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Playing the wild card

Company-specific risk affects many business appraisals

Risk is everywhere. It can be found in the health of the national and local economies. And it can be found in the industry in which a business operates or the industry that buys its products or services. Although these all may affect a business valuation, one commonly overlooked source of risk is that inherent to the business being appraised.

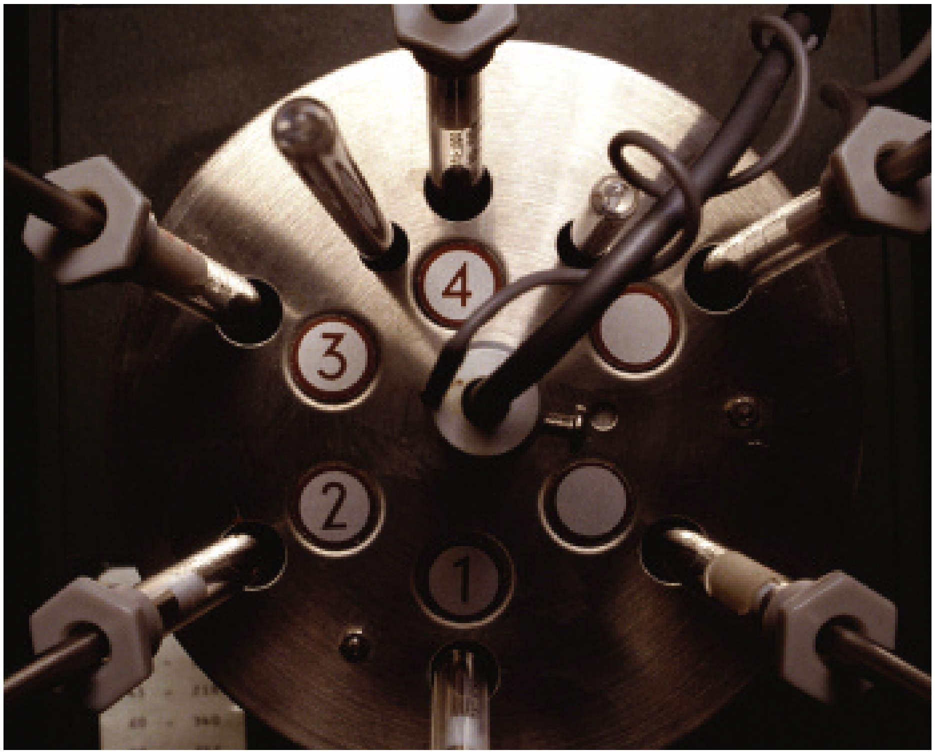
Company-specific risk (also known as "investment-specific risk" or "unsystematic risk") can play the wild card in many appraisals, bringing to bear a number of uncertainties and potentially affecting the value of the business quite significantly.

A critical component

Technically speaking, company-specific risk is a component of the discount rate used in a discounted cash flow analysis and the capitalization rate (the discount rate less the expected growth rate of the business) used in the capitalization of earnings or cash flow analysis.

The discount rate represents the rate of return an investor would require to invest in a privately held business. This rate is "built up" by an analysis of the returns of various investment options, from "risk-free" investments, such as 20-year U.S. Treasury Bonds, to riskier investments in large and small publicly traded stock.

As the risk increases, so does the required rate of return on an investment. (For an example, see "Building up to a discount rate" on page 3.)



Qualitative factors

Company-specific risk is extremely subjective. There are no empirical studies available to assist an appraiser in quantifying it, so valuators must often base their work on professional experience and judgment.

An appraiser can also base his or her decision on an analysis performed or researched from a variety of sources. These may include a ratio analysis of the business compared to industry peers, a trend analysis of the company's financial performance over a period of years or other more qualitative factors, such as:

Management. Specifically, the valuator will consider management depth. Does one person guide the financial direction and corporate policies of the business or do several? In most cases, the latter is better because, as the saying goes, "Two heads are better than one."

Another point to consider is whether the company's continued success depends on any key personnel. When its operations depend on just a few people — or maybe even just one — it risks financial losses or even failure if these individuals leave or die.

Future growth. The appraiser will consider whether there are plans to expand operations through acquisition or capital investment. This indicates how (or if) management intends to grow the company and gain further market share. Any plan preferably produces growth without significantly compromising the core business or its liquidity.

Company history. The longer a company has been in business, the less risk is associated with it. A company that has been around for 50 years would appear less risky than one that's been operating for only two years.

A valuator will also consider the company's *litigation* history. If the business has a record of being sued, the investment risk will obviously be higher, requiring a greater rate of return.

Internal viewpoint. In addition to the independent research performed by the appraiser, management's own view of its industry can often provide insights into the inherent risks of the business. The company's distinctive competitive advantages and disadvantages help the appraiser identify its value drivers and less successful products or services. Knowing these aspects, the valuator can estimate future financial performance, which will, in turn, influence the risk assessment.

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Customers, vendors and labor. If the business receives a significant portion of its revenues from one or a few customers, or buys most of its core materials from one or a few vendors, the appraiser may assess a higher risk when valuing the business. Risk will also be greater if the company experiences frequent labor strikes or union issues or substantial turnover.

Building up to a discount rate

In calculating company-specific risk, a valuator "builds up" to the applicable discount rate. Here's a hypothetical example:

Risk-free rate of return	5.0%
Supply side arithmetic mean equity risk premium	5.9%
Small stock premium	6.3%
Company-specific premium	6.0%
Required rate of return (discount rate)*	23.2%

* This rate does not include an adjustment for industry-specific risk.

Compliance issues. If a company operates in a highly regulated environment, it will often be considered riskier. Therefore, the valuator will assess a greater required rate of return on the investment.

Many possible outcomes

When looking at company-specific risk, it's important to remember that there are many possible outcomes. Some business owners assume the analysis will bring only bad news. But it's also possible the valuator will conclude that a company is less risky than others in its industry, which would reduce the rate of return required to invest in the business. This is yet another reason company-specific risk should be considered in business appraisals.

Going, going, gone …

Assessing lost value as a source of economic damages

Virtually all companies need other businesses to survive. Whether they depend on key customers or vendors (or both), companies can thrive only if these relationships remain intact. When one is disrupted, for whatever the reason, one party may incur financial damage — perhaps even leading to its demise. And valuators must often assess this lost value as a source of economic damages.

Dollars down the drain

In many cases, an appraiser will present a company's alleged damages as lost past and/or future profits. For instance, if a vendor breaches a contract to sell materials at a contracted price, the business may be forced to pay a higher price to the vendor, assuming no immediate alternatives are available.

If it takes six months to secure a new vendor at the originally contracted price, the company will presumably lose money if, to retain its customer base, it doesn't pass on the cost increase to buyers. The valuator can estimate this type of damage via a lost *profits* analysis because the business would be able to continue operating and the damage period would be finite. Thus, it would retain a good portion of the value it had before the vendor dispute.

Worst-case scenario

There are unfortunate circumstances, however, when a business interruption is so significant that the company's value is destroyed and the business itself ceases to exist or suffers irreparable harm.

For example, ABC Inc.'s main customer accounts for over 90% of its revenue, though there's no formal contract binding this relationship. One night a massive storm triggers a flood that devastates ABC's facilities as well as the surrounding landscape.

The flood causes the company to shut down operations for six months. During this time, the customer finds a new supplier and has no need to return to ABC when it's up and running again. Even after desperately trying to re-establish the relationship while also attempting to cultivate new clientele, ABC simply cannot survive. It eventually closes its doors for good.

In such a case, the appropriate measure of damages may be lost business *value* rather than lost *profits*. When this occurs, an appraiser will assess the company's lost value as close to the damaging event as possible. Why? Because the business had a fair market value based on its operating and financial characteristics, and the catastrophe has irrevocably changed these characteristics and, hence, reduced its value.

The lost value estimation

In a lost value estimation, the valuator will prepare a dual-dated appraisal with the valuation dates being just before the damaging event and whatever date management has designated as the point at which the business can no longer continue as a going concern. The difference in value will be the damages sustained by the company because of the event.

One thing that a valuator should almost never do is combine lost *profits* with lost *value* in an economic damages estimate. The reason for this is that, in most cases, calculating damages in such a manner would constitute "double dipping."

If the business and all of its value have been completely destroyed, the proper measure of damages is its fair market value on the day before the alleged damage. The company that recovers damages equal to the value of the business has, in effect, sold the business. The company's stockholders shouldn't also be able to recover future lost profits after the imputed sale.

The best indicator

No business is an island — all live or die based on their relationships with customers and vendors. When a disruptive event strikes a company, a valuator can go in one of two directions.

If the business can continue as a viable going concern, a lost profits analysis may be the appropriate measure of damages. But if the event is so catastrophic that it puts the company out of business, a lost value analysis may be the best indicator of economic loss.

Let’s hit the books

20 commonly used business valuation terms

Every profession has a language all its own, and business valuation is no different. Although many of these terms may seem familiar, it doesn’t hurt to hit the books once in a while and review the fundamentals. And if the terminology of appraisals isn’t familiar, an introduction is definitely in order.

La lingua franca

Here are 20 of the most commonly used valuation terms:

1. Fair market value is the price, expressed in terms of cash equivalent, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm’s 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.

2. The asset (asset-based) approach is a general way of estimating the value of a business, ownership interest or security using one or more methods based on the value of the assets net of liabilities.

3. The adjusted book value method (also known as the adjusted net asset method) is used under the asset approach to adjust all assets and liabilities (including off-balance sheet, intangible and contingent) to their fair market values.

4. Cash flow is money generated over a period of time by an asset, group of assets or business enterprise. The term should be supplemented by a qualifier (for example, “discretionary” or “operating”) and a specific definition in the given valuation context.

Proper definition of any economic benefit used is essential.

5. Economic benefits/earnings are inflows such as net income and net cash flows. Proper definition of the economic benefit used is essential.

6. Normalized earnings are economic benefits adjusted for nonrecurring, noneconomic or other unusual items to eliminate anomalies and facilitate comparisons. Various adjustments may include items that are above or below their respective fair market values. These may include officers’ compensation, rents paid to affiliates, research and development, other wages, insurance, and professional fees.

7. Cost of capital is the expected rate of return the market requires to attract funds to a particular investment.

8. Discount rate is a rate of return used to convert a future monetary sum into present value.

9. The income (income-based) approach is a general way of estimating the value of a business, ownership interest, security or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount.

10. The capitalization of earnings method is used under the income approach to convert economic benefits for a representative single period to value through division by a capitalization rate. A multiple represents the inverse of the capitalization rate.

11. The discounted future earnings method is used under the income approach to calculate the present value of future expected economic benefits — which must be defined — using a discount rate.

12. The market (market-based) approach is a general way of estimating the value of a business, ownership interest, security or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities or intangible assets that have been sold.

13. The comparative company method is used under the market approach to derive market multiples from market prices of stock of companies that are engaged in the same or similar lines of business and that are actively traded on a free and open market.

14. The merger and acquisition method is used under the market approach to derive pricing multiples from past transactions in companies engaged in the same or similar lines of business.

15. Going concern value is the value of a business enterprise that is expected to continue operating in the future. The intangible elements of going concern value result from factors such as having a trained work force; an operational plant; and the necessary licenses, systems and procedures in place.

16. Goodwill is an intangible asset arising from factors not separately identified, such as name, reputation, customer loyalty, location and products.

17. Control is the power to direct the management and policies of a business enterprise.

18. Control premium is an amount or a percentage by which the pro-rata value of a controlling interest exceeds the pro-rata value of a noncontrolling interest in a business enterprise to reflect the powers of control.

19. Discount for lack of control is an amount or percentage deducted from the pro-rata share of value of 100% of an equity interest in a business to reflect the absence of some or all of the powers of control.

20. Discount for lack of marketability is an amount or percentage deducted from the value of an ownership interest to reflect the lack of liquidity for the interest.

More than words

These definitions represent merely a sample of those used by valuators. Many other terms may play a role in a business appraisal. Yet proper terminology alone does not a good valuation make. A report should be written in such a way that even an uninformed reader should be able to follow its logic.

How does industry-specific risk affect a company's value?

Most investors live by a simple mantra: To take on additional risk, there must be the possibility of additional reward. Why invest in the latest technology stock when you can earn about 4% in 20-year U.S. Treasury Bonds? The answer is simple: By and large, investors are looking for greater returns on their money and are willing to accept greater risk to achieve this goal.

As risky as any publicly traded technology stock may be, it's hard to argue that there's anything riskier than a privately held company. And though there are many sources of risk to private businesses, one that investors and valuators alike should be particularly wary of is the industry in which a company operates or to which it provides products or services.

No business is a safe business

Risk can come from a variety of sources. For instance, there is risk from the national or a local economy. If either is doing poorly and is expected to continue doing so for several years, and the business in question is a high-end restaurant, it wouldn't be surprising to find that the establishment's value is lower. When times are tough, people don't have the discretionary income to eat out as much as they otherwise would — and certainly not at an expensive eatery.

Yet other risks spring directly from issues affecting a specific industry. For example, nursing homes have an additional layer of risk as a result of operating in the long-term care industry. This additional risk can be traced to a number of factors including, but not limited to, the fact that this industry has a high level of government regulation and that changing demographics may have a negative impact on a nursing home's occupancy.

Various investments are considered

Appraisers usually consider industry-specific risk when performing a fair market valuation of a privately held company. It's typically reflected in the discount rate derived under one of the income approaches.

The discount rate represents the rate of return the investor requires and is "built up" by an analysis of the returns of various investment options. These options include "risk-free" investments such as government-backed bonds, as well as riskier investments in large and small publicly traded stock.

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Typically, the root of a build-up method is an entire market index, such as the S&P 500, that includes all industries. The subject company may, however, operate in an industry with different (higher or lower) risk characteristics than the market as a whole.

There will also be a component for company-specific risk. To learn more about this type of risk, see "Playing the wild card: Company-specific risk affects many business appraisals" on page 2.

A premium may apply

In some cases, a valuator may add an industry-specific risk premium to the discount rate to account for the risk associated with operating in a certain industry.

One source used by many appraisers is *Stocks, Bonds, Bills and Inflation Yearbook, Valuation Edition*, published by Ibbotson Associates. It provides estimated industry risk premia for virtually all Standard Industrial Codes (SICs), which provide descriptions of many industry categories and subcategories.

In some cases, however, the valuator may choose to *not* include the premium based on the number of businesses used in the risk premium study or the characteristics of the companies in the study. It's up to the appraiser's experience and professional judgment to make this determination.

The threat is real

Many factors can influence the value of a business. Industry-specific risk is one threat that cannot and should not be ignored — either by the company itself or the valuator estimating its worth.