

What To Do When Your Valuation Experts Disagree

It's not uncommon for valuation experts to disagree on the value of a company, particularly in a divorce setting. When this happens, an attorney is often left with one of two options: *attempt to compromise somewhere between the two expert's different values or, aggressively fight for your expert's opinion of value.*

Before delving into why valuations may differ, it is important to recognize that valuations by their very nature are subjective and based upon professional opinions about which reasonable people could disagree. In fact, it would be totally unreasonable to expect valuations performed by two different experts to have exactly the same opinion of value. A common rule of thumb is that valuations within 10% of each other reflect essentially the same value. If this fits your case, both lawyers and their clients are fortunate. However, it rarely happens.

Typically, two opinions of value will differ, and differences can be significant. What to do can be a complex decision. For example, in one divorce case, the other side's value was \$15 million. Our value was \$25 million. Clearly this was problem which had to be addressed.

Here are five things to consider:

1) *Is your expert's value reasonable?* Sometimes the "*ocular trauma test*" can give you the answer. Is it reasonable that an ongoing company which historically paid the owner \$1 million per year would be worth \$2 million? Sure it could happen, but not likely. Many times the answer is apparent, one of the experts value is simply unrealistic and the expert may have crossed the line and become an advocate for their client rather than serving as an independent and impartial valuator. Another common sense test is to ask yourself, *would I readily buy the company for this price?* If this is the case, the value is probably too low. If your answer is no-way; the price may be too high. The response to a solid opinion of value should be: maybe, but I would have to think about it. If your expert's opinion of value feels right, it may be time to fight. But for many valuation situations the decision is not always so straight forward.

2) *Look at the report wording?* Is the wording of the expert's report objective, simple to understand and well supported by fact, or is it unclear, aggressive and confrontational. Here are a few phrases which should lead you to question the valuator's work:

The "other" report contains judgmental errors... the correct calculation is... I believe... it is obvious...

A well done report does not require inflammatory words. It should speak for itself. It should not have a negative focus, its conclusions should be sound and well supported by facts.

Another test is whether all the report differences only benefit the valuator's client. Real differences of opinion do occur, but they are rarely all in one direction. This type of report should be challenged.

3) ***Look at the discount/capitalization (CAP) rate; is it supportable?*** Small changes in the discount/cap rate can lead to major changes in value. For example, a three (3) percent point difference in CAP Rate going from 15% to 18% can lead to a 17% difference in value.

Most valuations of small closely held company use the "Ibbotson Cost of Capital Build-Up". This is a well recognized and accepted way to arrive at an equity discount or CAP Rate. It has the following components which are added together to determine the cost of equity capital.

- Long Term Risk Free Rate
- Equity Risk Premium
- Size Premium
- Other Company Risk

Both experts should arrive at roughly similar values for the first three components since they essentially come from the Ibbotson SBBI Valuation Yearbook¹. The fourth component, Other Company Risk is judgmental and open to differences of opinion. As James Hitchner, a well recognized valuation expert writes:

The final component of the discount rate is the risk specific to the company being valued and/or the industry in which it operates. This is one of the most subjective areas of business valuation. Company-specific risk includes risk associated with the particular industry in which the subject company operates in relation to the economy as a whole, as well as the risks associated with the internal workings of the subject company, including such things as management, leverage, and dependence on specific suppliers and customers.²

¹ There are other sources for computing the cost of equity capital, but the Ibbotson SBBI book is most commonly used.

² James R Hitchner, Financial Valuation: Applications and Models, Wiley & Sons, Inc., First Edition, page 144.

It is our experience that the Other Company risk factor is typically within the range of 0% to 6%. It can be both higher and lower depending on the specific circumstances of the company being valued. However deviations from the typical range need to be very well documented with convincing support. The statement, "in the valuator's opinion..." should be a red flag to those using the report.

4) ***Are the discounts used reasonable?*** Most valuations have discounts or premiums for lack of control and lack of marketability depending on the ownership interest being valued. As Shannon Pratt says:

Often there is more money at stake determining what discounts or premiums are applicable to some business valuations than there is in arriving at the base value (pre-discount valuation) itself.³

There have been many cases in which the parties reached agreement on base values and the only disputes remaining involved premiums and/or discounts.⁴

For example, in one case our combined discount was 49% while the other side's discount was 73%. Unusually large discounts should immediately raise a red flag. They may be appropriate, but they need to be exceptionally well supported.

Some valuator's use formula based discounts. These discounts are generally wrong, since the marketplace does not follow a simple formula. Similarly, statements to the effect of: "it is our professional opinion" need to be backed up with well supported facts.

5) ***The number of normalizing adjustments made.*** Almost all valuations are based on "adjusted financial statements". That is the historical financial statements for the business are adjusted to reflect how the company would perform if it were owned by a financial buyer intent on maximizing her/his after tax cash flow.

Adjustments are important and necessary. They typically address officer compensation, related party transactions (typically rent) and some non-recurring expenses.

- Adjusted compensation should reflect a reasonable market wage for an outside person with comparable experience and job responsibilities.

³ Shannon P. Pratt, Business Valuation discounts and premiums, Wiley * sons, Inc., 2001, page 2

⁴ Ibid, page 3

- Adjusted rents should reflect the fair market rental price of comparable facilities in the area.
- Non-recurring adjustments should be few and far between. Certainly an adjustment for tornado damage is appropriate. However, adjustments for a new plant roof, landscaping, painting etc. need to be questioned. Over time most companies have these costs. They are not unusual and should be considered part of the cost of doing business.

Valuations with a lot of normalizing adjustments, particularly non-recurring adjustments need to be carefully scrutinized; especially if the opposing expert chose not to recognize the adjustment.

In conclusion, when expert valuations differ, they need to be reviewed in light of what is reasonable, what is well supported, and what is consistent with common valuation practices. Exceptions may be appropriate, but there must be very strong support for the position. The valuation should project a sense of objectivity and not a sense of advocacy.

Based on your assessment of these considerations; you should be comfortable deciding whether to *compromise somewhere in-between the expert's different values or, aggressively fight for your expert's opinion of value.*

Gary Meade, ASA, AVA, CFFA, Manager Business Valuation and Litigation Support Services for Mueller Consulting, LLC.