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valuation & litigation briefing

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A Venture Capitalist's View of Value

Valuation influences many management decisions. For instance, an owner may need to know the value of his or her business to raise capital or to react to an unexpected bid from a competitor. Valuation is also important in acquisitions, joint ventures, strategic investments or new business opportunities. Here are some valuation factors management has to consider in any major business move.

A Position of Strength

The key issue for management is to develop a model that accurately reflects the underlying elements of the business. To do this, management needs to create robust financial projections, select appropriate valuation methodologies, determine the parameters (such as discount rates or other variables) and then compare valuation ranges with similar companies.

After the valuation range has been determined, an owner will be in a much stronger position to negotiate with potential investors. Potential acquirers or investors typically develop their own forecasts and create their own valuation models. Investors are always seeking "undervalued" companies that offer an opportunity to improve earnings. They focus on the company's earnings potential, management capabilities and competitive advantage. It is therefore important to develop detailed financial projections.

Other Important Issues

Another important issue is whether earnings over the invested capital will exceed or fall short of the cost of capital. We calculate the cost of capital by adding the cost of equity and the after-tax cost of debt in their respective proportions. Although the cost of capital calculation has been simplified, it is actually known as the weighted average cost of capital. If, for example, the return on invested capital is less than the cost of capital, the company is unlikely to generate sufficient cash to stay in business. The time to break even is a critical consideration. On the other hand, if the return on investment is in line with the cost of capital, then the company is at least profitable, although it may not be generating the level of returns required by investors.

Obviously, the company may not yet be sustainable and may have some difficulty attracting investors, who may be more interested if the returns on investment exceed the cost of capital. Venture capital managers seek to achieve returns of 25% and above on their investments.

Earnings sustainability is a key consideration and is driven by strong competitive advantage. Capital will always flow toward sustainable companies with improving earnings. Some time ago, the buy/hold/sell recommendations of various brokers for listed information technology companies were reviewed. The companies with strong earnings rates, expressed as earnings before interest, taxes, depreciation and amortization (EBITDA) to sales greater than 20%, clearly had "buy" recommendations.

The Appropriate Valuation Method

Once a valuator has developed financial projections and considered different scenarios, he or she needs to determine the most appropriate valuation methodology, taking into consideration the investment stage (seed, start-up, early or late expansion, bridge funding) and the proposed exit form (IPO or trade sale). The valuator also looks at company-specific factors such as revenue growth, margins and return-on-investment rates. Generally, two main valuation approaches work best from a venture capitalist's viewpoint.

Projecting the Future

Financial projections can help determine whether a business is an attractive and sustainable investment proposition. Projections are required for a period of up to 10 years. Because assumptions may change as a result of industry factors as well as the particular competitors, suppliers and buyers, it may be appropriate to divide the projections into two periods: the first five years and the second five years.

1 ***Capitalization of earnings.*** The capitalization of future earnings approach is based on using an appropriate multiple and applying that to the projected earnings. This approach is fairly widely used in both the public and unlisted markets and is easy to understand. But some difficulties may arise in calculating "maintainable" earnings and the selection of appropriate multiples. Is it a price earnings multiple, an EBIT or EBITDA multiple, or a cash flow multiple?

For example, if the price earnings multiple is used, the calculation is: the price earnings multiple by the net profit after-tax figure. So if the company is trading at a price earnings multiple of 10 and has a net profit after tax of $5 million, the implied valuation of the business is $50 million (assuming no debt). This valuation method is generally not suitable for companies in the seed, start-up or early development stages. It is also inappropriate for "turnarounds" or badly performing companies.

A potential investor is usually very interested in the selection of the multiple and earnings estimates. If the multiple increases and the earnings grow, a "double whammy effect" may occur. Two separate factors are working together to provide an uplift in the valuation. Venture capital managers are keenly aware of this dynamic. Essentially, they want to buy low (with low multiples) and add value (by boosting earnings) on the way through.

2 ***Discounted cash flow.*** Valuations typically use the discounted cash flow approach to value companies, acquisitions or investment opportunities for which cash flows (amount and timing) are available. This approach also is appropriate for companies in the early development stages, companies with lumpy cash flows or companies seeking to break even in the near future.

The financial projections flow into the discounted cash flow model. The problematic issues for this approach relate to selecting the discount rate and calculating the terminal value at the end of the forecast period. Depending on the stage of the investment (seed, start-up, early or late expansion, or bridge), different discount rates reflecting the business risk apply. A liquidity premium is also included in the discount rate to reflect the illiquid nature of unlisted companies.

The terminal value, depending on the future earnings potential of the business, may represent a significant part of the valuation, which reflects valuation of earnings from current and future activities. Valuators usually calculate this value as of the end of the forecast period by using the capitalization of earnings approach and then discounting back the amount.

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After the valuator applies the appropriate valuation methodology to the forecast numbers and derives a valuation range, he or she should check the numbers against the valuations of comparable companies with similar economic characteristics (size, growth rates, profitability, capital intensity and risk).

Better Decisions

Developing the necessary projections and establishing a valuation model may seem time-consuming, but your clients can make better business decisions if they understand its benefits. Whether raising capital, negotiating a sale, or evaluating future acquisitions or other investments, an awareness of the business's value is key. Please call with any questions you or your clients have regarding the relationship of value to these decisions. We would be glad to advise you. ❑

Seize the Valuation Opportunity

A business owner typically has a good handle on the company's labor costs, monthly and annual revenues, profitability, taxes and the like. But suppose someone walked up today, blank check in hand, wanting to buy the business. Would he or she know how much to ask for?

We often find that otherwise astute business owners really don't know how much their company is worth in any context. Yet sales and acquisitions, buy-sell agreements or other transfers of ownership, refinancing and public offerings, employee stock plans, tax planning and litigation all require an accurate valuation. Here's why we recommend that these evaluations be done regularly, as a preventive measure.

Why Do You Need a Valuation?

Recent developments highlight the importance of obtaining accurate and timely business valuations. Among them:

- The continued wave of mergers and acquisitions in many industry groups that have local impact — especially the automotive supplier network, health care organizations and the financial services industry.
- The Small Business Job Protection Act of 1996, which liberalized the eligibility requirements for S corporation status, has encouraged, and will likely continue to encourage, more companies to select S corporation status. This change requires a valuation as of the date of conversion. The valuation would be used if the business, or portions of it, were sold within 10 years, possibly triggering tax obligations.
- Urban redevelopment has involved many negotiations of lost business valuation with respect to partial or complete condemnation of businesses.
- An increasing incidence of aging business owners leads to succession planning for business transfers or estate/gift valuation considerations.
- Aggrieved spouses who become more aggressive in investigating and claiming some part of a company's value as a marital asset.

These circumstances are very different, but each requires an accurate estimate of value.

What Does the Future Hold?

A business is a dynamic entity. That is why when someone buys a company, what he or she is actually buying is the future earnings stream of that business. It sounds simple, but it can be difficult to determine practically. Overall, valuations have a tendency to depend on historical operating results as opposed to an assessment of future earnings — which is really the driving force supporting a business's value.

Further, obtaining reliable projections from business owners can be difficult. They either don't have time to develop projections or they provide unrealistic assessments. We are always wary of "hockey stick" projections, in which an owner unreasonably imagines that sales will increase dramatically ad infinitum. This is not to say that all projections should be ignored — many companies provide detailed, realistic projections that a valuator can use in conjunction with historical records to provide an assessment of a company's value.

What About History and Competition?

Of course, while historical records are extremely important, they also can mislead. Obvious examples include a buggy whip manufacturer at the time the Model T was introduced or a slide rule manufacturer just before the advent of the personal computer. When we face rapidly changing technology or new distribution systems, we approach historical records cautiously. Another area that affects a valuation is the company's performance compared with competitors in gross revenues, labor costs, capital expenditures, overall capitalization, market share and return on investment.

In regard to competitive trends: As corporate America continues "rightsizing" and consolidating, taking substantial charges to earnings will remain common. Valuators must be observant here, especially if a charge was taken in the past, to make sure such charges are actually recurring and don't distort the overall economic picture of the business. A valuator is also mindful of contracts won or lost since the call for a valuation went out, and on top of new regulations or legislation, such as tax or environmental law, that could impact business expenses or competitiveness.

Is It Worth the Effort?

A good valuation considers intangible assets including quality of key personnel, stability and future availability of staff, potential legal claims against a business, quality of and prospects for continued financing, and marketability. An accurate valuation requires a careful and comprehensive look at your business, where it's been and where it's going. And like strategic planning, it's well worth the effort. ❑

It All Depends

An accountant must recognize that any business will have different values, depending on the prospective transaction or dispute. Thus, book (or tax) value is not synonymous with market value. A valuator needs to ask:

- What is this business worth to an independent party?
- What is this business worth in the context of a merger or acquisition, where certain efficiencies or synergies might be realized?
- Where are the potential buyers?
- How have similar businesses traded recently?

Other dynamics such as the standard of value, the audience, the nature of the report or value communication, and governing principles, standards and regulations will also have an impact.

Reflecting the Trapped Capital Gains Taxes Adjustment

Many corporations have appreciated real estate or securities that are economic time bombs because of capital gains taxes that will be triggered when these assets are sold. Often, valuation practitioners feel that such a liability should be reflected in an adjustment to value. Common sense indicates that a hypothetical buyer would pay less for a corporation with such trapped taxes than for one with a basis in the underlying assets equal to current fair market value.

The IRS tends to take a harsh position when confronted with this type of adjustment. Until recently, most findings had generally held that valuators should make no such adjustment to value for capital gains tax liability when liquidation of the assets is speculative. In *Estate of Luton et al. v. Comm.,* the court said, "This court has consistently held that an adjustment for potential capital gains tax at the corporate level is unwarranted where there is not evidence that (1) a liquidation of the corporation was planned, or (2) a liquidation could not have been accomplished without incurring a capital gains tax at the corporate level." This decision is consistent with other court cases as well.

But in *Estate of Stewart B. Kett,* the IRS and the taxpayer settled a case that was scheduled for trial in February 1995. The issue pertained to the adjustment applicable to a real estate holding company that operated as a C corporation in which the decedent owned 100% of the stock. The settlement between the taxpayer and the IRS included a 40% adjustment from net asset value. This support of significant adjustments for the capital gains tax liability is a notable win for taxpayers.

More recently, in the appeals reversal of *Dunn,* the court stated that, "as a matter of law, the built-in gains tax liability of this particular business's assets must be considered as a dollar-for-dollar reduction when calculating the asset-based value."

How To Test the Business Damages Model

In lawsuits involving business damages, a plaintiff's damages expert commonly constructs a model that states his or her analysis and damages opinion. Understanding the elements of this model and how to question it can give you an edge in your damages cases. Let's look at the business damages model, how it is used and its potential strengths and weaknesses.

4 Categories To Consider

A business damages model typically incorporates historical data, assumptions, variables and projections which, when blended together, yield the valuation expert's opinion. The damages the valuator addresses can usually be broken into four categories:

1. Loss of past profits,

2. Loss of future profits,

3. Loss of business or intangible value, and

4. Out-of-pocket costs.

The model may be sophisticated and impressive and often includes charts and graphs. Typically, the defendant's expert evaluates the work done by the plaintiff's expert, prepares his or her own damages model and assists defense counsel in preparing for the cross-examination of the plaintiff's expert.

In evaluating the plaintiff's expert's model, it is important to address each of the four categories separately, because each may be based on different data, variables and assumptions. For example, "loss of future profits" is a prophecy of events yet to occur. The prophecy may be based on careful and thorough research or it may be based upon dreams and speculation. "Out-of-pocket costs," on the other hand, are usually based on hard evidence of actual expenditures made in the past. Accordingly, considering the quality of the data, the reasonableness of the assumptions and the soundness of the projections becomes important when evaluating the components of an expert's damages model — and the resulting opinion.

That's a Good Question

Here are several questions to consider in evaluating an expert's damages analysis:

Are the Assumptions Reasonable?

All too often an expert incorporates assumptions into his or her damages model at the direction of retaining counsel or the litigant. A typical assumption that plaintiff's counsel might provide is to "assume that the customers lost as a result of the defendant's actions are lost forever and will never be replaced." Accordingly, the expert adopting this assumption may choose to calculate the plaintiff's damages in perpetuity.

A closer look at the historical basis for this assumption might reveal that the typical longevity of a customer was only three to five years. Replacing the assumed variable (perpetuity) with the more reasonable variable (a three-to-five-year customer life) will produce a more conservative — but more accurate — measure of damages.

Does the expert have a solid foundation for the revenue, expense and earnings growth rates used in calculating his or her projections? It is not uncommon for a damages expert to naively assume that the future growth rate will be equivalent to the company's actual growth rate experienced over the past three to five years. When simply calculating or averaging a historical rate, the expert ignores changes in the economy, the industry and the company's operations. A well-prepared expert recognizes the significance of each of the important variables that affect a company's growth.

Did the expert consider the components of the company's cost structure, or did the expert merely use average cost, margin and profit percentages? A proper analysis involves unbundling the company's expenses between fixed expenses (those that do not change with changes in sales volume, such as rent, depreciation and administrative salaries) and variable expenses (those that change directly with changes in sales volume, such as materials and factory labor). Using average cost profit percentages usually renders an expert's calculations invalid, because it does not acknowledge the inflexible nature of fixed costs.

Did the expert, in gathering his or her foundational data, speak with or contact persons other than the litigants? Keep in mind that litigants are often unable to take an unbiased view of the underlying data. Accordingly, litigants may provide their experts with data that supports only their side of the case. Important documents, management reports and correspondence may have been selectively withheld from the expert in the interest of skewing the results of the expert's analysis. The information that an expert has failed to consider provides fertile ground for effective cross-examination.

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Did the expert apply his or her methods in a sound and reliable manner? With the advent of the electronic spreadsheet (for example, Microsoft® Excel) the damages expert has a broad assortment of financial and statistical analysis tools available at the click of a mouse button. But he or she may choose to apply one of these formulas without really understanding its limitations. The result is that an otherwise impressive set of calculations may have such a high rate of error as to render it meaningless.

A typical example would be an expert who simplistically applies a spreadsheet-based regression formula to five years of historical data in an attempt to project sales 20 years into the future. Although the computer will produce a projection based on the generally accepted formula, the computer won't disclose that the projection has questionable reliability.

A Model Expert

These questions represent only a few of the many that should be considered. When preparing for an expert's cross-examination, counsel is well advised to solicit the input of his or her own damages expert to help evaluate the opposing expert's analysis and opinions. ❑