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Valuation Implications of Valuing a Business Using a Measure Other Than Net Income or Net Cash Flow

In this article we consider the implications of valuing a business based on something other than net income or net cash flow. Most people can understand pricing a business or a piece of a business based on net income or net cash flow because that is truly the portion of the income stream that is left-over, or residual, profitability which could, at least in theory, be paid to shareholders as dividends. The value of any business is most simply defined as the present value of shareholder level cash flows (dividends and the terminal value when the interest is sold). But some valuations are prepared on the basis of something other than the present value of net income or net cash flow. What accounts for this?

> ***"Many industries have favorite rules of thumb ... Are they useful? Yes. Are they conclusive of value? Hmm."***

Leaving aside, for the purpose of this article, the topic of balance sheet values, appraisers often find themselves compelled for one reason or another to value a company on some other basis that net profits. Commonly, one might look at EBITDA (Earnings before interest, taxes, depreciation and amortization), EBIT (Earnings before interest and taxes), or OCF (operating cash flow, defined as EBITDA minus capital expenditure requirements). Only slightly less commonly, appraisers might define value in terms of gross profit or even revenue itself. Of course, there are also various rules of thumb and activity valuation measures that are outside the scope of this article (price per access line for a telecommunications company, price per bed for a nursing home, price per unique user for an internet company, etc.).

Valuation on these bases is somewhat confusing, because none of these measures (EBITDA, EBIT, OCF, gross profit, revenue) represents the true dividend paying capacity of a company. They are a step along the way, however, and therefore often reasonably receive considerable attention in valuation. The choice and use of these measures of value depends, at least, upon 1) the level of value appropriate for the assignment, 2) the company itself, and 3) the industry in which the company operates.

Different Levels of Value: Different Valuation Indications. Is the valuation being prepared on a minority interest basis or a controlling interest basis? If the valuation is being prepared on a minority interest basis, these other indicators of value should be used with great caution.

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Litigation Update

When to Call in a Business Appraiser

There is no doubt that valuation advisory services provide the peace of mind and thoughtful documentation required to conduct those once-in-a-lifetime transactions that may be scrutinized by tax collectors, regulators, courts, and a myriad of other lurking adversaries. Good advice is to plan to avoid negative surprises and to protect a closely held business asset from being spirited away in a cash crunch that accompanies death, retirement, change in ownership, or a similar disruption.

Compliance issues (tax, regulatory, and legal/fiduciary compliance) trigger many needs for qualified, independent valuations of closely held securities. The familiar gift, estate and income tax issues relate to minority interests, discounts for lack of

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If control is the issue, an appraiser can take more liberties. Why? Net income and/or net cash flow, depending upon which is most applicable, represents the residual income available to shareholders after accounting policies are set, capital items are funded, taxes are paid, etc. Valuing a business on the basis of such a residual income measure offers the potential to represent the value of a company to its shareholders without regard to their ability to influence any of these issues.

Since minority investors cannot unilaterally influence capital structure, revenue recognition methods, inventory accounting, and other entries above the net income line, residual profits have a particularly important meaning. Valuing a company on the basis of, say, operating cash flow (EBITDA minus capital expenditures) implies assumptions about accounting policies with regard to depreciation and amortization, the amount and type of interest bearing debt used to finance capital expenditures, discretionary tax issues, and the level of capital spending. Lots of those issues interact, of course, but, even laying that aside, a minority investor simply does not have the opportunity to affect those issues which effect value. So, an appraiser valuing a minority interest using OCF has to either accept things as is (making no adjustments), or perhaps assume certain normalizing adjustments that would arrive at a value of a well-run as-if-publicly traded company (the classic definition of a marketable, minority interest basis of value).

All in all, a controlling interest buyer has more opportunity to manipulate the structure of a company's finances to influence value than does a minority investor. The difference becomes apparent when one tries to value a particular stream of operating cash flows by developing a weighted average cost of capital (or WACC). Modeling a WACC requires three primary inputs, the cost of equity, the cost of debt, and the proportion of equity to debt. A strategic acquirer might model their weighted average cost of capital using their costs of debt and equity, which might be considerably lower than the target company's might be on a stand-alone basis. If an acquirer is willing and/or able to increase the proportion of leverage in a subject company, it can generate higher returns and/or a higher valuation (at least up to a point). A minority investor, on the other hand, can only consider the existing company's cost of debt and equity "as-is", and the proportion of the capital structure financed with debt and equity "as-is." A well-run private company will generate a WACC that is optimal, and thus the marketable, minority interest value may be very close to that of a controlling interest value, at least to a financial buyer.

Choosing Valuation Metrics Based on the Company Itself. In addition to considering the level of value, choosing which valuation metric best describes the value of a company can often depend upon the company itself. Is the company capital intensive? Is it over-leveraged? Is it under-leveraged? Is it development stage? Is it reinvesting heavily to fund more rapid growth? Importantly, is it any of these things relative to its peers? If a company is being valued even on a minority interest basis, and it is, say, over-leveraged relative to most publicly traded companies in its industry, then valuation on a debt free basis can help to normalize some of that differential. The only danger here is that it is easy to understate the risk borne by minority investors in an over-leveraged company, because their subordinate position exposes them to a very high degree of volatility of returns.

What if a company is development stage? In general, it is safe to say that developing companies generate sales first, then gross profits, then operating profits, and then net income, and maybe only then net cash flow. If a company is a new entrant to a relatively mature industry, it may have value based on strong sales or gross profits even though it has not yet generated net income. The assumption here, of course, is that one day it will,

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Litigation Update

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marketability, intangible assets and the like. Many regulatory considerations relate to transactions with ESOPs and certain (re)financings, mergers, and acquisitions. Legal and fiduciary compliance issues stem from ESOPs, transactions that affect minority shareholders and practically any deal where a law requires “fair” treatment of parties who lack control. When it comes to addressing these compliance considerations, the benefits of valuation services are understood by practically all legal and financial advisors to business owners.

Moving beyond the typical compliance issues, valuation services can be extremely useful in the litigation arena. Undoubtedly, value is the centerpiece of much business and personal litigation. The high-stakes, hard-to-quantify issues of litigation are always aggressively challenged. In essence, an expert analyst should do three things essential to assessing any question of value, whether in a litigation or a compliance environment: focus on relevant information; draw conclusions that have economic substance; and, articulate the reasonableness of conclusions in a manner that appeals to common sense.

A qualified expert has practical experience dealing with real problems of real companies and individuals. A business appraiser should be able to define the valuation issues, assemble the relevant information, and quantify the financial aspects of a case. Moreover, an expert should be able to communicate the soundness of conclusions convincingly.

Litigated issues are as diverse as the people involved and the problems that haunt them. These areas of litigation are the ones most likely to require the type of support that a business valuation professional can provide:

- **Divorce.** Controlling interests, minority interests, professional practices, partnerships, valuation

of publicly traded and restricted securities.
- **Bankruptcy.** Postmortem analysis, going-concern valuations, reorganization feasibility assessment, fraudulent conveyance, forecasting.
- **Dissenting Shareholder Actions.** "Fair value" as defined in the various states.
- **Damages.** Breach of contract, lost earnings, anti-trust, eminent domain, forecasting.
- **Arbitration.** Review of opposing experts, negotiation assistance, range estimates of value.
- **Trial Support.** Critique of opposing experts, cross examination assistance, expert testimony, economic research, public securities, market and industry research.

Having a qualified business valuation expert on a litigation team can be a wise asset-protection strategy. Downside exposure is a problem for both plaintiffs and defendants. Please give us a call to discuss our litigation support services. ◆

Purchase Price Allocation

Why Now?

Statement of Financial Accounting Standards No. 141, Business Combinations ("FAS 141"), drew a sharp distinction between goodwill and other intangible assets acquired in a transaction. As a result, the allocation of the purchase price to the various assets acquired has taken on new urgency for both public and private acquirers. The purpose of this article is to address four critical questions that are likely to be asked by the acquiring company.

1. Does my company really need to perform a purchase price allocation for acquisitions?

Yes. Allocations have actually been required since APB Opinions 16 and 17. However, prior to the issuance of FAS 141 (and 142), there was really no difference in the manner in which goodwill or other specifically identifiable intangible assets were treated subsequent to the acquisition. For this reason, readers of financial statements generally observed a single line item, "Goodwill & Intangibles" on the balance sheet, to which a uniform amortization schedule was applied. Given the disparate amortization treatment for goodwill and other intangibles under the new standards, the FASB has indicated that specific allocations of the purchase price are necessary.

As noted by the FASB's Emerging Issues Task Force in Topic No. D-100, "The Board believes that many entities concluded that their financial statements were prepared in accordance with generally accepted accounting principles, in all material respects, even though intangible assets acquired in a business combination were not recognized and accounted for separately from goodwill." Such treatment will certainly not be deemed appropriate in the future.

2. What is the process for creating a sound, defensible purchase price allocation?

The process for determining the appropriate purchase price allocation invariably differs for each transaction. However, the following outline can serve as a general guide:

- *Determination of the Purchase Price* - This often-overlooked step is not so simple when a portion of the consideration consists of assets other than cash.
- *Identification of Intangible Assets Acquired* - FAS 141 provides extensive guidance to aid in determining whether a specific intangible asset needs to be recognized in the financial statements. In general, an intangible asset must be recognized if it arises from contractual or legal rights, or if it is separable from the acquired entity.
- *Valuation of Tangible Assets Acquired* - Before determining the value to assign to the intangible assets acquired (including goodwill), the appropriate valuation of the acquired tangible assets must be considered. In other words, do the tangible assets require a discount or premium to their stated book values? For acquisitions with a large component of fixed assets, the services of a real estate or machinery and equipment appraiser may be helpful.
- *Valuation of the Recognized Intangible Assets* - While specific techniques may vary somewhat, the valuation of intangible assets relies upon the same basic approaches (cost, market, and income) as the valuation of business interests. Valuations should include thorough support for each major assumption.
- *Reconciliation to Purchase Price* - When all required intangible asset valuations have been performed, the conclusions should be compared and reconciled to the price paid for the acquired entity. On a relative basis, are the amounts assigned to the various assets consistent with the purpose of, and rationale for, the acquisition? What does the amount of goodwill imply regarding the motivations of the buyer and seller, the prevailing market and industry conditions, and the nature of the business acquired?

3. What is the deadline for completing the purchase price allocation?

FAS 141 is not explicit with regard to how promptly the purchase price allocation must be completed after an acquisition. The Standard defines the allocation period as "the period that is required to identify and measure the fair value of the assets acquired and the liabilities assumed in a business combination. The allocation period ends when the acquiring entity is no longer waiting for information that it has arranged to obtain and that is known to be available or obtainable." The Standard further states that "Although the time required will vary with circumstances, the allocation period should usually not exceed one year from the consummation of a business combination."

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4. Can we perform the purchase price allocation internally?

There is no specific proscription in the Standard against performing the purchase price allocation internally. However, FAS 141 does state (at paragraph 36) that, "Among other sources of relevant information, independent appraisals and actuarial or other valuations may be used as an aid in determining the estimated fair values of assets acquired and liabilities assumed." In other words, retention of a valuation expert is not required, but your auditor will likely be eager to hear the explanation of why an independent expert was not retained to assist in the allocation.

The best independent expert to assist in the allocation process will possess a breadth of experience in business valuation, intangible asset valuation, and transaction advisory work. The expert should be thoroughly acquainted with the provisions of SFAS 141 and 142 and have experience performing both purchase price allocations and goodwill impairment testing. We will partner with your finance staff in completing an appropriate, defensible purchase price allocation. ◆

Valuation Implications

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in fact, have profits and margins similar to that of other more established companies and that a dollar of its sales will be worth an amount equivalent to a dollar of sales of another company. Of course, companies don't exist to make sales, they exist to make profits. So its important to not be lulled into a false sense of security valuing tomorrow's net income today. There needs to be a reason to think that, ultimately, returns to shareholders will materialize.

Industry Valuation Metrics. Many industries have favorite rules of thumb and popular valuation measures which are far from net income or net cash flow. All of these seek to describe the value of some kind of activity in an industry that has unique meaning. Are they useful? Yes. Are they conclusive of value? Hmm.

Beauty is in the eye of the beholder. A control-based strategic buyer with an existing platform in an industry may find more meaning in these valuation metrics than in any other. A financial buyer seeking a controlling interest should consider these valuation metrics in the context of their ability to create cash flow need to finance the capital structure. A minority investor can really only rely on these measures to the extent that they believe a company will be subject to acquisition by a strategic buyer.

There was a time in which these indications of value were meaningful even to minority investors in public companies because mergers and acquisitions were frequent, and everyone knew that those transactions were being priced based on measures which were a far cry from net income. So you could feel confident investing in a company with a triple digit P/E ratio because the acquirers in the marketplace were trading at five times revenue and your company was only trading at three times revenue, so it was undervalued.

Conclusion. In the end, earnings have become more fashionable, as have dividends. Those who knew the price of everything and the value of nothing are still licking their wounds. Appraisers need to keep in mind that, ultimately, value can only be described in the terms of some form of residual cash flow and a discount rate. ◆

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