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Valuation Concepts

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Site visits can reveal hidden surprises

Site visits provide valuation experts with a hands-on opportunity to learn about a company's operations and to interview management. Unfortunately, companies sometimes object to valuators' requests for site visits.

Some companies, for instance, perceive plant tours and on-site interviews as intrusions or wastes of time. In addition, many adversarial parties — such as a monied spouse in a divorce case or a controlling shareholder in a dissenting minority shareholder lawsuit — refuse to allow the opposing expert to perform a site visit.

When a company's representatives balk at the idea of a site visit, attorneys often step in to help the client understand a site visit's objectives. If the opposing side still refuses to allow a valuator access to the company's facilities, attorneys can demand court-ordered site visits.

When a company prevents a site visit, the valuator typically lists the refusal as a limiting condition in the valuation report. Such limitations compromise the reliability of the valuator's conclusions and may even suggest to a judge that management is trying to hide something.

Site visit objectives

More than passive participants, professional valuators typically make germane inquiries and request interviews with members of the company's management team. A valuator considers many questions during his or her tour, including:

- Do the company's operations appear efficient and organized?
- Do employees and managers seem competent and productive or disgruntled, overworked or adversarial?
- Are there any capacity constraints?
- What is the condition of the company's property, plant and equipment (for example, any obsolete, unused, unrecorded or nonoperating assets)?
- For retail operations, does the company have adequate signage, ingress-egress and parking?

Site visits can produce measurable benefits. Adversarial managers, however, may try to hide assets or make the company appear less profitable to lower the company's value. Although site visits don't provide as much assurance as a formal fraud investigation, they can reveal fraudulent behavior.

Scheduling the visit

Because no rule dictates the "best" time for a site visit, scheduling is left to the appraiser's judgment and management's convenience. Many valuators prefer to wait until they've performed a cursory review of the company's financial statements and its industry before touring the facility.

Although not compulsory, some preparedness helps experts understand the industry's key value drivers and precludes misguided or superficial interview questions.

Furthermore, site visits should ideally occur before the valuation's effective date to prevent the expert from factoring subsequent events into his or her value conclusion. Sometimes the timing is unrealistic — for instance, when the valuator is asked ex post facto to review another expert's conclusion.

In most cases, valuators must disregard events that occur after the valuation's effective date and the report's completion date. When site visits occur after the valuation's effective date, valuators usually consider whether the company's operations were materially different as of the valuation's effective date.

In certain circumstances, a formal site visit may be unnecessary. When valuing a company to which the expert has previously provided other consulting services, for instance, an appraiser may sidestep the site visit to save time and expense. In lieu of a formal site visit, the valuator may simply interview management via telephone or written questionnaire.

Furthermore, clients occasionally forget to mention certain items — such as deferred maintenance, capacity constraints or weak internal controls — that can materially affect the company's value. Without conducting a formal site visit, valuators risk overlooking these factors.

Site visit in action

John Doe gifted shares of his manufacturing company to his two daughters. To save money, John created his own valuation report, which listed the company's value at $10 million.

A year later, the IRS challenged John's homemade report. The IRS's valuation expert extrapolated the company's historic income trends to arrive at a value estimate of $20 million. She did not, however, perform a site visit.

To defend himself, John hired his own professional valuator. After touring the plant and interviewing the production supervisor and marketing director, John's valuator uncovered several material errors in the IRS agent's calculation.

For instance, several pieces of expensive equipment desperately needed repair, and the facility was running at maximum capacity. To achieve the aggressive growth the IRS agent projected, the company would need to rent more storage and manufacturing space and purchase machinery.

Rather than prepare his own valuation report, John's expert simply factored his site visit discoveries into the IRS expert's analysis. This reconfiguration showed that the agent had grossly overvalued the company. Thanks to this analysis, the IRS dropped its contention that John had undervalued his company.

Common intellectual property valuation techniques

Intellectual property (IP) comes in many forms, including patents, trademarks, copyrights and brand names. As our economy grows increasingly dependent on these intangible assets, the need for IP valuations has grown exponentially.

Although these are used for management decision making, financial reporting and tax purposes, the most common reason businesses value IP assets is infringement litigation.

Relief-from-royalty method

One of the most popular ways appraisers value IP is the relief-from-royalty method. From a corporate perspective, this approach strives to estimate how much in licensing fees a company saves by directly owning an IP asset. From an inventor's perspective, the relief-from-royalty method estimates how much money the inventor could make from licensing IP ownership rights to a third party.

To estimate a reasonable royalty rate (or licensing fee), professional valuators typically rely on proprietary or commercial databases of IP transactions.

The valuator applies selection criteria — such as the type of IP, industry, date and stage of development — to these databases to generate a sample of comparable royalty rates. The similarity of the subject IP and comparable transactions is often questionable, however, because IP is particularly distinctive and most IP databases contain a limited number of transactions.

Another problem with the relief-from-royalty method is that many licensing agreements in the databases do not convey the licensor's full "bundle of rights" to the licensee. For instance, some agreements restrict the licensee's use to a limited time period or geographic region. Thus, the relief-from-royalty method tends to undervalue a client's IP.

The 25% royalty rule

One oft-quoted rule of thumb for estimating equitable IP profit distributions is the "25% royalty rule." This oversimplified formula allocates 25% of the profits generated from an IP asset to the licensor and 75% to the licensee. Theoretically, the licensee should be entitled to a greater share of the profits to compensate for bearing the risks of manufacturing, marketing and distributing the end product.

Many courts like this rule because it appears to be straightforward and objective. Another appeal is that the formula is based on the licensee's ability to pay, rather than on financial theory and abstract market data.

Although a useful starting point, the 25%-75% split is not carved in stone. Many real-life negotiations vary significantly from this rule of thumb. Licensing agreements may diverge from this formula for reasons including the risks assumed by the parties, industry norms and a party's relative bargaining power.

Another problem with the 25% royalty rate rule is that it allocates "profits" — an ambiguous term that often spurs debate, especially in infringement lawsuits. Most experts agree that profits should be before taxes and interest.

Differences exist

But that's where the consensus ends. A few experts subtract depreciation and amortization expenses, because they are noncash items. Some experts subtract only incremental production costs, whereas others subtract all costs, including some overhead expenses.

Because of the ambiguity of this terminology — as well as the possibility that the licensee may understate profits — the 25% royalty rule is generally not used as the sole method to value IP. When used in conjunction with other methods (such as the relief-from-royalty method), however, it can provide an insightful reasonableness test.

Make the smart choice

The resources used and the analyses performed in IP valuations differ significantly from traditional business valuation assignments. Hiring an expert who specializes in this niche is key to obtaining a useful, reliable conclusion. <>

Major issues surround minority interest discounts

Among the most common — and sizable — valuation discounts is the discount for lack of control (also called the minority interest discount).

Minority interests generally trade at a discount from their pro rata share of a company's overall enterprise value, because minority shareholders can't control key aspects of the company's operations. They can't, for example, hire management, set policy, liquidate the company or its assets, register for a public offering, or declare dividends.

The traditional approach

The traditional approach for valuing a minority interest starts with the company's overall enterprise value (that is, 100% of the company's value on a controlling, marketable basis). From there, the valuator multiplies the company's enterprise value by the shareholder's ownership percentage. Finally, the expert subtracts the minority interest discount (and, tangentially, other discounts — such as a lack of marketability — when applicable).

To support minority interest discounts, valuators traditionally turn to the *Mergerstat Review* and Houlihan Lokey Howard & Zukin (HLHZ) control premium studies. These studies quantify the premiums paid in public company mergers and acquisitions (controlling values) relative to the same companies' pre-acquisition stock prices (minority values). From these studies, valuators can impute a minority interest discount by taking the mathematical inverse of the average control premium.

Minority interest discounts based on these control premium studies do include elements of control. The observed acquisition premiums, however, can be attributed to other reasons.

For instance, a strategic buyer may pay a significant premium for distinctive synergistic benefits. But these studies are somewhat flawed because they don't distinguish true control premiums from other factors, including uninformed buyers and strategic synergies.

Furthermore, quantifying a company's minority interest discount is highly subjective. Rather than simply apply the average minority interest discount from these studies, most valuators factor in the specific characteristics of the subject interest. For instance, the appraiser might consider shareholder agreements, ownership distribution and the company's dividend-paying history.

An alternative approach

Fortunately, appraisers can often circumvent these sometimes controversial subjective minority interest discounts. The key is to modify the valuator's methodology to arrive at the company's value on a minority basis — as opposed to a controlling basis, as is traditionally done.

When applying the market approach to value a minority interest, for example, the appraiser can circumvent the need for a minority interest discount by relying on public stock prices (instead of private acquisition databases).

Like minority shareholders in a private company, investors owning shares of public stock don't control the public company's day-to-day operations. In essence, the minority interest discount is already built into the appraiser's base value.

Similarly, when applying the income approach to value a minority interest, a valuator can avoid minority interest discounts by using the company's income stream "as is" — that is, without making discretionary adjustments for such items as above-market officers' compensation or related-party expenses.

Minority interest discounts based on certain control premium studies do include elements of control.

When employing this method, the valuator estimates the cash flow available to minority shareholders, who lack the control needed to alter these discretionary items.

Don't discount the need for a valuation

Though these techniques sometimes make minority interest discounts unnecessary, they do *not* circumvent the need for *other* valuation discounts or premiums. For instance, marketability discounts may still be required to reflect an interest's relative illiquidity or a key person discount may be needed to estimate a company's disproportionate reliance on one person.