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FAIR VALUE™

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The Selective "Expert"

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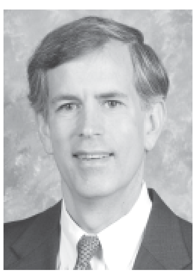
Introduction. We have seen many changes in our collective 50 years of business valuation experience. One of the biggest changes (and improvements) we have seen has been the near-extinction of the Excess Earnings method (see *Kick the Habit: The Excess Earnings Method Must Go!* at www.businessvalue.com). Although this method may still lurk in various shadows and dark alleys, we have not had a confirmed sighting of it for at least ten years. This is a tremendous improvement in the business valuation field as it represents the death of a method that was ridiculously subjective and resulted in significantly inaccurate valuations. What was especially nefarious about the excess earnings method was the degree to which it had been accepted in the profession – due to continued use by lazy or incompetent practitioners and acceptance by finders of fact because it was offered so frequently by so many "experts."



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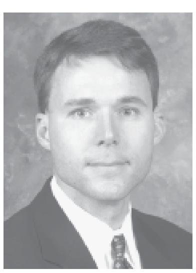

Michael Paschall

Unfortunately, we have recently run across another interesting "theory" in business valuation that warrants the attention of anyone who has a stake in ensuring that quality and integrity remain as high as possible in the field. Like the excess earnings method, this theory is especially dangerous due to its repeated use, familiarity, and acceptance by lawyers and judges based on repeated use by business valuation "experts." Our experience with this new theory and one particular expert who is championing its cause is outlined below.

Meat Loaf

We were engaged to testify regarding our review of the valuation report of a court-appointed valuation "expert." For purposes of this article, we will call this expert Meat Loaf (for reasons to be explained later). Meat Loaf has been around a long time in his city, testifying in many divorce matters. Due to his familiarity, numerous attorneys and judges have grown comfortable with him. Meat Loaf has valued a small business jointly for two parties in a divorce. Meat Loaf's report is thick and is bulked up with lots of boilerplate filler, pictures, graphs, tables and data.

Meat Loaf's valuation report is circulated among the parties and their attorneys for their review. Meat Loaf uses three methods to value the business:

1. The capitalization of earnings method. Meat Loaf takes the historic profits of the company and adjusts them to exclude personal and other non-business expenses. This results in an income figure available to a prospective buyer. This income is capitalized into an estimate of value of **$350,000**.

2. The guideline transaction method (called the "Direct Market Data Method" in Meat Loaf's report). Meat Loaf obtains data from two transaction databases and finds information on prices paid in 251 sales of similar small businesses. These transaction companies are in the same industry and are of a similar size as the company being valued. After applying a median multiple from this database, Meat Loaf arrives at an estimate of value by the guideline transaction method of **$825,000**.

3. The adjusted net asset value method. Meat Loaf also uses a cost approach based on the value of the subject company's tangible assets. Meat Loaf adjusts each asset of the business to its market value, arriving at an overall net asset value for the business of **$525,000**.

In the end, Meat Loaf places 100% of his weight on the $525,000 finding under the adjusted net asset method. Since the $350,000 finding by the capitalization method is less than the Company's adjusted net asset value, Meat Loaf correctly puts no weight on the capitalization method, saying the net asset value puts a floor on the value. Meanwhile, Meat Loaf gives no weight to the higher $825,000 value under the market approach. Meat Loaf's reason for ignoring the market approach is stated in his report as follows:

> The Direct Market Data Method relies completely on actual market data (comparable sales) as an indicator of the value of the subject company. In this sense, this method is perhaps the purest indication of value available to the analyst. Unlike real estate comparable sales, there is less information about the sales transactions of businesses and there is a significant degree of uncertainty in the multiplier that was derived from the transactional data. Therefore, I assign no weight to the indication of value produced by this method.

Despite strong market evidence based on hundreds of transactions of similar small companies in the same industry that suggest a value that is higher than the net asset value, Meat Loaf nonetheless ignores this data and places 100% of his weight on the lower value under the net asset value method. After his review of the report, the attorney for the wife is concerned that the value is too low and asks us to review the report.

Analysis of Guideline Transactions

The first step taken in our analysis was to independently obtain and review the guideline transaction data used by Meat Loaf. The data was obtained and statistical analysis of it was undertaken. Regression analysis, a widely accepted statistical technique (discussed elsewhere in this issue of *Fair Value*), was used to assess the degree to which the prices paid for the reported company sales transactions were explained by various factors, including annual revenues, annual profits, and other measures. These relationships were tested using regression analysis to determine if the correlations were statistically significant.

The results were clear. Regression analysis indicated a very strong and statistically significant correlation between revenue level and the price paid. The conclusion was inevitable: a huge sample of transactions, companies in the same industry, companies of similar size, prices paid by real world buyers and sellers, and widely accepted statistical techniques showing a reasonable prediction of price paid based on the revenues of the acquired company. All of this data and analysis pointed to the use of the higher value determined under the market approach, as opposed to the lower value under the cost approach that was used by Meat Loaf.

Furthermore, the market data clearly indicated that in the overwhelming number of sales transactions the prices included a payment for goodwill (whereas Meat Loaf's 100% weighting on the net asset value method under the cost approach resulted in zero value for goodwill). This was despite the fact that the subject company outperformed its industry peers on a number of measures (profit margins, return on equity, etc.) which further supported evidence of intangible value.

Why?

Following our analysis, we were scratching our heads as to why Meat Loaf would have disregarded the market approach, especially since he stated in his report (as noted above), that the market approach "is perhaps the purest indication of value available to the analyst." It was not until we witnessed Meat Loaf on cross examination that we got our answer. The verbatim exchange is as follows:

WIFE'S ATTORNEY: First of all, let me ask you this: How many times, if ever, in your experience as a business appraiser, have you actually used the market approach in a valuation?

MEAT LOAF: I have used it in virtually every valuation that I have prepared.

ATTORNEY: Well, let me ask it this way then. If you've used it in every business valuation, because you used it in this one as well, how many times, if ever, have you relied on the market approach to reach your final conclusion of value?

MEAT LOAF: I can only think here and now about two comprehensive reports that I have prepared in which I have relied or used or given the market method weight.

ATTORNEY: Any weight?

MEAT LOAF: Given any weight to the market method.

ATTORNEY: Now, I believe that you testified that you do between 20 and 40 engagements per year – is that correct?

MEAT LOAF: That's correct.

ATTORNEY: And that you've been doing business valuations since, what, 1992?

MEAT LOAF: In the early 90's.

ATTORNEY: Do you know which year? Is it fair to say '92?

MEAT LOAF: That's as good as any.

ATTORNEY: So, you've been doing it for about 17 years. And if we just split the difference and say you've been doing 30 each year. You've done 510 business valuations and you can only recall two out of those 510 where you put any weight on the market approach?

MEAT LOAF: That's probably accurate.

Wow. Two out of 510. Once every 255 times. Not a great batting average for the market approach (.004, to be exact). Meat Loaf decided long ago not to trust the market approach, no matter what its results say, no matter how many transactions are available, and no matter how strong the relationships are shown to be with objective statistical testing (not that Meat Loaf does any objective statistical testing in the first place). Meat Loaf certainly creates the impression that he is considering the market approach by putting all the usual boilerplate narrative in his report, however, Meat Loaf knows from the beginning he will reject the method in the end.

Meat Loaf is a biased business appraiser. Now he may not necessarily be biased against one party versus the other. Malicious intent may not be evident. Meat Loaf, however, has unilaterally determined how a business should be valued and in the World According to Meat Loaf, that does not include the market approach. By the way, we call this appraiser Meat Loaf due to his acceptance of the income and cost approaches but his rejection of the market approach (i.e., "Now don't be sad, 'cause two out of three ain't bad").

Problems

Unfortunately, Meat Loaf's policy of valuation predestination has many problems:

1. Violation of Long-Accepted Valuation Practice. On the first day of Business Valuation 101, students learn there are three approaches in business valuation: the income approach, the market approach, and the cost approach. In Meat Loaf's world, however, there are only two approaches: income and cost. The market approach, while acknowledged, effectively does not exist for Meat Loaf.

Shannon Pratt, FASA, CFA, is widely recognized as the George Washington of business valuation. In his *Market Approach to Valuing Businesses*, Dr. Pratt makes the following comments on the market approach:

> The market approach is a pragmatic way to value businesses, essentially by comparison to the prices at which other similar businesses or business interests changed hands in arm's-length transactions. It is favored by the Internal Revenue Service in Revenue Ruling 59-60 and is widely used by buyers, sellers, investment bankers, business brokers, and business appraisers.
>
> The market approach to valuation is relevant because it uses observable factual evidence of actual sales of other properties to derive indications of value...The market approach is especially relevant if the standard of value is fair market value.
>
> Revenue Ruling 59-60 strongly advocates the guideline public company method within the market approach...When Revenue Ruling 59-60 was written in 1959, none of the private company transaction databases that we use today existed. The emergence of these private company transaction databases in recent years makes the use of sales data for entire companies, including many small

> companies, a viable method within the market approach.
>
> Good market comparisons can be the most compelling evidence of the value of a business or a business interest. These comparisons allow us to make informed pricing decisions for purchases and sales and to present convincing empirical evidence of value for other purposes.

These (and similar) comments about the market approach have been believed and followed by business appraisers since the beginning of the profession. They have been followed by judges and courts and validated by countless real-world transactions. None of this matters to Meat Loaf. Meat Loaf's refusal to consider the market approach cuts off one of the legs of a three-legged stool.

2. Self-Contradiction. Meat Loaf contradicts his own valuation report. As noted above, Meat Loaf has the following language in his report:

> The Direct Market Data Method relies completely on actual market data (comparable sales) as an indicator of the value of the subject company. In this sense, this method is perhaps the purest indication of value available to the analyst.

Yet, by his own admission, Meat Loaf rejects this "purest indication of value" as being lacking in 99.6% of his reports.

3. Shortchanging Clients. By knowing that he will not use the market approach, Meat Loaf saves himself a lot of time and trouble with each valuation report. Sure, Meat Loaf does a quick industry search and reproduces the various companies he finds in his report (along with standard boilerplate language on the market approach), however, Meat Loaf never has to dig through other databases, public filings, news releases, and other sources to hunt down potential transactions. Meat Loaf never has to then dig into this data to determine which transactions are suitable for use in a report. Meat Loaf never has to dig even deeper into the financial and operational information to determine which companies he will actually use in the market approach. Meat Loaf never has to compare the subject private company with the transaction companies to determine differences in operating and financial characteristics. Take it from a firm who believes in and frequently utilizes the market approach – this takes a lot of time and in many cases is the single most time-consuming part of a valuation project.

Like attorneys and other service professionals, the only thing business appraisers have to sell is their time and expertise. Not having to actually "fully" consider the market approach saves Meat Loaf a significant amount of time and trouble. This is a great business model for Meat Loaf as he can charge market prices for a valuation report (competitive with other appraisers) yet know that he enjoys significant cost advantages versus his competitors who are doing a full and proper market approach as a part of their report. As a result, Meat Loaf is far more profitable than his peers as he may be doing 60% or 70% of the work for 100% of the fee. Meat Loaf's clients are none the wiser as Meat Loaf's reason for not putting any weight on the market approach appears plausible and these clients are clueless to the fact that: (1) Meat Loaf puts no weight on the market approach in virtually all of his reports and (2) other business appraisers are actually doing a market approach in their reports.

4. Flaws with the Income Approach. In our particular experience with Meat Loaf, the cost approach had a greater value than the income approach. In many valuation cases, however, the cost approach is the lowest value determined, therefore, the analysis often boils down to comparison between the values under the income approach and market approach. With appraisers such as Meat Loaf, this is an easy analysis as weight is virtually never given to the market approach, therefore, the final opinion of value is based upon the income approach.

As noted earlier, Meat Loaf decided not to weight the market approach in the particular case we saw due to "less information about the sales transactions of businesses and...a significant degree of uncertainty in the multiplier that was derived from the transactional data." Perhaps this has been boilerplate language in the 508 (out of 510) valuation reports where no weight has been placed on the market approach, however, we do not have access to those reports so cannot determine this with certainty. In any event, Meat Loaf decides to forego weighting the market approach due to "less information" and a "significant degree of uncertainty" and place all his weight on the income approach. For those companies where the value under the income approach exceeds the value under the cost approach (which we speculate is the majority of the cases), this has Meat Loaf placing 100% of his weight on the presumably more reliable income approach.

In the income approach, whether he uses a capitalization of earnings method or discounted cash flow method, Meat Loaf must develop a capitalization and/or discount rate. In developing either rate, Meat Loaf must use long-term historic rate of return data based on the average annual returns (dividends and capital appreciation) for a sample of thousands of public company stocks from such sources as Morningstar or Duff & Phelps. The irony of Meat Loaf's belief that the transaction data in the market approach is uncertain lies in the fact that none of the public companies he is willing to use to determine his capitalization and/or discount rate are anything like the subject private company to be valued. In fact, it is a virtual certainty that nearly (if not entirely) all of the public companies are in a different and/or far more diversified line of business, are far larger on a revenues and asset basis, and contain a number of attributes that make them very dissimilar from the small private company to be valued. Yet, despite these major differences (which are known with certainty), Meat Loaf is willing to put 100% of his weight on this method. By contrast, the existence of scores (or hundreds) of transactions of private companies in the same industry and of the approximate same size as the subject private company is completely disregarded by Meat Loaf as being too "uncertain."

5. Hypothetical Willing Buyer and Seller. In nearly all valuation engagements, the standard of value is fair market value. Fair market value is defined as the "price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts." Our philosophy in business valuation has always been to put ourselves in the shoes of both the hypothetical willing buyer and the hypothetical willing seller and ask the key question: what information would we want to know and consider before making a decision as important as the purchase or sale of this privately-held company?

By failing to use the market approach, Meat Loaf is effectively decreeing that the hypothetical willing buyer and willing seller would be completely uninterested in what the market approach has to say. In the specific case in which we were involved, Meat Loaf effectively implied that the hypothetical willing seller could care less that the market approach indicated a value of $825,000 whereas the next highest method (the cost approach) indicated a value of $525,000. Said another way, the hypothetical willing seller is perfectly willing to leave $300,000 on the table in this transaction. This, of course, is complete nonsense. The hypothetical willing buyer and willing seller are going to examine every possible methodology in trying to determine an accurate value for the company at issue. No rational person would completely ignore over two hundred comparable transactions in the same industry. Meat Loaf's philosophy is the real estate equivalent of buying or selling a house without examining any comps to see if the per square foot price is in the ballpark.

6. What to Do? Consider the case where a private company has a history and near-term expectation of losses as well as a negative book value. In this case, the income approach cannot be used (due to the losses), nor can the cost approach (due to the negative book value). This situation must be completely baffling to an appraiser such as Meat Loaf as it is beyond his comprehension how such a company can have value. Such a company can, however, have value (and many in the real world do). The determination of value with these companies is based on market approaches. It may be that this company has a customer base and generates revenues that a competitor or consolidator would love to add to its portfolio. In such a case, a value could be determined from a market approach (revenue multiplier or price-per-customer metric). Companies in this situation may not have value in every case, but the exclusion of the market approach by appraisers such as Meat Loaf rules out the possibility of value in any case.

Support for the Method

Common arguments you will hear from Meat Loaf as to why the market approach is unreliable are as follows:

1. The data in the market approach is not good enough. This argument takes a number of forms. There are not enough comparables. The data on the comparables is not detailed enough. The comparables are too old. The comparables are too big or too small to use. The comparables are too different. The fact of the matter is that you will *never* have perfect comparables. The sooner you make peace with that fact, the sooner you can move on to the next realistic stage of your report and *analyze* what you have and try to make some determination as to the value of your company. Remember that the standard of value in the vast majority of cases is fair market value which includes a hypothetical willing buyer and willing seller and knowledge of all relevant facts (like comparable transactions). As noted above, appraisers such as Meat Loaf believe that the willing buyer and willing seller would ignore all of the market data available in trying to determine the price. This is a ludicrous proposition.

2. Values under a market approach are just rules of thumb. This is a complete smoke-screen by the appraiser in an attempt to divert attention from the foolishness of his position. A rule of thumb is a pariah in business valuation as it implies the application of a simplistic formula or multiple to a company without any independent research and analysis as to the specific company being valued or the validity of the formula or multiple. We agree that the application of a rule of thumb in this context is careless valuation practice. The key difference here is that multiples from actual transactions are not rules of thumb – they represent actual amounts paid by willing buyers to willing sellers for companies in the same line of business as the subject company. If you want to call this a "rule of thumb," that is your mistake. Calling this a rule of thumb, however, does not negate what it actually represents – valid and accurate measures of how companies in the same industry were priced when they were bought and sold.

Conclusion

This article is not meant to serve as a blanket support or condemnation of the market or the income valuation approaches. Every company situation is unique and a business appraiser needs to use judgment to determine which methods are appropriate. Certainly we have done reports in which the market approach was examined and found to be inappropriate for use. The same can be said for the income and cost approaches.

The point of this article is to illustrate the dangers of a business appraiser who has developed a mind set whereby any particular approach is DOA. The hallmark of a good business appraiser is to always approach each new situation with a fresh and open mind and assess the merits of the company and the appropriate valuation technique(s) as they apply to the unique matter at hand. Once an appraiser digs in his heels and decide some of these issues in advance of the engagement, the quality of the valuation results will never be the same. Sometimes bias is malicious, aimed at reaching a desired end result. Bias, however, can also be unintentional. Appraisers, lawyers, judges, and all users of valuation reports must be aware of these biases and be vigilant to avoid falling into the trap of familiarity and comfort at the exclusion of logical and sound valuation results.

It took many years to kill the Excess Earnings method and it may take many years to kill this new theory of business valuation. Bad valuation theory is difficult to kill and takes many years due to the fact that it has permeated into so many areas – by practitioners who misuse it and lawyers and judges who have been fed it so long that they don't know any better. That, however, does not lessen the importance of practitioners, attorneys, and finders of fact to recognize this new theory, point out its flaws, and ultimately rid the profession of such malpractice. ♦

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