Higher The Risk, Lower The Value

By JoAnn Lombardi, VR Business Brokers/Mergers & Acquisitions, President

All businesses face risks, but some companies are riskier than others. Assessing a company's risk is an important part of estimating its value. Risk and value are inversely related. That is, the higher a company's risk, the lower its value.

Risk is a function of a company's external threats and internal weaknesses, but these forces only tell part of the story. On the flip side, a business's strengths and opportunities minimize risk and, therefore, build value.

When valuators focus exclusively on one side of the story, their conclusions are likely to be skewed. For example, to minimize an estate's tax burden, an appraiser might unduly emphasize a company's weaknesses and threats to justify excessive valuation discounts. Conversely, the IRS's expert might downplay these negative elements and, instead, call attention to the business's strengths and opportunities.

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Framework for Evaluating Risk

Providing a complete, accurate depiction of a company's future performance requires the valuator to consider both positive and negative aspects of its operations. A strengths, weaknesses, opportunities, and threats (SWOT) analysis provides a four-pronged framework for analyzing risk that links a business's internal strengths and weaknesses to the opportunities and threats in its external environment. This popular tool helps valuators organize their thoughts and provides a holistic risk assessment.

External forces: Opportunities and Threats

Before jumping headfirst into a company's financial performance and operations, the valuator assesses the external environment in which a company operates. Opportunities are favorable conditions that — if exploited — may enhance shareholder value. Alternatively, threats are barriers that jeopardize future performance. In many cases, management has little control over these external factors.

Internal forces: Strengths and Weaknesses

After the valuator understands the company's external forces, he or she is ready to identify its internal strengths and weaknesses relative to its competitors'. Strengths are competitive advantages or core competencies that enhance value. In contrast, weaknesses restrict the company's performance.

Strategic Management

During the valuation process, the valuator also addresses whether a company recognizes and manages its strengths, weaknesses, opportunities, and threats. Are the company's short- and long-term goals congruent with these factors? Does management plan to mitigate threats and correct weaknesses? Is the company taking advantage of potential opportunities and exploiting its strengths? A company's value can be adversely affected if management is unaware of these internal and external factors or if management fails to incorporate them into its strategic plans.

Impact of Information on Value Estimate

Finally, valuators use the information obtained from their analyses to help them:
- Select the appropriate valuation technique
- Forecast future income streams
- Decide on relevant selection criteria and other subjective adjustments under the market approach
- Build discount and capitalization rates when using the income approach
- Quantify valuation discounts, such as discounts for lack of marketability and control

Review and Investigate

In adversarial situations, a valuator's subjective decisions may come under attack. Attorneys and clients need to review valuators' written reports to ensure that all risk factors have received adequate attention. They also should investigate exactly how these risk factors affect the appraiser's computations and assess whether any factors have been double-counted. Above all else, a valuator's subjective decisions should be well supported and reasonable.

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Key External Forces that Affect Value:

The Macro-Environment

- National and local economic conditions
- Social and cultural trends
- Political factors
- Environmental policies
- Government regulations
- IRS rules

Industry Sources

- GAAP (Generally Accepted Accounting Principles) revisions
- Level of competition
- Substitute products
- Technology
- Licensing and capital requirements
- Power of customers and suppliers