Keeping an Open Mind

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There are a LOT of different types of businesses out there, each with different characteristics that affect how they can be appraised.

As business appraisers, we run into businesses with poor financials, detailed financials, businesses that operate in multiple industry codes, businesses that are very profitable, and others that are losing money every year. We see businesses that hold excess assets, some that only hold assets and never generate a dollar of income. There are businesses that operate as non-profits, C-corporations, S-corporations, sole proprietors, Limited Liability entities, or partnerships and some that have never filed a tax return.

We could be asked to appraise any of these businesses for a wide variety of purposes ranging from a 100% controlling interest to any size of a non-controlling ownership interest. There could be a partner dispute, or maybe a partner wants to buy in. We could be appraising the equity position or an invested capital interest in a business. We could be asked to appraise a 100% interest in the assets that typically transfer in a sale or we could be asked to appraise a non-controlling equity interest in a holding company.

All of these factors can have an effect on how we reach our value conclusions.

Real estate appraisers, machinery and equipment appraisers, all tend to use the same appraisal techniques over and over. In fact, many of those appraisers even refer to their methods as 'approaches', saying things like, "I performed a cost approach to arrive at my conclusion of value." In business appraisal, we have multiple methods available to us under each of the asset, income and market approaches of appraisal theory. And, there are quite a few ways we can modify most of those methods in different ways to accommodate the particular aspects of the subject assignment. For example, under our market approach, we have the option to consider either publicly traded comparables, or privately held comparables. We can look at a price to revenues multiple, or a price to EBITDA or some other income stream multiple. We can even consider prior transactions in the subject company that we are appraising. We can use these methods to appraise an ownership interest in the business' assets or an equity position with just a few adjustments.

The point I am trying to make, is sometimes we need to get creative and look at a method or an aspect of a method that we don't typically use in order to arrive at a credible value conclusion.

I had a conversation with another appraiser the other day, who had a valuation assignment that was giving him a hard time. His indications of value under the market approach and the asset approach were all coming in at several million dollars of value, but the method he was using under the income approach was a negative $600,000. He shared his Excel file with me and we spent about 45 minutes on the phone going over his schedules with a fine tooth comb, looking for some error, some misjudgment on his part that would account for the discrepancy. After 45 minutes of examining well thought out valuation theory presented in an easy-to-read format with no significant errors at all, I finally realized that calculating the equity directly, instead of first calculating the invested capital and subtracting out all the liabilities would provide an indication of value that was much closer to what he was looking for. We were both stuck on the one idea, that to get to an equity number, one first calculated the invested capital value, then subtracted off the debt and all the other liabilities that needed to be accounted for. The problem was with the very material accounts payable category. The "Changes in Working Capital" step took care of that issue, and in calculating net cash flow to equity instead of net cash flow to invested capital, we avoided having to subtract out all the liabilities, which gave an indication of value that supported the others already determined, instead of showing a large negative value which we knew was not reasonable.

I've had a case where the nature of the business I was appraising required me to use a Discounted Cash Flow method because I needed to forecast out multiple years of volatility, however, I did not have any balance sheet data so I could not calculate the net cash flow income stream, which meant that I could not use the Build-up method for my discount rate, because then I would arrive at a wrong conclusion of value. Before this case, when I needed to come up with a discount rate and the Build-up method was not available, I simply looked at the market data, selected a multiple, then converted that multiple to a capitalization rate, added my long-term growth rate to the result and used the same earnings stream that applied to the selected multiple such as EBITA or SDE in my forecast.

However, in this particular case, the business operated quite a bit differently then the closest industry operators did, therefore the subject market transaction data was not really that comparable to my subject, which meant that I could not feel comfortable relying on that data to represent the risk of investing in the subject business. I was appraising this business for a divorce case, and I did not want to have to sit in the stand and testify that my report had relied on data I knew was not comparable. I struggled with this report for several days, until I remembered the Factor Rating method, which is another way of calculating a multiple applicable to seller's discretionary earnings (SDE) used mainly by business brokers, but in this case, I used it to calculate the discount rate I needed to use the Discounted Cash Flow method, however with SDE instead of net cash flow.

It is good to be reminded every so often, that just because many businesses can be appraised using the same techniques or methods, not all of them can be. I often run into something that requires a material change to my basic template, which is another reason why I am happy with Microsoft Excel instead of some software tool that I can't modify on the fly, but that's a discussion for another day.

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