



WHAT TO LOOK FOR WHEN REVIEWING A BUSINESS VALUATION

A. OVERVIEW

So, you or your client have hired an appraiser to value your client's business for any number of reasons. Perhaps your client wants to retire and sell his company to key members of management, or to his children, or to an outside strategic buyer. The appraisal arrives in the mail, you tear it open to find out how much the company is worth, but other than the value conclusion in bold on the first page of the report, you have no idea how the conclusion was arrived at or if it's even a reasonable conclusion. In this section, we will give you some quick tips for doing an initial review of a business valuation in order to help you identify some key areas of discussion with the appraiser.

B. STANDARD OF VALUE; PURPOSE OF THE VALUATION; VALUATION DATE

Probably the very first thing to look at is the first paragraph of the report, which will usually give the date of the valuation, the purpose for the valuation, and the standard of value. Make sure that each item is appropriate for the particular circumstances.

With regard to purpose, note that valuations prepared for different purposes can result in different value conclusions. For example, a valuation prepared for divorce purposes may result in a different conclusion than one prepared for estate purposes.

We often run into the situation where a company was valued one or more years ago for purposes of obtaining bank financing, for example, and the owner would like to use that appraisal

for purposes of a shareholder buyout. It is generally best in that situation to obtain a new appraisal as of the appropriate date and for the specific intended use.

Also check the standard of value. Fair market value, fair value, strategic value, and intrinsic value will all result in different value conclusions.

The standard of value will also help determine whether it is appropriate to take discounts. If the standard is *fair market value* and the valuation is of a minority interest, the report should include discounts for lack of control and lack of marketability. However, if the standard of value is *fair value*, the value of a minority interest will likely be a pro-rata portion of the whole, without regard to discounts.

C. IS THE FORECASTED CASH FLOW REASONABLE?

When reviewing a business valuation that has relied on an income approach, the fastest check for reasonableness is usually a look at the forecasted cash flow.

While financial statements are historical and represent the company's past performance, business valuations are forward looking and attempt to predict the company's future performance (because the value of an investment is a function of what it will do for an owner in the future, not what it has done for an owner in the past). Future performance is typically based on the company's historical performance, as well as an assessment of qualitative factors that will impact its future performance, such as the outlook for the industry, the competitive environment, and forecasted economic conditions. The company may have also undergone internal changes that will impact its future performance, such as the acquisition of new, state-of-the art machinery, or new leadership. Given all of these factors, does the forecasted cash flow appear reasonable? Things to look for include:

Use of historical averages- when the company's financial outlook is expected to be different from its historical performance, using historical averages is unlikely to result in accurate cash flow projections.

Projections that look like a hockey stick – when a company has had relatively stable historical results that resemble the flat part of a hockey stick, and then the projections shoot up like the handle of a hockey stick, we call these “hockey stick” projections. It is generally unreasonable, except perhaps in the situation of a start-up company, for a company's performance to change so drastically in such a short period of time. If a company is expecting such drastic improvement, this should be supported by explanation in the valuation report.

Reverse hockey stick – Likewise, the valuation may project that the company's earnings are going to decline drastically, perhaps because of some significant change in the industry or because of the impact of new competition into the market. It is important to try to predict whether the forces that are driving the downturn are completely out of the control of the company, or whether they might seek to develop new products or sell in new markets, in order to prevent such a downturn.

For example, we reviewed an opposing appraiser's valuation of a residential construction company, in which the appraiser claimed that, due to limits on building permits in the town where the company builds most of its homes, the company was not going to be able to build as many homes and as such, was going to experience a significant decline in revenue and profit. However, it is more likely the case that the company would seek to expand its business into surrounding towns where such building permits did not exist, in order to maintain its current level of home building. In fact, the company has done just that.

The forecasted cash flow is a critical component of a valuation that relies on the income approach. Double check it for reasonableness and look for supporting explanations within the valuation report itself.

D. DOES THE DISCOUNT/CAPITALIZATION RATE MATCH THE FORECASTED CASH FLOW?

It is essential that the economic income stream that is projected be clearly defined and that the discount or capitalization rate used is appropriate for that definition of economic income being used in the analysis.

The capitalization rate (for capitalized cash flow method) and the discount rate (for discounted cash flow method) should also reflect the riskiness of achieving the projected cash flow. For example, if there is a great degree of risk of achieving the projected cash flow, one would expect the rate of return to be relatively high. Likewise, if there is more certainty of achieving the projected cash flow, you might expect a relatively low rate of return.

E. ARE THE COMPANIES CHOSEN FOR THE MARKET DATA APPROACH COMPARABLE TO THE SUBJECT COMPANY?

If the market approach was used in the valuation, take a look at the companies selected to see whether they are, in fact, reasonably comparable to your client.

A good place to start is to see whether the business descriptions of the selected companies match your client's business description. The wording of the business descriptions may not be an exact match, but the industry, economic, and competitive forces that impact your client should be the same forces that impact the comparable companies.

We once reviewed an opposing appraiser's valuation report in which he had used transactions of regular grocery stores as comparable to the subject company, which was a whole foods/natural foods store. In fact, these two types of business are extremely different in terms of profit margins, customer demographics, sensitivity to shifts in the economy, etc. As would be expected, the pricing multiples for these two distinct types of business were vastly different, and as such, application of

market pricing multiples of grocery stores to the financial results of a whole foods store results in an inaccurate value.

Another check is to see whether the companies selected are comparable to your client in terms of sales size, profit margins, and asset base. A company generating \$100 million of revenue and ten locations across the United States is probably going to command different pricing multiples than your \$5 million client in Waterville. Or vice versa, there are many transactions of very small companies out there, which will also not be comparable to your \$5 million client. A range of sizes of companies is fine, but the range should not be too extreme in either direction.

F. WHAT ADJUSTMENTS HAVE BEEN MADE TO THE CASH FLOW AND ARE THEY REASONABLE?

During the valuation process, there are several adjustments that may be made to a company's financial statements in order to present the company's financial results in terms of current economic reality. In this section we will review items that may require adjustment and how to spot them.

Owner compensation: As noted above, owner compensation may not be at market levels. This adjustment can sometimes have a significant impact on value and should be checked for reasonableness.

Working Capital: If the company is being valued using the income approach, and the measure of economic income is cash flow, the appraiser should give consideration to additional working capital needs if growth is forecasted. Likewise, a reduction in working capital needs may result if a downturn is forecasted for the company.

Other: Double check other adjustments to cash flow, such as adjusting related party transactions to fair market value, adjustments to owner perquisites, and others, to see that they appear reasonable.

G. NON-OPERATING ITEMS

If the company has non-operating assets or liabilities, such as excess cash or marketable securities, non-operating real estate, or equipment not necessary for operating the business, these items must be added back to the value of the business as determined under all three valuation approaches. Double check to see that these add-backs have not been overlooked.