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BUSINESS RISK: THE KEY TO A SUPPORTED VALUATION (AND WHY ATTORNEYS MUST UNDERSTAND IT)

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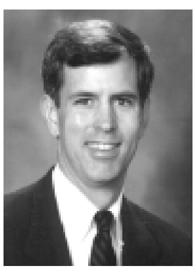
Introduction. An attorney reviewing a business valuation for his or her client or preparing for trial in a domestic or dissenting minority shareholder case must be able to ascertain if the valuator has correctly identified key business risks and opportunities and how they impact the value. While corporations, partnerships and LLCs are merely legal creations, each business is a unique mix of management, people, customers, suppliers, competition, industry, regulatory, and numerous other internal and external factors. These elements come together in unique ways to make the company what it has been, what it is today, and what it might become in the future.



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The valuator's job is to identify how these elements are present in a specific company and to discern what each element implies about the risks, opportunities, and future of the business from the viewpoint of a buyer. The most substantial risks and opportunities facing most businesses usually comes down to a handful of critical issues that tend to predominate over the others. The ability to identify these issues depends on the thoroughness of the valuation effort.

This article provides a glimpse into many of the internal and external forces that impact a company and why they are relevant to value. Banister Financial's valuators approach the company interview in a methodical way to insure a thorough understanding of the company and the identification of relevant issues and risks. A typical interview might follow the chronology shown below:

Chronology of the Company Valuation Interview

1. Background and History
2. Products and/or Services and Marketing
3. Customer Relationships
4. Supplier Relationships
5. Management and Personnel
6. Ownership
7. Past Transactions in the Shares
8. Competitors in the Industry
9. General Industry Information
10. Financial Results and Information
11. Banking and Financing Relationships
12. Contractual Relationships
13. Outlook and Forecasts at the Valuation Date
14. Litigation and Material Factors
15. Corporate Insurance
16. Wrap-up of the Interview
17. Remaining Information Needs to Complete Valuation

The following discussion covers these areas from a broad perspective in assessing the risks and potential of the business being valued. However, the list of potential issues in a given valuation assignment is far more diverse than can be covered in this brief article.

Company Background and History. An excellent way to build a foundation for understanding the business, as well as to establish rapport is to ask management to provide a brief history of the company. This builds a perspective of who founded the business, the challenges it has faced, how it has evolved over time, its activities, and the risks, and ups and downs it has faced over a longer time horizon.

Product Lines and Marketing Strategy. What does the company do or sell, and how does it purchase, manufacture or provide its product or service, and market and price them? For example, if the company manufactures a product, how does it do so? Is the manufacturing process labor intensive, or does it require a large investment in capital equipment? If the manufacturing process is capital intensive, is the technology used subject to continuing change so that the company must continually re-invest a large amount of its cash flow into purchasing new equipment? How far can the company's current manufacturing support revenues before it must add additional plant capacity? Even if the company does not need to add new equipment to expand, what is the productive life of its existing equipment and how often must it be replaced and at what cost? Are there technological innovations coming into the industry which could radically reshape the manufacturing process, or that might be proprietary to a competitor and not available to the company? If so, does that threaten the future viability of the company?

As opposed to manufacturers, most distributors and wholesalers merely stock products made and shipped to them by their suppliers. Therefore, the first focus in this analysis is to identify the brands and specific products carried. Where do the company's products stand in the price and quality spectrum versus competing products? Do the products carry a high or low market share and why? Distributors often hold contractual distributorship rights to exclusively market a product, typically in a defined geographic area such as a county or state. For a strong brand this is a positive attribute since it provides a barrier to entry that presents competition from selling the same product. Since similar competitive distributors will likely carry competing brands, the valuator's focus is on reaching a determination of how well this company's brand compares to those carried by competing distributors.

How does the company market its products or services? For example, if a company relies on independent distributors to sell its products, do they also sell competing products? How does the company differentiate its products versus others? If the product is a commodity (e.g., sugar or lumber), the company's ability to sell its product may be solely determined on having the lowest price. This would suggest that there is little customer loyalty and unless the company is a low cost producer, it may not survive on a long-term basis. If a company uses independent sales representatives or agents to sell its products or services, is there a large reliance on any one of them for a significant portion of the sales generated? If this is the case, the agent's abandonment of the line, perhaps in favor of a competing product, could be devastating. When concentrations are evident, the length and stability of the relationship should be explored, and the valuator should determine if any contracts tie the parties together, in order to assess risk.

Many companies that sell a product are subject to the forces of a product life cycle, which may be growing, mature, or declining. It is important to find out where the company's individual products stand in their respective life cycles and what this implies about risk, as well as pricing in the future. This will impact how the valuator goes about attempting to forecast a company's future revenues, expenses and earnings used in the income valuation approach. Tied to the life cycle issue is the need to identify the degree to which a company's products or services are subject to the impact of technological change and the risks this presents. In general, companies whose products or services are subject to rapid technological change tend to have a higher degree of financial and business risk.

Customers. Without customers there would be no company. Therefore, it is important to understand the nature of a company's customer relationships and what they indicate about its risk. The reliability, volatility and continuity of customer relationships affect the risk associated with a company's ability to generate revenues and earnings. A buyer is concerned with the future results that the business will generate, and is therefore interested in how the customer base impacts the returns to be realized.

The type and stability of a customer relationship is a key issue. Some businesses have transactional customers who have a non-recurring need for the company's product or service. This means that at the conclusion of the sale, the company cannot count on a future purchase by the customer. Therefore, this type of company must continually generate new customers in order to generate revenues, leading to less predictable financial results, greater volatility, and risk. A general building contractor is a good example of a company with transactional customers. The contractor places bids to win a construction project where the low price (bid) is a key factor (perhaps the only one) driving the customer's selection of a contractor. After winning and completing the project, the contractor must then find a new project to take its place or company revenues will drop. By contrast, a company with recurring customers generally has more predictable revenues.

The factors that drive the customer purchase decision impact risk. If the customer purchase decision is largely driven by price, as with a commodity, the customer may have little loyalty to a given supplier, leading to greater risk. If the customer buys the product because of its attributes, perhaps proprietary, the customer base may be more stable.

The length of customer relationships is an indicator of the stability of revenues. Companies that have long, enduring relationships with customers tend to be less risky. It is important to discern why the relationships are enduring. It may be due to something unique that competitors cannot provide, or the result of a low price, better service, or personal relationships with customers. The latter factor, personal relationships with customers, while solidifying ties, also presents a risk factor in many closely held companies. A customer may have dealt with the company because of close personal ties to the owner or a key salesperson. If either individual at the company were to die or leave the company, the personal relationship would no longer exist and the customer might go elsewhere.

The degree to which one or several customers account for a significant portion of a company's revenues can be a significant risk factor and is common in many closely held companies. For example, if one customer accounts for 50% of a company's revenues, the loss of that customer could be devastating. In situations where larger concentrations exist, the degree or risk can be impacted by the longevity of the relationship, the degree to which any long-term contracts exist which tie the customer to the company, and the volatility of the revenues the customer generates from one year to the next.

The geographical distribution of the customer base can increase or reduce risk. A company whose customer base is concentrated in one geographic area may be more susceptible to downturns in that area's economy that impact its customers. A company that has a geographically diverse customer base may be less threatened since one area's economy may do well, offsetting or mitigating the full effect of an area where the economy is doing poorly.

Supplier Relationships. If customers push the throttle, the suppliers furnish the gas. A company cannot sell its products to customers if it cannot secure what it needs from suppliers to do so. Therefore, the nature and stability of suppliers is an important consideration in identifying a company's risk.

If a company is heavily dependent upon a particular supplier, or could not find the product elsewhere, it is important to know if the company-supplier relationship is a good one and not in jeopardy of being lost. It is also helpful to know if a company has long-term supply contracts with a key supplier which give it a competitive advantage by locking in a favorable cost for a product. Alternatively, a long-term contract may be disadvantageous for a company by being at a price which is now well above market levels.

Suppliers can sometimes become future competitors of their customer (such as a distributor) and cut them out entirely, going straight to the end customer with the product at a lower price. Whenever a valuation involves a wholesaler or distributor in particular, this is an issue to consider. Many wholesaling and distribution industries are experiencing a compression of the distance between the manufacturer and the customer, with levels of intermediaries being eliminated. Even if this has not yet occurred in an industry, it does not mean that the risk is not present in the future

Management and Personnel. The quality and continuity of management is often the key that differentiates successful companies from those that perform poorly. Additionally, the degree of a company's reliance on one or several people can materially impact a company's risk since the death or departure of these individuals could hurt the company. It is important that the valuator assess these issues in a closely held company valuation.

Other sources of key person risk can arise if there are other individuals whose loss could harm the company. A key salesperson might be responsible for the company's two largest accounts. If she leaves to go to a competitor the customers may leave also. A company's chief financial officer may be largely responsible for the continuing ability of a company to retain the confidence and financing from its banks. The potential for key person risk can be found by examining the roles various individuals play in the company and where their loss would damage the business.

Ownership. In valuing less than a 100% controlling interest, the distribution of ownership, shareholder rights, the impact of state law, and other factors impact the applicability and size of control premiums, or minority and lack of marketability discounts that are warranted. When there are multiple shareholders, the valuator should be attuned to evidence of discord among existing shareholders that may impact the company's present or future performance. If the shareholders do not get along, there is a good chance the financial results of the company will suffer. Management attention will be diverted and there may be a lack of clear direction, increasing the risk that the company will experience difficulties.

Past Transactions in the Shares. Past transactions in the shares of a company can sometimes serve as valid indicators of the current fair market value of the shares. Therefore, it is important that this information, if it has not already been supplied to the business appraiser, be discussed in the interview process.

It is important to determine if management is considering a possible sale of the company, if it has recently received offers for its purchase, or is in negotiations with a prospective buyer. The knowledge that there are discussions underway with a buyer could be highly relevant. Suppose the assignment were to value a minority interest for gifting purposes. Without knowledge of a transaction the shares might be discounted for their minority interest status and lack of marketability, and be valued at $30.00 per share. What if the company was in negotiations to sell all shares to a buyer for $100.00 per share, a 100% control price? A willing seller of the shares, having all knowledge of the relevant facts, would be very unlikely to part with their shares for the minority price knowing the control price was likely.

Competitors in the Industry. Companies do not live in a vacuum and are influenced to a significant degree by the competitive environment they face. The degree of competition and the company's relative strengths and weaknesses versus its competitors has a significant influence on its financial performance and risk. Who is the competition? Where are they headquartered and how large are they? What are the relative strengths and weaknesses of competitors versus the subject company? Do competitors have a better product or service, access to cheaper capital, proprietary techniques, patents or trade secrets, or other factors that place them at an advantage? The company being valued might also possess certain of these attributes that might enhance its ability to compete. What is the market share of the company and its competitors? A company with a high market share may have economies of scale and be able to produce or distribute its product or service more cheaply, giving the company a competitive advantage.

Are there any barriers to entry into the industry which limit competition? Barriers can stem from a variety of factors such as licensing, large capital requirements to operate, exclusive distribution rights, possessing proprietary patents, or technology, to name a few. The presence of these factors may serve to reduce the risk of competition. In some types of businesses, the limits to potential competitors are negligible. On the Internet, innovators will frequently be found marketing a product on-line. Unless the company has a proprietary product, imitators quickly spring up, copying the idea. In many cases, Internet commerce requires little more than a computer, the ability to design a web page, and limited capital to get started.

General Industry Information. Industry trends and factors impact participants. A smart company owner and well-prepared business strategy may not overcome a poor industry demand outlook or the threat of regulatory problems. The valuator should attempt to identify positive and negative factors impacting the industry, information on any short or long-term growth forecasts, industry participants, and any threats.

Banking and Financing Relationships. Unless a company is in an industry that requires limited capital (such as a professional practice) or has the luxury of a strong equity base, most companies could not survive without access to affordable bank credit. Therefore, it is important to make an assessment of the degree to which a company can rely on sufficient and continued credit in the future. This includes an examination of the past history of banking relationships. If a company has made frequent changes of its principal banks, this is sometimes a red flag that there are underlying credit problems with the business, real or perceived. The company's loan covenants in its bank loan agreement should be understood, and the financial information should be analyzed to determine if the company is in compliance. Are banking relations good or tense? A consideration of these and earlier factors tells a lot about the company's risk as perceived by banks and other creditors, and about the likelihood of the company's ability to count on bank financing in the near future.

Contractual Relationships. Contractual relationships can impact a company in a variety of ways, good and bad. There is obviously a wide range of contracts a valuator might encounter in a given engagement. These might include distributorship agreements, employment agreements, covenants-not-to-compete, supplier and franchise agreements, customer agreements, leases, labor contracts, shareholder and buy-sell agreements, to name a few. The only way to gauge the implications of these types of agreements is to study them.

Outlook and Forecasts at the Valuation Date. The future financial outlook is important to determine since it is an integral part of using the income valuation approach. The company may already have prepared detailed forecasts for internal use, or as required by its bank or other parties. If this is the case, the valuator needs to understand the basis behind the forecasts, the individual assumptions used, and determine if they are reasonable. Just because they are management-prepared does not mean the valuator should use them if they are not realistic. In the majority of cases, however, there are no forecasts available, leaving the burden of development to the valuator.

Litigation and Other Material Factors. Pending or threatened litigation and other material factors (such as environmental waste problems, audits of the books by the Internal Revenue Service, and host of potential factors) could impact a company's risk, its current or future earnings, or deplete its financial resources. It is important to uncover any such problems if they exist, and determine the extent to which they might financially impact the company. Once a material factor has been identified, it may or may not be possible to quantify its financial impact. Therefore, the factor may represent an issue that increases risk but whose effect is unknown. The best the valuator may be able to do is to increase the discount rate applied in the income approach to reflect this increased risk, however the question of how much to do so may ultimately be subjective.

Corporate Insurance. Most companies have general and product liability coverage, or, in the case of professional practices, malpractice coverage. However, this is not always the case, so the valuator will need to inquire if the coverage is in force, if it is with a financially solvent carrier, and the amount of protection it provides. Equally important is a determination of whether or not management is aware if the coverage will not be renewed at its expiration date, or, if it will, determine if the premium expense will jump substantially, impacting the company's profitability.

Conclusion. The key to a sound valuation result is the direct result of the level of inquiry and analysis made by the business appraiser. The valuator's must be thorough and cover a wide variety of issues internal and external to the company that increase or decrease its risk, or create future opportunities. Many of the issues covered in this article are really common-sense, and provide a basic framework for the practicing attorney to better understand and identify relevant risks that impact how a buyer would view a company. ♦

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