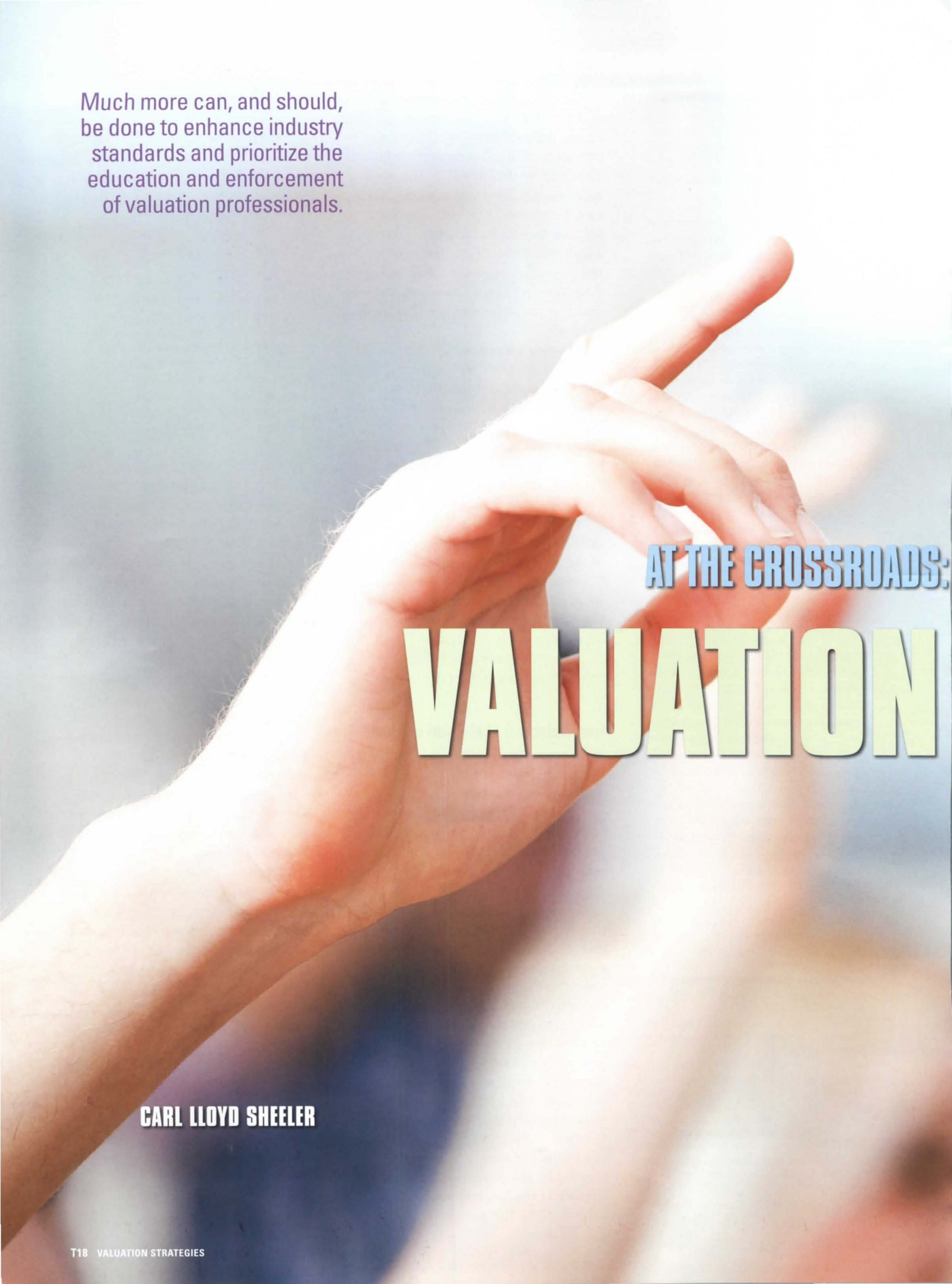


Much more can, and should, be done to enhance industry standards and prioritize the education and enforcement of valuation professionals.

AT THE CROSSROADS: VALUATION

CARL LLOYD SHEELER

A CHALLENGE TO RAISE THE COMPETENCY BAR

THE

thoughts below explore existing business valuation (BV) practices. The discussion may cover issues that are unfamiliar to BV analysts whose clients have businesses of below $5 million in revenues, or for those who deal primarily with midmarket clients of $50 million in revenues and above. First, it is necessary to acknowledge the many BV thought-leaders who have propelled our current body of knowledge forward. These valuation heroes have assisted countless practitioners and clients. In the absence of the development of best practices, those wishing to make a buck off of the market's ignorance would abound. Also, special thanks to the theoreticians who embrace the ethereal aspects of our industry with application of concepts such as regression analysis.

The Industry

The practice of BV will evolve and be enhanced in time; arguably, not soon enough. Similar to accounting in the United States prior to the 1940's, which reached its pinnacle as a respected profession in the 1950's and early 1960's, BV's nascent path will be shaped by those who comprehend that the fields of economics, accounting, and finance are not the same. Absent that, there will be many who believe that software, rules of thumb, and "cheap" reports are all that is necessary to produce a value for a few hundred or a few thousand dollars.

Having been an executive of an association with 32 million members, I understand that the existence of professional societies is designed for the betterment of the market and those that they serve; however, many associations fall victim to self-interest as they vie for member attention and retention. This means an ongoing tug-of-war between generating member revenues from dues, education, testing, collateral materials, and services, offset by the need to elevate the industry as a whole. Instead of enhancing and enforcing standards, many associations have simply broadened their offerings. When quality suffers in the pursuit of quantity, the meaningfulness of affiliations becomes diluted. Those who wish to dedicate themselves to our industry have a moral and ethical duty to demand change.

The Practitioners

After two decades and over 1,000 personally prepared valuation reports, I feel that I have sufficient skin in the game to see how, despite our industry's best intentions, it has been affected by insufficient enforcement and end-user education. The net result is the market commoditization of both professional designations and work product, to the skilled practitioner's detriment. The first question asked by many prospects and clients is "How much and how long?" This is the end result of the work of the majority of folks who perform valuation reports without designations, as well as that of many who possess a designation, but do below standard or part-time work. If clients do not know what good work looks like and there are nominal consequences for substandard work, then why not select the cheapest services?

Competence. Only one, out of the four national valuation associations, requires five years of full-time experience for designation eligibility. During these five years, there's much for new professionals to learn. Most complete approximately 150 reports during this period; however, "mastery" is unlikely to be achieved and skills are honed from being challenged repeatedly.

While the AICPA has a conduct standard that addresses "dabbling" under its competency provisions, the fact of

CARL LLOYD SHEELER, Ph.D., ASA, CBA, CVA is the national managing partner of Business Valuations, Ltd. He has authored treatises on valuation and litigation support and been a designated expert in over 160 disputed matters in federal and state courts. His practice includes serving as an authority on liquidity and valuation advisory issues for family offices, family businesses, and midmarket companies. He may be reached at carl@bizvalsltd.com or 1-800-286-6635 x211.

the matter is that most of their members who perform valuations do so part-time, and relatively few hold BV designations. If working part-time means performing less than four reports annually, it could take a 30-year career to mimic the experience gained from a five-year period of full-time learning. This is tantamount to learning on the client's dime and harms the industry.

Compounding the part-time dilemma are the use of computer-generated reports, and production of what can be termed "cookbook valuations." While such valuations are theoretically compliant, the results are faulty at best and egregiously incorrect at worst. There are also concerns relating to the type of data used by part-time valuators. Each year, established firms spend thousands of dollars on data to ensure their research is robust. Dabblers either omit using such data (preferring their "assumptions") or simply acquire limited data, which is insufficient. It is hard to suggest which is worse:

- A seasoned designated analyst generating substandard work and charging a premium.
- An unskilled analyst conducting substandard work and doing so at a discount.

Both harm clients and the industry with no consequences, and reinforce the "art" moniker in the 'art and science' perception of the industry.

Clients

In litigation, clients (often an attorney with a liberal arts background) will lack sufficient grasp of the fact that substandard work has been performed until at least the deposition stage, and sometimes not until trial, or never at all. In many cases, clients are oblivious to their lack of knowledge. Some who know better simply play the system with its flaws. In disputes, this tends to mean going to the middle ground. At first glance, this seems appropriate, but it assumes equal distance from the central tendency by both BV practitioners, and means that outliers will not be exposed.

In client examinations and audits, matters rarely go to court. The logic goes that the "right answer" is somewhere between a spread of two opinions. However, without breaking a client's budget, there can be a narrowing of the pool of data points nearer to the central tendency. Simply negotiating a result fails to expose that one or both parties may have done a poor job.

Investors

It is generally accepted, unless specified to the contrary, that a valuation result is the product of a notional transaction which the pool of buyers and sellers are most likely to agree with. These buyers and sellers are investors seeking arbitrage (an economic advantage). How much time is expended by practitioners in discussing who these investors are? It *is* relevant for valuation purposes.

As an example, in looking at Bizcomps or Midmarket Comps data, errors often occur from selection bias. First, not all consummated deals are reported. And, the lower a business' revenues and profits, the more difficult it is to sell the listed company. In fact, the odds are stacked against the seller. Reported transactions only reflect the subset of *consummated* deals, not those that have listed and never sell. We also do not know whether the transactions relied on for pricing multiples concluded at the initial price and terms, which may have used debt or equity funding. Nominal time is spent exploring investors and deal capitalization details. And while most deal-makers will say that business management and culture are often key factors in transactions, this is not reported as a consideration for comparison or adjustment in selecting multiples/rates.

Similarly, issues like cash, cash equivalency, and capital availability should be influencing the pricing multiples and investor concessions ubiquitously referred to as "discounts." It should hold true that the fewer the investors, the greater the expected concessions. So, who these investors are, and what their numbers are should be part of the discussion. It rarely is.

Control

The manner in which control influences premiums and discounts also needs to be visited. First, why do real property appraisal standards require "marketing and exposure time" while valuations of intangible assets do not? For example, if a business owner recently suffered a heart attack and tried to sell 100% of the business to the first solid offer received, would this count as a legitimate data point? Consider whether a reasonable marketing and exposure period, after the business has been prepped for sale, is more akin to what "control" infers. Also, control of a business should not assume a business is optimally operated. What "optimal" means requires more valuator skills than simply examination of financial and comparative data.

Risk

When drilling down to what a valuation conclusion is supposed to capture, the answers are simply (1) investor expectation of economic benefit; and (2) risk. There are two primary risks that valuators are retained to quantify:

- Entity level risks.
- Equity level risks.

When so little time is expended addressing asset class risks and highlighting the entity and equity level risks, it is no wonder that there is a prevalent end-user perception that valuation work products are "as much art as science." Actually, drilling down to what factors are influencing risk is what minimizes the "art" and maximizes the science. If empirical data exists to support a premise, then the facts are the facts. They are not subject to averaging. They are not unsubstantiated notion of rates and multiples. Our industry has been woefully weak in this arena. Teaching methodologies is not the same thing as understanding and quantifying risks.

Relationships. For example, relationships are often a key risk variable, such as the existence of banking relationships at the entity level. A business owner may be happy with his bank, but where the banker has not been able to demonstrate the optimal use of debt leverage for better growth and performance, the relationship would be seen as less than optimal. This is higher risk. Key relationships also exist with trusted advisors. Does an advisory board exist, and is it comprised of individuals who tell the controlling interest holders what they need to hear? Is the accountant performing tax and compilation work simply looking in the rear view mirror instead of building value? Is this an ideal relationship?

Staff. Since human capital is among the largest investment of most companies, understanding the subject's culture and importance placed on labor seems to receive short shrift. This clearly reflects various risks that can and should be quantified. The age, health, education, and experience of key individuals is relevant. How much does staff tenure and turnover matter? How about relationships with and between supervisors and employees? The absence of medical, life, or disability insurance? These issues all reflect concerns that should be considered in the context of how risks are eliminated, minimized, or mitigated through agreements, policies and culture. However they generally do not show up on provided financial statements or most legal documents (and the documents that are provided may be outdated).

If the company has legacy staff (human capital) in lieu of investment in equipment such that reported headcount and labor expenses are atypical, is this a risk that flows through both equipment downtime, repair and maintenance, insurance, tax, and occupancy costs? What if the company estimator is in his sixties and has a stroke, or the superstar sales person who accounts for 40% of revenues elects to go to a competitor? Are there any compensation incentives to prevent employee defection?

Risk is also associated with vendors. What is the impact of too much capital being tied up in high inventory? What if a critical vendor is having financial difficulty or might be acquired by a competitor? Clearly, the relationship issue is much more than the founder and family who establish a company's culture. Yet how much are these risks discussed and measured when quantifying a price multiple applying the market approach or a discount or capitalization rate under the income approach?

The Data

Interestingly, while there is often discussion of what transactional data was relied on by valuators, and warnings that too few transactions are unlikely to provide a result with reasonable accuracy, what seems to be missing is sufficient analysis of comparative and industry data.

Many valuators rely on Risk Management Associates (RMA) data to compare their subject company to the industry, based on asset or revenue size. The data clearly has utility, but has asset-based bias, as it is primarily geared to bankers performing credit analysis. There is already some data bias given that the data points are from businesses seeking, or with existing, banking credit relationships. It stands to reason that the financial information reported and relied on likely leans towards more bankable candidates.

Another issue is the availability of data points. If the data pool of companies with over $25 million in revenue consists of 19 files, is that a sufficient sampling to compare to the subject company for the purpose of normalizing reported economic benefit? And what if the company was operating in the lower measures of $5 to $10 million and $10 to $25 million in prior years? Have these two groups been used? Or if the subject was at $22 million, which is in the upper register of the $10 million to $25 million revenue range, how would the provided data skew if the median or mean company was nearer to $12 million?

These examples illustrate how there can be incorrect normalization adjustments, assuming any are attempted. IRS comparative data has the advantage of having more data points broken down by:

1. Only net income.
2. Net income as well as more operational level indices such as repairs, maintenance, and advertising.

However, the Service groups businesses in differing maturity stages together, so a five-year old company that recently merged with another company and now reports $25 million in average assets is compared the same sized 30-year old company that divested a subsidiary with the same level of assets. In addition, IRS data runs four years behind. In other words, the 2012 data is derived from 2008 tax returns. The motivation of reporting the lowest possible taxes and that of achieving a loan or line of credit can each produce skewed results.

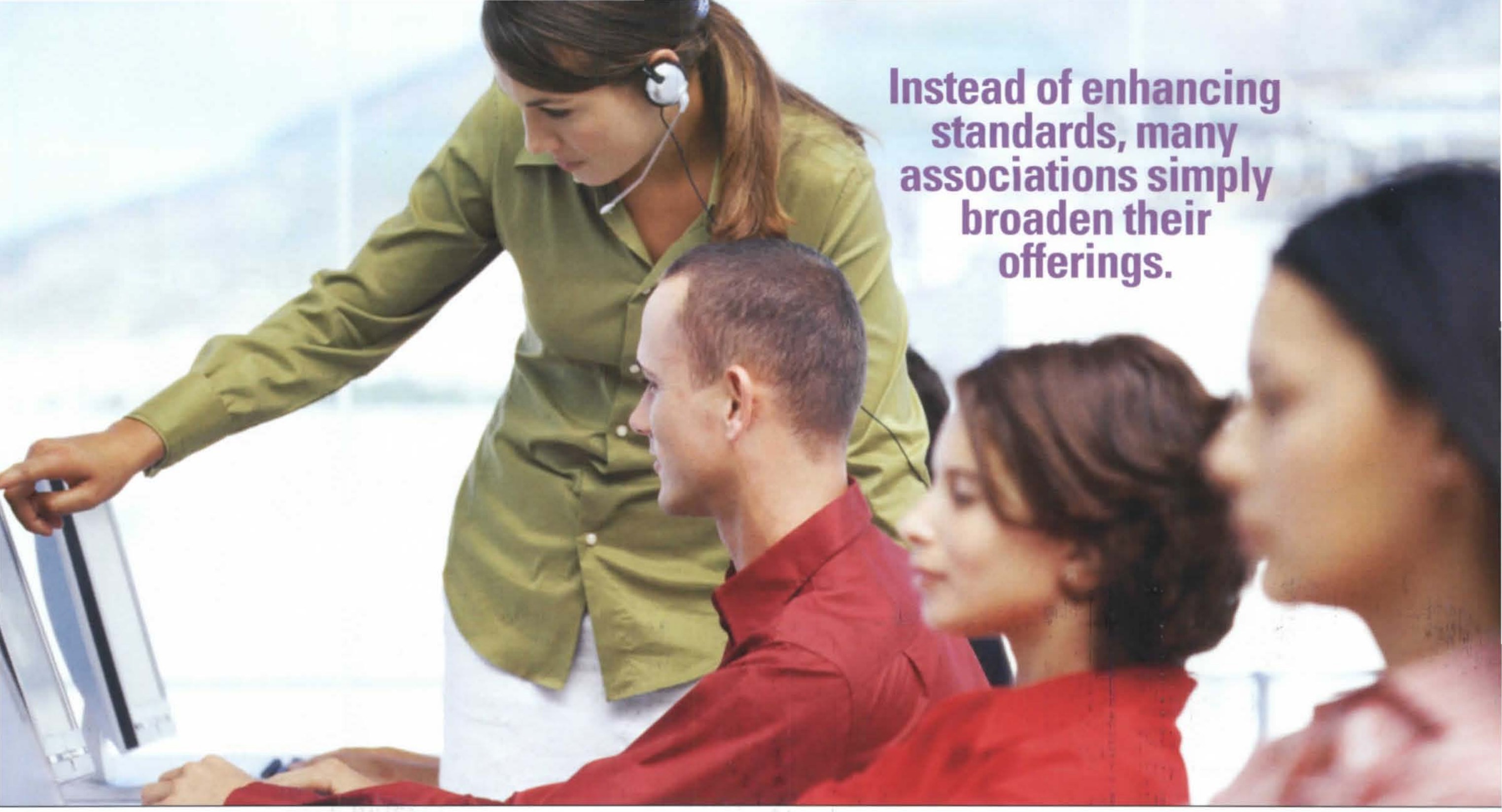
Industry data from IBISWorld may be useful for addressing headcount, average salary, or average sales per employee. However IBISWorld's weakness is that there is no segmentation by company size. Other sources include First Research for comparison data, and Dun & Bradstreet, which provides a good degree of geographic and industry- specific competition and characteristics, so issues such as competitive landscape and market size may be ascertained. No one source is a magic bullet and dissimilarities need to be discussed. It stands to reason that reporting the data limitations may make the veracity of the analyst's results more transparent. Why is the usage of multiple databases not common practice and required? Why are the limitations of these data sources other than transactional data not required to be reported?

Illiquidity/Marketability Discounts

Most DLOM studies have selection bias. And in one area, they all seem to fall short. While it is understood that an interest in private equity is less liquid than its actively traded public cousin, the issue of viable and well supported DLOM adjustment is still murky.

As mentioned earlier when discussing real estate, several things are known with a reasonable degree of certainty. The period when real estate is available for sale does influence the level of price concessions made. Home sales volume, demand, and prices are all currently greater than just three years ago. Then it stands to reason that DLOM data results *are* influenced by external events at the time they are reported. The context as to what was occurring as of a given date, if not considered, skews study data.

Consider the real estate market in 2009 as a comparison. There were high foreclosure rates and limited capital available for lending. This created a glut of supply. The result was real estate had much less liquidity despite falling inter-



est rates, and this supply-demand imbalance was reflected in asking prices as home inventory languished on the market with greater and greater seller concessions (see Miami, Las Vegas, Phoenix, and Sacramento as prime examples). It can be observed that:

1. If the discount would be the same during two periods, it would only be as a result of coincidence or a great deal of market and asset stability.
2. Every asset has an optimal marketing and exposure period.

Studies relating to illiquidity seem to suggest that beginning on day one, an equity's illiquidity impairment would gradually rise, as seller concession become greater, since the equity could not be readily converted into cash. This is nonsensical. Revisit the scenario of a house during a stable market. If there was a certain inventory of available homes for sale with most listing for $300,000, most selling at asking price in 120 days and a certain number of qualified buyers looking to buy, then the variables tends to be time and pricing. In other words, what would happen if a seller "discounts" their home by 10% to $270,000? While more buyers are likely to make an offer in the first 30 days, the seller has not likely optimized the investment since an additional $30,000 could be expected if the listing period was an additional 90 days.

Conversely, if the seller lists the home for $330,000 and 120 days passes without a qualified offer, then the duration following this period likely has an associated opportunity cost—especially, if the seller concedes to a price at or below $300,000 as the listing becomes "stale." The point is that optimal return is sought by the investor, with time, duration, marketing exposure, and external variable (such as interest rate) considerations. Accepting a low offer too soon or adjusting to a market rate too late is likely to result in an unnecessary concession. Buyers' risks are associated with return expectation, holding period, and availability of capital.

There is more than adequate data for understanding the degree of performance of assets held for differing holding periods. We have data that captures the influence of the cost of capital when debt is used. It stands to reason that the level of illiquidity impairment would have to be adjusted such that the return on benchmark indexes are, at a minimum, being met. Stated another way, if equity return "norms" are 15% reflecting investor expectations and the investment held is providing only 10%, then a 33.33% concession will be sought. Certainly, this then requires further discussion of what portion of total return is derived from distributed yield and what portion is derived from capital appreciation.

Arguably, if no immediate economic benefit occurs from capital appreciation, then the illiquidity concession would be greater. Conversely, if most of the economic benefit derived is yield that is distributed and approaches total return, then a lower impairment concession is likely to be expected. Stated another way—the 15% total return has to be studied to determine what portion is yield (income) and what portion is capital appreciation (growth).

The Income Approach

The refinements for measuring company-specific risk by Duff & Phelps and Roger Grabowski must be acknowledged. With the splitting of the 10th decile of Ibbotson's equity risk premium into new breakpoints and size premia, decile 10z (micro-cap companies) recognizes size risk. As of this writing 10z small public company capitalizations range from $1.1 to $96.2 million with an overall 11.65% size adjustment, versus the 10th decile (10) reported as 6.03%. However most companies comprised in this decile have no reported earnings. In fact, not until the mid-cap companies (3rd to 5th decile) with values in the billions does one find that most report positive earnings.

For thinly traded (below 50,000 daily trades) unmonitored public companies in the *(Continued on page 45)*

(Continued from page 23) 10th decile sector, since their shares are mostly held by insiders and institutions, the application of additional illiquidity adjustments, without fully understanding whether this impairment is already baked into their price, is akin to double-counting. Conversely, treating these interests as though they are non-controlling also may be inconsistent with market realities.

Finally, the issue of tax-affecting needs a revisit under this approach. The great majority of companies that owe taxes pay average combined rates of 25% or below; therefore, simply applying combined rates to the S corporation of 30% to 40% just further skews the data.

These relevant issues require further examination and until there is a better approach to quantify company-specific risk, control, and liquidity impairments, and discuss adjustments, the opined results are suspect.

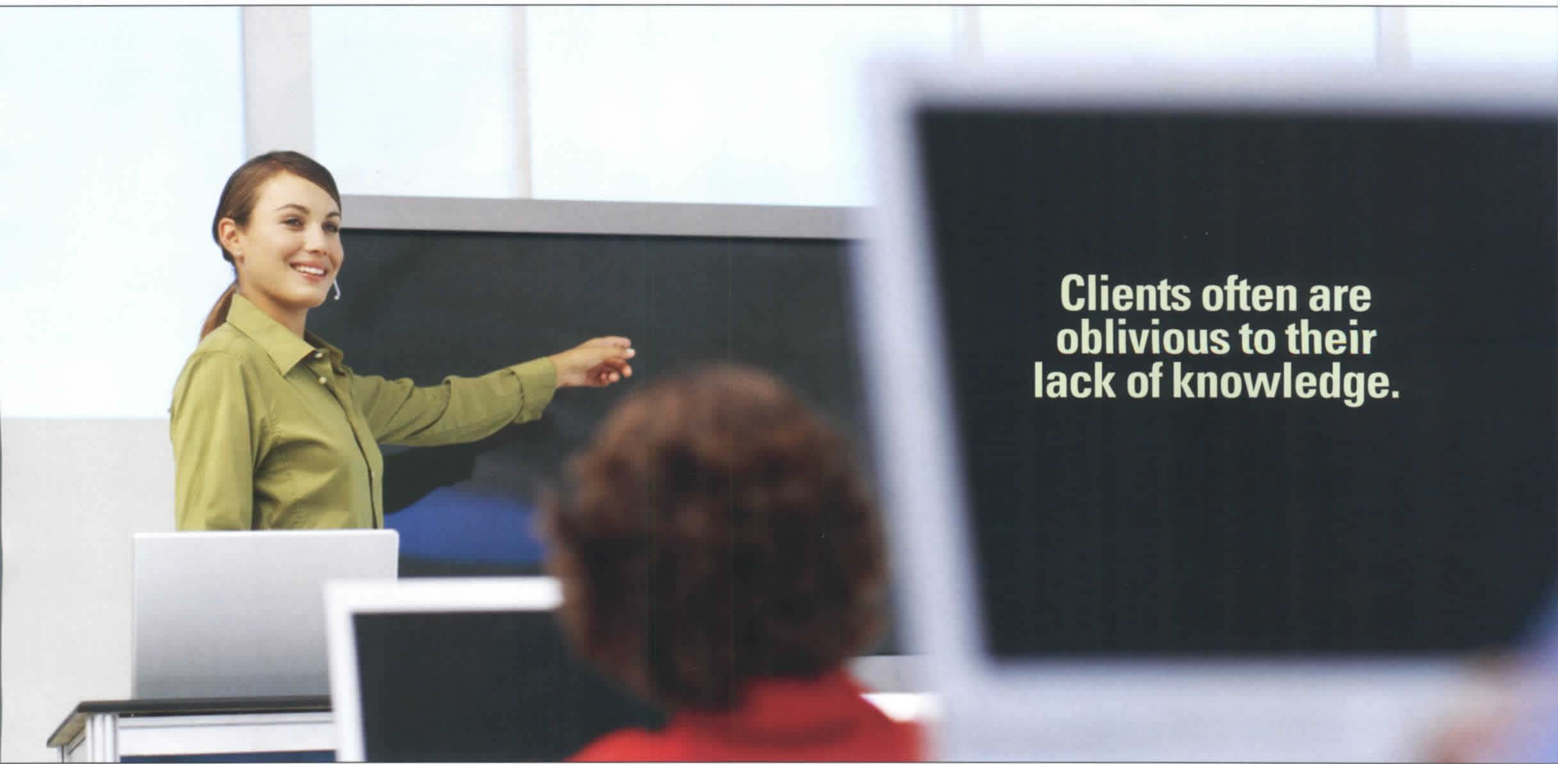
Market Approach Concerns

As addressed above, time frame and listing period will affect transactions. And in the absence of consideration of terms and amount of cash down payment, the results can be skewed. But there is a larger point, which is seldom addressed. If the subject company's performance/risk profile has been identified to be less risky than its peers by 30%, then it stands to reason that the selected multiples should be other than the medians found for the transactions relied on in this approach. However while some data has more points of comparison, such as Pratt's Stats, there may be insufficient transactions to use. Regardless, if the trend appears to be that price to revenues multiples does not appear to change significantly between companies with $5 million and $500 million in sales, then size adjustments may be inappropriate (either in the market or income approaches). Also, some industries place greater emphasis on the price-to-revenue multiple, so weight should reflect this factor.

Again, examination of debt may be germane in considering whether the multiple should be adjusted. When observing cash flow, EBITDA, SDE, net income, and earnings multiples in the double and sometimes triple digits, the first thing to check is the reported economic benefit (% net income/cash flow/EBITDA to earnings and returns on assets/equity), then how much weight the price to revenue multiple may have for the industry (using regression analysis). It's rare that a given transaction has both a high price to earnings multiple *and* high earnings as a percentage of revenues.

So, selecting the higher multiples to imply better performance is likely to skew results. The converse would also be true for lower performance. What is important is to determine how much relevance the investors (buyer and seller) are placing on asset composition, level of profitability, or past growth (not found in most transactional data), which may have much more to do with selecting and adjusting multiples than simply choosing a quartile or quintile.

Unless there has been clear evidence that market factors have driven elevated multiples, such as the period of the dot.com boom where premiums were being paid (with use of buy versus build equations), in most cases the market approach is likely to provide much better evidence of arm's-length value than trying to divine company-specific risk within the income approach. The income approach can and should be considered when the elements of growth, profitability, and capitalization



(debt/equity mix) may not be adequately captured in the market approach. The inherent and oft unspoken weakness of the market approach is it can seldom capture the proper risk of a company going through significant transition, such as expecting to lose 30% of its business, or achieving significantly high growth year-over-year for six consecutive years. In such cases the income approach is likely to better capture the present value of economic benefit achieved in the future.

Listings. Similar to the use of real estate transactions as comparables, listings should be used as the most recent reflection of what sellers are thinking (with presumed guidance from their intermediaries). Listings can provide insight to the degree of activity and asking prices of companies in given markets. The asking prices can be adjusted by the concessions found between asking and sales price in transactional data.

Possible Solutions

The above observations are not entirely objective but rather formed through the lens of personal experiences, which is the same bias that occurs from an experiment being conducted by one person absent a control. The intent is to challenge thought leaders to hold the majority of valuation professionals to either raise their A-game or stay on the sidelines.

Candidly, until it can be impressed on leaders in academia, accounting, and law to teach, know, and expect more, we risk the federal and state oversight that befell the real estate appraisal industry in the early 1990's. How much more would certification be worth to full-time practitioners, and the clients they serve, if enforcement and education of both full-time practitioners and client end-users were a top priority?

Nothing replaces time and practice. At a karate dojo, the Sensei thought it was a selling point how quickly my son could become a black-belt. Like many associations, the Sensei was motivated by the fees achieved in testing, not the reputation of having a dojo producing top-flight mentally and physically fit disciples. I'd gladly pay ten-fold in annual BV membership dues if thought leadership and higher industry standards were upheld.

This would vet those simply "dabbling" due to the cost-benefit, leaving those of us who wish to make this "trade" more into a revered profession that is respected by the users of the services provided. Consolidation would pave the way for having more funds available for legitimately higher levels of credentials, which could in part be more peer-based selection. The process for obtaining higher credentials could be similar to defending a masters' or doctoral dissertation, and demonstrating mastery in defending a position, not simply comprehension.

Conclusion

Further inaction assures the continued peril of a race to the bottom in BV services, fees, and quality as well as disenfranchised practitioners who receive less work because they are unwilling to lower their fees and standards. The upper-tier work will be captured by larger institutions looking to expand their advisory portfolio. These factors will serve as a trigger for attrition within BV association membership, as many members are baby boomers contemplating retirement. An everybody for him or herself mentality has developed which is arguably the antithesis of why an association is created. Much more can and should be done by the industry. The current industry response however appears to be to broaden designation offerings, which serves to dilute quality at the member level. Our industry, our clients and our practices deserve better. ●