

Viewpoint on Value

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The art of quantifying
company-specific risk

Fatal flaws
Finding weaknesses in
an opposing expert's opinion

Beware of the
capricious court

Qualities every
valuator must have



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The art of quantifying company-specific risk

Company-specific risk (CSR) is one of the most subjective components of business value. According to Business Valuation Resources' 2009 *Glossary of Business Valuation Terms*, company-specific risk (also known as unsystematic or investment-specific risk) is “the portion of total risk specific to an individual asset that can be avoided through diversification.” In other words, CSR represents the incremental risk an investor bears by investing in only one particular business.

Quantifying CSR can be tricky absent good empirical research or market data. This is where the “art” of appraisal comes into play.

Using CSR in valuation

A valuator typically assesses CSR when estimating a private firm's cost of equity — one component of the company's discount rate, or required rate of return. The valuator uses the discount rate as a variable in the income approach, which is one of the three generally accepted valuation techniques.

A valuator can observe other components of the cost of equity directly from public markets or empirical studies, such as data published by Morningstar/Ibbotson or Duff and Phelps. For example, the valuator might begin by measuring the risk-free rate per the return on a long-term U.S. Treasury bond.

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But virtually no published market data exists for private firm prices or financial performance. So quantifying CSR for a privately held company ultimately is left to a valuator's professional judgment.



A valuator usually captures CSR by adding a premium to the cost of equity. The riskier a business is, compared with a diversified investment portfolio, the higher its CSR premium — and the lower its value. Each business faces, and responds to, unique risk factors. The current sluggish economy has adversely affected many firms, increasing their risks and decreasing values. (See “CSR in an uncertain economy,” on page 3.)

Demystifying CSR

It's important to note that valuers don't arbitrarily pull CSR premiums out of their hats. Rather, they use models and factor analysis to quantify CSR. A valuation expert's techniques vary, depending on

case specifics and personal (or firm) preferences. While the concept of CSR is widely accepted in valuation science, no consensus exists on *exactly* how to estimate it — or on the appropriate range of the CSR premium.

In general, however, some important qualitative factors a valuator addresses when quantifying CSR include:

Market risk. Macro- and microeconomic factors affect risk. To illustrate, a valuator considers the level of competition, relative market share, risk of product substitution, regulatory environment, and local and national economic conditions.

Business risk. Internal factors also impact CSR. Operating inefficiencies, insufficient plant capacity, dilapidated equipment, pending litigation and poor labor union relations add business risk, for example. Small firms and startups also may be riskier.

Management risk. Undue reliance on key persons increases CSR. Other signs of management risk include restricted access to accounting information and weak internal controls.

Concentration risk. When evaluating concentration risk, a valuator assesses the relative power of buyers and suppliers along the company's supply chain. If a customer (or supplier) represents 10% or more of the subject company's revenues (or purchases), that should raise a red flag — especially if there are no long-term contracts.

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Financial risk. Investors also consider the ratio of debt to equity. For example, investors prefer businesses with low debt levels and high credit ratings.

Another way a valuator tackles CSR is by analyzing a company's strengths, weaknesses, opportunities and threats — or SWOT. A SWOT analysis not only

CSR in an uncertain economy

Today's business landscape is markedly different than it was ten years ago. Evaluating company-specific risk (CSR) in an uncertain economy presents numerous challenges.

Value is a function of long-term future expectations, not historic results. A valuator must consider how current economic conditions affect the subject company's long-term operations, as well as how effectively management responds to these challenges.

Recessions and economic uncertainty are part of the business cycle. But a bad downturn can force many sectors, such as homebuilders, auto dealers and retailers, to radically rethink their business models.



On the other hand, a valuator needs to avoid double-counting risk factors when valuing a business. For example, he or she might factor economic uncertainty into income projections, marketability discounts, guideline company selection criteria, pricing multiples and CSR premiums. An experienced appraiser understands how to achieve balance — by equitably accounting for economic adversity in his or her valuation.

identifies pros and cons, but it also addresses how management responds to its environment. A strength or an opportunity only builds value if management capitalizes on it. Similarly, management can mitigate threats and weaknesses by taking corrective action.

Defending CSR

Like a work of art, a valuator's opinions sometimes need to be defended from critics. CSR premiums are an easy target for opposing counsel. A strong valuation report defines CSR, establishes the need to apply a CSR premium and details how the premium was quantified. On the stand, a valuation expert should be able to fully articulate his or her analyses and opinions. ●

Fatal flaws

Finding weaknesses in an opposing expert's opinion

A key function of a financial expert is to provide effective rebuttal to the opposing expert's analysis and opinions. Accordingly, counsel must gather foundational information about the opposing expert's opinions, including a complete understanding of their methodology, information, sources, authorities and assumptions.

Use the deposition to your advantage

To ensure your expert witness has full knowledge of your case, ask him or her to prepare questions for the opposing expert's deposition. You may even want your valuator to attend the deposition, in which case he or she should be familiar with, and be prepared to respond to, questions about the opposing expert's opinions.

If your expert doesn't attend the deposition, make sure he or she reviews the opposing expert's deposition transcript before trial to point out any weaknesses or inconsistencies with the expert's written report.

Connect with the case

Someone is bound to disagree with your valuation expert's opinions. But the key for an expert is to

connect his or her valuation opinions with the case at hand. The expert witness must show the judge and jury why a particular expert opinion applies to the case.

This may also involve showing why the opposing expert's views aren't relevant to the case. It may be clear that the opposing expert is unfamiliar with the plaintiff's industry, or that his or her expertise doesn't pertain to the business under discussion.

In addition to clarifying his or her own financial analyses, your valuator can also critique the opposing expert's report — either formally in a rebuttal report or informally in a verbal discussion or memo.

One valuable piece of information is the opposing expert's workpaper file. Time and money permitting, ask your valuator to inspect the other expert's files to



uncover the documents reviewed, assumptions made and other underlying details of the valuator's work. This step can be especially fruitful if the valuator's report is brief, vague or hard to follow.

Understanding the opposing expert's testimony and report (if any) is — or should be — an important part of your valuation expert's work. In addition to clarifying his or her own financial analyses, your valuator can also critique the opposing expert's report — either formally in a rebuttal report or informally in a verbal discussion or a memo format. This critique will likely expose the other side's technical flaws.

Common attorney mistakes

When using valuation experts in court, attorneys typically make the following common mistakes that erode the expert's effectiveness:

Narrowly defining area of expertise. When an expert witness designation too narrowly defines the expert's area of testimony, the court may exclude his or her opinions on important matters.

Engaging an expert too late in the process. Often, attorneys attempt to conserve costs by deferring the retention of experts until the last possible moment. The downside is that the expert is at a disadvantage — he or she isn't able to consider evidence that would customarily be relied on.

Failing to ask which documents the expert needs in discovery. An attorney might hand over a stack of discovery documents to the expert, implying that

they cover everything the expert needs to make his or her analysis. But the expert may quickly find that the documents are insufficient to allow a thorough enough analysis to support his or her intended testimony.

In addition, unanticipated events — including evidence exclusion or new evidence, witness testimony that differs from expectations, and scheduling changes — may come up during a trial. New evidence is often important to the expert's analysis, and he or she should be given the opportunity to consider it.

Style and substance

You and your expert witness may be unfamiliar with the opposing attorney's style. You may find it difficult to predict whether opposing counsel will be polite, arrogant or condescending.

Will opposing counsel pose questions crisply or engage in long prefatory statements before getting to the actual question? The manner in which questions are asked can affect how a judge or jury perceives your expert's testimony.

Cover the bases

These are just a few of the factors that can affect your cases' outcomes. The more you and your valuation expert know about the opposing expert's knowledge, methods and assumptions, the more effective your expert will be in critiquing and responding to his or her analysis and opinions. ●



Beware of the capricious court

In every civil lawsuit, the goal is to settle amicably out of court. Settlement allows disputing parties to consider their individual preferences and customize how payouts are structured. Undesirable and even irrational outcomes may result if settlement is left to the court's discretion.

A controversial divorce case, *In re Marriage of DeVries*, drives home this point. Here, a California family court cast aside business valuation standards in favor of legal precedent that permits flexibility in valuing business interests. The results — which a California Court of Appeals affirmed — surprised the husband, his legal team and the business valuation community.

Court embraces 30-year-old case law

One of the key marital assets in the DeVries marital estate was the husband's construction business. The court-appointed valuation expert used three methods to value Brian DeVries Construction Inc.

Using both the excess earnings and income capitalization methods, she testified that the company was worth \$750,000 (adjusted net book value), concluding that its goodwill had no value on Dec. 31, 2005.

Using a rule of thumb of three times past gross profits, she estimated a value of \$850,000, including goodwill of \$100,000. She chose a multiple of gross profits because she felt it was the "cleanest number" on the income statement.

In accepting the value based on her third method, the rule of thumb, the court cited *In re Marriage of Foster*. In this 1974 divorce case, the husband's medical practice was valued using a rule of thumb of three times accounts receivable.

A surprising result

On appeal, the husband asserted, among other things, that the trial court had erroneously valued his business. He argued that valuing a business based solely on a rule of thumb violates "Statement of Standards on



Valuation Services, Statement One" (SVSS-1), issued by the American Institute of Certified Public Accountants.

The husband's accountant testified that "a rule of thumb is typically a reasonableness check against other methods used and should generally not be used as the only method to estimate the value of the subject interest."

But the California Fourth Appellate District Court, Division Three, affirmed the lower court's determination of value. Its unpublished opinion states, "The courts have not laid down rigid and unvarying rules for the determination of the value of goodwill but have indicated that each case must be determined on its own facts and circumstances and the evidence must be such as legitimately establishes value."

Moreover, the appellate court concluded that a valuator's opinion is "admissible but is not conclusive." It's also noteworthy that SVSS-1 took effect almost two years *after* the business was valued in 2005.

Leave nothing to chance

As this case demonstrates, trials can be a gamble. A judge may well cast aside expert testimony and instead “split the baby.” It’s important to remember that legal precedent — even if outdated or applying to an entirely different industry — is inside a judge’s comfort zone. However, professional valuation standards often are unfamiliar territory.

When settlement is an unrealistic goal, protect your side’s financial interests with a detailed valuation report and comprehensive verbal testimony. A valuation expert should understand, reference and, if necessary, dispute relevant professional standards, valuation publications, empirical data and legal precedent. Attorneys and valuers must educate one another, so no stone is left unturned. ●

Qualities every valuator must have

Gone are the days of “cowboy” valuation. Courts and regulatory agencies expect today’s valuation expert to commit full-time to appraisals and to stay current with the latest techniques, legal precedent and empirical research.

Specifically, both the Small Business Administration (SBA) and the IRS are currently evaluating what it takes to be a “qualified appraiser.” The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) also are putting together standards for fair value reporting.

Up-to-date credentials are imperative in a valuation-savvy world. Several organizations offer training and licensing for valuing businesses, including the:

- American Institute of Certified Public Accountants (AICPA), which offers the Accredited in Business Valuation (ABV) designation,
- American Society of Appraisers (ASA), which offers the Accredited Senior Appraiser (ASA) and Accredited Member (AM) designations,
- Institute of Business Appraisers (IBA), which offers the Certified Business Appraiser (CBA) designation, and
- National Association of Certified Valuation Analysts (NACVA), which offers the Certified Valuation Analyst (CVA) designation.

Each organization has specific requirements for work experience, course work, examinations and recertification. It’s a good idea to inquire whether your valuator is current on his or her continuing professional education. It’s easy for part-time valuers to become lax.

Also check how much time the expert devotes to appraisal. With such a vast body of knowledge, it’s unrealistic to expect an individual who spends, say, 10% of his or her time valuing businesses to be fully up to speed on the process.

Valuers without these must-haves can place their clients at risk. For example, a part-time valuator who uses unconventional methodology might trigger — and lose — a *Daubert* challenge in federal court. Avoid unnecessary hassle and potential disqualification by picking a qualified expert from the get-go.

