

# Viewpoint on Value



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## Risk assessment

# The added value of benchmarking

**A**ssessing risk is a crucial part of valuing a business. Appraisers use risk assessments in the income approach to estimate discount rates and in the market approach to select comparables. All else being equal, the higher a business's risk, the lower its value. Benchmarking a business against its competitors — or itself over time — is one way that valuers assess risk.

### Factors that affect risk

A comprehensive benchmarking study — also known as a “financial analysis” — compares various attributes of the company being valued against industry averages or specific competitors. If an attribute compares unfavorably, that generally indicates higher risk.

Here's a look at the components of a comprehensive benchmarking study and how various factors affect risk:

**Size.** The size of a business is conventionally measured in terms of market share, annual sales or total

assets. In general, small private firms are riskier than large public companies. Large firms tend to have stronger internal controls, more professional management, more reliable financial reporting, and more resources to weather economic downturns.

But bigger isn't always better. Sometimes niche players earn higher profit margins because they specialize in one market segment. Firms that deviate from their core market sometimes choose to divest noncore operations to improve performance. For example, McDonald's Corporation sold off subsidiary Chipotle Mexican Grill in 2006 to strengthen its balance sheet and to refocus on its core burger operations.

**Growth.** Typically, valuers measure growth as the dollar and percentage change in revenues, profits or market share from year to year. Steady upward growth is ideal. But rapid growth can be just as perilous as a rapid decline. Companies that grow too fast have a voracious appetite for cash — and it's all too common for such firms to take on more debt than their cash flow streams can support.

Like all benchmarks, historic growth is relevant only to the extent that it demonstrates future trends. Valuation is a prophecy — so to speak — of future earnings potential. Companies with strong growth expectations almost always carry less risk than those with poor outlooks.

**Liquidity.** Liquid companies have sufficient current assets to meet their current obligations. Cash is



## Benchmarking comes in many shapes and sizes

Appraisers use various strategies to help analyze a company's financial performance. Here are three:

**1. Horizontal.** A good starting point is to put the subject company's financial statements side by side and compare them. A comparison of two or more years of financial data is known as horizontal analysis. Often changes are shown as a dollar amount and percentage.

For example, if accounts receivable increased from \$1 million in 2009 to \$1.2 million in 2010, the difference is \$200,000, or 20%. Horizontal analysis helps valuers identify trends.

**2. Vertical.** Valuers also highlight changes with vertical (or common-size) analysis, which shows line items as a percentage of sales or total assets. For example, a common-size income statement — which shows each line item as a percentage of sales — explains how each dollar of sales is distributed between costs, expenses and profits.

Changes in such statements over time — a combination of horizontal and vertical analysis — can highlight trends and operating inefficiencies.

**3. Ratios.** Ratio analysis shows the relationships between various items on a company's financial statements. For example, profit margin equals net income divided by sales.

Valuers typically use ratios to benchmark the subject company against competitors (which may be bigger or smaller) or in comparison with industry averages. What's good or bad for a particular ratio depends on the industry in which the subject company operates.

Sources of comparative data include industry trade associations and benchmarking publications, such as Risk Management Association's *Annual Statement Studies*, MicroBilt's *Integra 5 Year Industry Benchmarking Data* reports, and First Research's *Industry Profiles*.

obviously the most liquid asset, followed by marketable securities, receivables and inventory.

Working capital — the difference between current assets and current liabilities — is one way to measure liquidity. Others include working capital as a percentage of total assets and the current ratio. (See "Benchmarking comes in many shapes and sizes" above for more on ratios.) A more rigorous benchmark is the acid (or quick) test, which excludes inventory and prepaid assets from the equation.

**Profitability.** Public companies focus on earnings per share, but private firms tend to look at profit margin and gross margin. Comparisons usually require adjustments for nonrecurring items, discretionary spending and related-party transactions. When comparing companies with different tax structures, leverage or depreciation methods, valuers turn to earnings before interest, taxes, depreciation and amortization (EBITDA).

**Turnover.** Turnover ratios show how efficiently companies manage their assets. Total asset turnover (sales divided by total assets) estimates how many dollars in sales a company generates for every dollar invested in assets. In general, the more dollars earned, the less risky a business is.

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Turnover ratios also can be measured for each category of assets. Valuers often calculate inventory and receivables turnover ratios in terms of days. For example, the collection period equals average receivables divided by annual sales times 365 days.

A collection period of 45 days indicates that the company takes an average of one and one-half months to collect invoices.

**Leverage.** A company's ratio of debt and equity also sheds light on risk. But leverage is a double-edged sword. Debt allows businesses to earn a return using other people's money. But debt load can spiral out of control if a business is paying an exorbitant interest rate and can't repay its obligations.

The debt-to-equity ratio is one leverage ratio, but valuers also look at the interest coverage ratio — earnings before interest and taxes (EBIT) divided by interest expense. The latter ratio shows how many

times EBIT will cover interest expense. Burden ratios are similar but incorporate principal repayment into the equation.

### A management tool

A comprehensive benchmarking study can help valuers gauge risk, but it offers value beyond the appraisal, as well. Owners and managers can use a valuator's risk assessment (including the company's cost of capital) as a strategic management tool, and benchmarking can help identify a business's strengths, weaknesses and trends. This portion of a valuation report can serve as a springboard for discussions on how to improve a company's operating efficiency and build value. ●

## Re-evaluating discount rates in a distressed economy

Under the income approach, value is a function of risk and return. Put another way, investors require a certain *return* for taking on the *risk* of investing in a business. Valuers measure risk using discount (and capitalization) rates and measure return using future income streams.

Estimating discount rates is a complex task — even in the best of times. But the volatile economy has forced valuers to re-evaluate traditional methods of quantifying discount rates.

### Many questions, little agreement

Here are some of the issues currently facing valuers as they estimate discount rates:

**What's the appropriate risk-free rate?** The risk-free rate is a fundamental building block of the cost of equity and, therefore, of every discount rate. Long-term Treasury bond rates — which are commonly used to estimate the risk-free rate — have dropped significantly compared to historic rates.

Some valuers are grappling with the issue of whether to use current T-bond rates or adjusted rates based on higher historic values.

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### Are historic capital structures reasonable?

Valuers often use the weighted average cost of capital (WACC) as their discount rate. WACC includes the cost of both debt and equity financing. With debt financing scarce, some private firms might have to finance future growth internally, rather than with loans, thus altering their historic blend of debt and equity.

**What's the appropriate cost of debt?** Interest expense is tax deductible, so valuers typically use an after-tax cost of debt. The tax shield is an added bonus of debt financing, which decreases WACC. But for unprofitable companies there's little if any tax benefit to paying interest, because they owe no taxes and often have net operating losses that carry forward to offset tax liability in future years.

**How should ERP be quantified?** Equity risk premiums (ERP) are another component of the cost of equity. Valuers may use the cost of equity as a discount rate or as a key component of a discount rate, depending on the income stream being discounted (equity or invested capital). Valuers can refer to several data sources, including Duff & Phelps or Morningstar. Moreover, they can refine the data — by size and industry code, for example — to obtain a more comparable sample. Currently, ERP is on the rise, and some valuers advocate using current rates over historic long-term rates.

There's little consensus on these issues. And finding the correct answers requires professional judgment and knowledge of case specifics. Given this context, many valuers are modifying their traditional methods and models by taking into account both historic and current long-term rates. And written appraisal reports must address the above questions to adequately support the valuers' estimates and opinions.

## Pitfalls and best practices

Valuers typically weave the effects of economic uncertainty into their analyses to avoid double-counting risk factors in the various components of their discount rates (such as the risk-free rate, equity risk premium and company-specific risk) or elsewhere in their calculations (such as when they quantify income streams and marketability discounts).

At the end of the day, however, appraisers must stand back and ask themselves whether discount rate results appear reasonable — that is, whether the discount rate reflects an accurate return as required by an investor based on the risk associated with a particular investment.

No one can predict the future with 100% accuracy, but detailed market and industry research goes a long way to support discount rates and other appraisal judgment calls. The recession has permanently altered some businesses. This being the case, historic performance may not always be a reliable predictor of future performance.

## Experience counts

When quantifying discount rates in an uncertain economy, one thing is certain: You need an experienced, full-time valuation professional who's on top of the latest research, trends and professional debates. Status quo, cookie-cutter approaches are perilous in today's economic environment. ●



# Valuators cover the gamut from A to Z

Estimating and documenting the value of a business interest is neither intuitive nor the result of applying basic rules of thumb. A credible valuation that can withstand professional scrutiny requires diligent research and analysis of both the business interest itself and relevant valuation data, documented in an explanatory report.

Whether the situation involves assessing the value of an apple orchard in a divorce settlement or zeroing in on the damages suffered by a zipper manufacturer, a valuation professional begins by gathering background information about the business interest and its industry. Much information is gathered by talking with management and other relevant parties. The appraiser also considers economic forecasts and information affecting the future of the industry. But a valuator's real skill is in transforming the assembled information into a meaningful valuation analysis.

## Specialized analyses are key

Suppose a valuator looks at the value of one of the most important assets of a marital estate — the retirement plan benefits accruing to the principal wage earner. A vast and complex body of knowledge exists regarding benefit analysis and valuation. So, to make an educated decision concerning value, the valuator must understand vesting schedules, actuarial considerations and other factors.

On the other hand, assume a valuator is developing an estate plan for a principal shareholder of a large corporation. Specialized valuation expertise is essential to determine the value of controlling stock interests for gifting in a recapitalization, minority and marketability discounts in the sale of partial interests, and so on. Further, if the same shareholder were involved in a divorce action, the valuation considerations and approaches would be substantially different.



Someone with only superficial knowledge of valuation theory may arrive at answers in these cases that could be inappropriate — and potentially damaging.

## The appropriate standard of value

A valuation professional understands how to determine which standard of value is most appropriate, given the specific circumstances. For example, if determining value for income, gift or estate tax purposes, a valuator typically uses fair market value, or the price a hypothetical willing buyer would pay to a hypothetical willing seller (with neither party under compulsion to act and both parties having reasonable knowledge of the relevant facts).

If involved in dissenting stockholder or other types of shareholder litigation, the valuator typically uses fair

value, or the price that fairly compensates an owner involuntarily deprived of the benefit of his or her ownership interest when neither a willing buyer nor a willing seller exists.

In a business purchase or sale transaction when the buyer and seller are likely to know each other and, in fact, may be cooperating through due diligence, a valuator is likely to choose investment (synergistic) value, or the price an identified buyer (or class of buyers) would be expected to pay in light of any unique benefits or synergies the buyer will likely receive.

## A valuation can be invaluable

Valuation services can be helpful in numerous situations, including transaction planning, creating buy-sell agreements, financial restructuring, strategic and marketing analysis, litigation support and dispute resolution, tax, succession or estate planning, and divorce — to name just a few.

Whatever the circumstances, business valuations involve numerous complex analyses that can be difficult to explain to laypeople. A valuation professional understands these nuances and their ramifications and can determine the most appropriate approach for each situation. ●

## Understanding liquidation value: Are you in the know?

Numerous businesses have filed for bankruptcy in recent years. Today's faltering economy has rendered many businesses worth more "dead than alive." In other words, some businesses' liquidation values exceed their going-concern values.

Most business valuation assignments estimate the entity's going-concern value. The *International Glossary of Business Valuation Terms* defines going-concern value as "the value of a business enterprise that is expected to operate into the future."

In contrast, liquidation value is "the net amount that would be realized if the business is terminated and the assets are sold piecemeal. Liquidation can either be 'orderly' or 'forced.'" Orderly liquidation maximizes selling proceeds, because assets are sold over a longer time period. A forced liquidation (or fire sale) occurs as quickly as possible.

A company's balance sheet is a logical starting point for estimating liquidation value. But net asset value and liquidation value are not necessarily synonymous because many companies being valued using the net asset value method are going concerns.

So valutors adjust the subject company's balance sheet to reflect the amount management could reasonably expect to receive in an orderly or a forced liquidation scenario. For example, a liquidating manufacturer might receive 70 cents for each dollar in receivables and 40 cents for each dollar in inventory. Valutors also will consider that certain intangible assets — such as trained workforces and customer lists — that add value to a going-concern enterprise may be more difficult to sell in liquidation.

Liquidation value can serve as the floor for a business's value. Moreover, liquidation value is an important benchmark in bankruptcy proceedings and informal workouts. When liquidation value exceeds going-concern value and this situation isn't expected to turn around, it may be time to abandon Chapter 11 (reorganization) plans in favor of a Chapter 7 (liquidation) filing.

