband. The appellate court determined that the trial court had erred by failing to value the businesses and by assigning the spouse disproportionate ownership percentages without considering differences in control and marketability.

No value consensus

The main assets of the McCulloch marital estate were two affiliated companies worth between $106 million and $126 million combined, according to the parties' valuation experts. The court appointed a third valuator to reconcile the valuation discrepancy.

Cash can be used to buy other assets or pay off debts. But what can be done with a stock certificate — especially if there's no ready market in which to sell the stock?

The third appraiser couldn't arrive at a value opinion due to a pending merger with a Chinese supplier and extraordinary market changes. So the court decided to abstain from assigning a value to the businesses. Instead, it awarded the wife a 25%

interest in each of the businesses. The husband retained a 75% interest in each business.

On appeal, the wife argued that receiving an in-kind distribution of stock is different from receiving its cash equivalent value. Cash can be used to buy other assets or pay off debts. But what can you do with a stock certificate — especially if your former spouse controls whether you receive dividends and you have no ready market in which to sell your stock?

In-kind distribution or cash equivalent value

The Rhode Island Supreme Court agreed that the in-kind distributions essentially put one spouse in the undesirable position of having no control over his or her investments and no avenue for selling them. The opinion states that it's both "appropriate" and "necessary" to include discounts for lack of control and

marketability when a court awards unequal in-kind business interests to divorcing spouses.

These discounts wouldn't have been necessary if the wife had received cash (or another asset) for her interest in the businesses. Here, the cash equivalent value would have equaled the wife's pro rata share of the business before valuation discounts.

The appellate court remanded the case to the trial court to determine the value of the businesses and then to craft a more equitable asset distribution, based on that valuation.

Lessons learned

In *McCulloch*, the appellate court didn't mandate a cash payout. Instead, the opinion states, "An assignment of stock in a closely held corporation, which makes one spouse a minority shareholder, is generally disfavored and should be avoided whenever possible." It's generally better for one spouse to buy out the other's business interest, rather than continue to co-own or co-manage after the divorce settles — particularly when the spouses will retain unequal ownership percentages.

The case also underscores the importance of coming up with a settlement plan outside of court, rather than being at the mercy of a judge. If left to the court's discretion, the parties may end up with an undesirable settlement arrangement.

Finally, it shows that reviewing any proposed divorce settlement agreement from the perspective of a hypothetical investor is advisable. It's important to consider the rights and liquidity each spouse receives with his or her retained assets. ●

The give and take of earnouts

In a business acquisition, the buyer and seller may have difficulty reaching agreement on the business's value. To avoid a tug of war, both parties may benefit from an earnout provision requiring the buyer to make future payments to the seller. With an earnout provision, the seller enjoys the fruits of its labor if the company performs as expected, while the buyer is protected from overpaying in the event the acquisition target's performance falls short of projections. To be successful, such negotiations involve give and take — and attention to detail.

Breaking the deadlock

Earnouts can be useful not only in instances where buyers and sellers can't agree on a price, but also when the transaction is possible only if the seller decides to finance a portion of the purchase price. For example, the seller may believe the business has valuable financial prospects, therefore meriting a higher sale price, but the buyer may be unwilling — or unable — to pay it, primarily because of doubts about achieving acceptable financial projections.

To break the deadlock, the seller might agree to accept a lower payment at closing along with held interests and the promise of receiving additional remuneration if the business meets certain financial milestones. As the buyer pays these remunerations, the seller releases the held interests. In addition, the seller may maintain

rights to assets of the company if the buyer fails to meet a specified schedule.

Laying out the terms

As you can imagine, earnout provisions have several components. A valuator or financial expert can set up a quantitative formula to determine how much is to be paid if the business reaches a certain financial target. For instance, a buyer might be willing to pay the seller 20% of annual earnings that exceed the previous year's earnings by a certain amount. The target also might be based on annual cash flow, sales or other metrics. The payout provision specifies when and how many payments are to be made.

The term the earnout provision covers generally runs no longer than three years. A longer period can subject the seller to additional risk, because it increases the possibility of adverse business events that are beyond the seller's control. So if a longer period is envisaged, the seller might consider financing in the form of a loan or preferred stock in the company — both of which offer remedies in the event the business is mismanaged and the buyer can't meet its financial obligations.

Addressing contingencies

Earnout provisions also address certain contingencies that could affect the business's ability to reach the agreed-upon milestones. Say, for example, an acquired company is required to achieve a specific level of earnings. After the sale, the new owner decides to write down the value of a large asset or invest in expensive new equipment that boosts depreciation expenses. The resulting changes could significantly lower earnings, and the seller could lose out on one or more earnout payments.

Developments like these aren't uncommon, so earnout provisions need to address contingencies such as whether accounting changes should be allowed to reduce payouts and whether large capital investments should be permitted to distort expenses.

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The seller may require regular open-book access to accounting reports and other proof of financial operability to ensure accurate earnout payments. The parties will also need to address Acts of God, receiving insurance proceeds, selling the business early and arbitration procedures (in case of disputes). Finally, to avoid disagreements in the future, both parties should specify how they expect each contingency to affect earnout payments.

Getting expert advice

When buyer and seller have conflicting views about a business asset's value, an earnout can bridge the valuation gap and ensure that the deal will be beneficial for both parties. A professional valuator has the experience and expertise to ensure the earnout terms are both equitable and reasonable. ●

Expect more from rebuttal experts

Attorneys typically use rebuttal reports to critique other experts' reports or to identify sources of discrepancies between two experts' opinions. Because rebuttal reports are based on work that already exists, they can save time and money. But such reports are only effective if they're substantive and accurate.

Be calculating

A rebuttal report that identifies weaknesses and mistakes in the opposing expert's report can provide valuable insight. An attorney can use the rebuttal critique to develop his or her own technical cross-examination questions. But if a rebuttal report doesn't revise the original expert's calculations, it probably won't help a judge or jury quantify damages or value a business interest.

Case in point: *B-K Cypress Log Homes v. Auto-Owners Insurance Co.* Here, the federal district court rejected the testimony of the defendant's rebuttal expert because he didn't provide his own estimate of damages. A rebuttal report that merely criticizes another expert's work without providing an alternative methodology or analysis is "redundant and unduly prejudicial," according to the court opinion.

Put it in writing

If a rebuttal expert will testify in court, you might wonder whether a written report is necessary. Sometimes it makes sense for a rebuttal expert to provide oral testimony. Not only can oral testimony save money — because the expert doesn't spend time writing a report — but it also can introduce an element of surprise into the case.

But oral testimony about complex financial matters can be difficult for laypeople to understand and recall. So a written report that gives the judge and jury a document to consult is usually the preferred format for rebuttals.

Cover all the bases

Rebuttal reports typically take the form of memos or letters that describe:

- The rebuttal expert's methodology,
- Key errors and discrepancies,
- Authoritative references to textbooks and reputable websites, and
- Exhibits that quantify the effects of the other experts' errors, omissions or discrepancies on their conclusions.

Often alternative amounts are quantified for each error separately, cumulatively and in various combinations to help triers of fact decide cases. A strong, relevant rebuttal goes beyond poking holes in another expert's report. Objective rebuttal experts identify areas of agreement as well as *all* errors, omissions and discrepancies — not just those that support their attorneys' theories or their clients' financial interests.

Extra mile

For rebuttal experts to stand out in court, they need to go the extra mile. This means proposing an alternative methodology or analysis, putting it in writing and pointing out all errors. ●

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