

Have We Lost the Forest for the Trees?

By R. James Alerding

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“This is valuation. I don’t even have 95% confidence regarding the amount of change in my pocket.” – Dr. Aswath Damodaran

When I first started in business valuation the world was a much simpler place. You still had the three approaches to value—asset, market, and income—and you still had to determine which one(s) to use and apply in determining your value. You also still had to determine whether discounts and premiums were warranted and apply them appropriately. And finally, you had to determine if there were any other assets or liabilities to add to or deduct from your operating value conclusion.

We are going to focus on the income approach in this article and ask the question: “Have we lost the forest for the trees?” Valuation steps have become so complex and so numerous and with so many choices that it begs an answer to our question.

Whenever I teach valuation basics, I always start with the easy part. I tell the students that the valuation premise is very simple: $V = I/R$ where V = Value, I = Income, and R = the required rate of return. Of course, even in the early days of valuation, that simple formula became complex very quickly. In my opinion, in today’s world of valuation, we are coming close to the breaking point. How much is enough? Do not think that I am harkening back to the old days. I am not, *but* (there is always a *but*) I do believe that valuation analysts need to think more about the end result and less about how we got there. In 1991 I participated in an all-day program (closed circuit TV—you youngsters can look that up) on a panel with Shannon Pratt, Gary Trugman, Jim Hitchner, Larry Cook, and a special video guest named Butch Williams. The opening question of the day was whether valu-

ation was an art or a science. Everyone agreed that valuation has elements of both and that it was a matter of degree. The trick, of course, is to keep the elements in balance.

So let’s look at some of the elements now flooding the process under the income approach. Once again, I am not advocating for eliminating the basic steps required to arrive at a supportable and reasonable value, but it does seem that there continue to be added complications that might confuse rather than aid the process. It hearkens to the old adage, “How many angels can dance on the head of a pin?”

Here is a sampling of the head notes on the methods to define the benefit stream from *Financial Valuation Applications and Models* (FVAM), fourth edition:¹

- Net Income
- Net Cash Flow
- Defining Net Cash Flow
 - Cash Flow Direct to Equity (Direct Equity Method)
 - Cash Flow to Invested Capital (Invested Capital Method)
- Current Earnings Method
- Simple Average Method
- Weighted Average Method
- Trend Line-Static Method
- Formal Projection Method (Detailed Cash Flow Projections)

Okay, I get that these are all helpful methods and things that should be considered, but the process really starts to become complicated when we move from the “I” in our value equation to the “R,” required rate of return, represented in the process by the “cost of capital” (COC), also known as the discount rate. The common measure-



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ment for the COC is the modified capital asset pricing model or CAPM. The equation for that model, which all are likely familiar with, is:

$$E(R_i) = R_f + B \times R_{Pm} + R_{Ps} \pm R_{Pc}^2$$

Where:³

- $E(R_i)$ = Expected rate of return on security i
- R_f = Rate of return available on a risk-free security as of the valuation date
- B = Beta
- R_{Pm} = Equity Risk Premium (ERP) for the market as a whole
- R_{Ps} = Risk premium for smaller size
- R_{Pc} = Risk premium attributable to other company risk factors

The other popular method of determining the COC is the build-up method (BUM). The difference between the MCAPM and the BUM is that the BUM uses an estimate of the
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expert TIP

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industry risk premium (RP_i) instead of a beta.

All of these factors need to be determined in order to obtain a proper COC using the CAPM. With that I have no quarrel. However, within these factors there is a divergence of opinion as to the methodology to be applied in determining the COC. In 2013, Jim Hitchner put together a good analysis of the impact of these differences⁴ in methodology, which included:

- BUM:
 - SBBI Historical⁵
 - SBBI SS
 - D&P RP_m, RP_s
 - D&P Risk
- MCAPM
 - SBBI Historical
 - SBBI SS
 - D&P RP_m and RPS

Interestingly, Hitchner's analysis resulted in a fairly tight range of COC conclusions. The low end was in the 18 percent range and the high end was in the 22 percent range. While that can result in a 20+ percent change in value from top to bottom, it nevertheless can complicate the process and perhaps causes the valuation analyst to perform all of the options noted above and then select and support some COC conclusion within the range determined. Not only is this burdensome for the valuation analyst, but it may be difficult to explain to the user of the valuation.

This is just the tip of the iceberg. The new Duff & Phelps Cost of Capital Navigator moves the multitude of data from a print form to an online form and provides the models and modules to calculate the COC "with you." The danger here is two-fold. As with any online model (and there are plenty of others in the valuation arena, so I am not picking on the D&P Navigator), the user will have a tendency to not learn the theory behind the model's purpose. This is more likely with those who are perhaps part-time valuation analysts, but even those who make it a full-time profession can fall into this trap. Second, and closely

related to the first issue, is that the COC determined using the Navigator might be more difficult to explain to the user(s) of the valuation.

So now let's take a look at betas. Interestingly, the BUM is often criticized as being too subjective, so we should all herd around the MCAPM so we can find the magic beta that will make our valuation much more precise. Let's squeeze as much of the guesswork out of the process as we can.

Systematic risk refers to the risk that is common to all stocks or what can be considered market-wide risk. Beta is an estimate of the systematic risk of a security. Beta measures the sensitivity or volatility of the return of a security relative to movements or the return of the market as a whole as measured by an index, such as the S & P 500 Index. The market index has a beta of one. A security with a beta greater than one would be considered more risky, whereas one with a beta lower than one is considered less risky than the market. But there are no published betas for privately held companies. So we use the public market as a proxy, and some of the stocks used (usually in the same industry as the valuation subject) have already been rejected for the guideline public company method under the market approach.

Nevertheless, we march forward into the land of betas and there are choices at every turn. We have many types of betas:

- 1) Ordinary least squares (the standard beta)
- 2) Lagged or summed beta
- 3) Adjusted beta
- 4) Downside beta
- 5) Implied beta
- 6) Total beta
- 7) Fundamental beta (aka a Barra Beta)
- 8) Size-adjusted beta

But that is only the beginning. Along the way we must choose from a variety of sources that include Bloomberg, Computstat, Duff & Phelps, and Mer-

rill Lynch. And the betas published by different sources can display different results due to differing time periods, methodologies, and adjustments.

Now we all know that it is proper and necessary to unlever and relever our beta in the COC formula so that we account for the different debt structures between the comparative betas (always public companies) and our privately held company that is the subject of our valuation. Not surprisingly, there are several choices on the methodology to use in performing this function. There are the Hamada Formula, the Miles-Ezell Formula, and the Harris-Pringle Formula.

So far we have covered some of the normal channels that a valuation analyst should travel in determining a company value. But what inspired me to write this article was the seeming proliferation of assertions and theories—espoused in many valuation journals—of even more arcane methodologies to apply. For example, the Winter 2017 issue of *Business Valuation Review* features an article on adjusting the terminal value to account for inflation.⁶ The thrust of the article is as follows:

Despite the fact that it typically accounts for the majority of the estimated value of a company, the terminal value in discounted cash flow (DCF) valuations is often treated formulaically without appropriate consideration for the impact of inflation on the inputs.⁷

Okay, so I can buy that inflation could have an impact on the inputs in certain situations, but is this really a universal computation that should be made in every valuation?⁸ Interestingly, the article focuses on the depreciation issues. That happens to be one of the focus issues on valuation impact of the Tax Cuts and Jobs Act (TCJA),⁹ so the two concepts might actually interfere with each other. Collateral damage, I suppose.

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Speaking of the TCJA, this is the first time in my career that I can remember that a tax act had any impact on the valuation process, or at least not to this extent. Admittedly, valuation was not as refined a process as it is today, but up until the TCJA there was scant consideration of the impact of taxes on the cash flows. *Financial Valuation Applications and Models*¹⁰ offers one table and a few paragraphs to the following statement:

The determination of tax on future income can incorporate the:

- Actual tax rate
- Highest marginal tax rate
- Average tax rate¹¹

In fairness, the table did demonstrate that the value could vary by almost 20 percent, depending on which of these options was selected. However, it was rarely an issue in any particular valuation, including those that might be the subject of a litigation matter. The TCJA has now focused the valuation community on tax issues in determining a value for a business. We are now talking about things like “bolt-on models” and such to determine the impact of depreciation issues in the TCJA on a particular valuation.

I recognize that the lower tax rates will result in higher values for companies, but it appears to me that there is somewhat an overreaction taking place. My informal survey of some business brokers indicates that the TCJA will not have any impact on multiples of income, EBIT, EBITDA, etc. for the values of smaller businesses. As some have pointed out, we will have to wait for a year or two to see if the multiples in the transaction market actually reflect a difference in values.

One good result of this focus is that there is a lot of soul searching going on as to the value of a pass-through entity as a result of the TCJA. Full disclosure: I have never believed in an added value for a pass-through entity, especially in the case of a control interest. The TCJA should put the pass-through premium issue to rest, but alas, it likely will not. At least not



until the Tax Court gets off of its false premise of assuming that because there is no corporate-level tax, there is no tax at all.

There are many more overlapping process issues than the ones we have discussed in this article. We have not really touched the market approach and the myriad of process issues there. In fact, there are many more in the income approach that we have not discussed. There are also issues such as discounts and premiums.

So just what am I espousing? I am suggesting that we stand back at the end of whatever process and decisions we make in performing a valuation and take a hard look at the resulting valuation conclusion. Does it really make sense considering all of the other issues that should be taken into account in the determination of the value of a business interest? The AICPA’s *Statements on Standards for Valuation Services*¹² outlines the process for performing a valuation engagement. Paragraphs 25 to 30 outline the analysis of the subject interest. It is a good place to start in applying the necessary analysis to the preliminary conclusion of value to an engagement.

Too often I find that the valuation analyst simply follows the process but excludes what I call the “art” part of valuation. All of the BV standards of the major valuation organizations (AICPA, NACVA, ASA, IBA, The Appraisal Foundation, and USPAP) allow for a range of value or a single amount. They realize that the value determined, for example, in a fair mar-

ket valuation is an estimate of value and not an actual value (as, for example, a “sale price” might be). As a result, there has to be an *art* part of the process or all that has been done is to produce a formulaic answer. The art part is aided by the analysis part of the process. Along the way it can assist in determining the cost of capital under the income approach and/or the multiples to be used in the market approach.

It is the skill in applying the art part of the valuation process that separates the great from the good. So I urge all valuation professionals to value the forest and not to simply count the trees. ☞

¹ James R. Hitchner, ed., *Financial Valuation Applications and Models*, fourth edition (Hoboken, NJ: John Wiley & Sons, 2017), p. 128.

² *Ibid.*, p. 194.

³ *Ibid.*

⁴ “Cost of Capital: Comparisons of Ibbotson and Duff & Phelps Data Inputs in the MCAPM and BUM,” *Financial Valuation and Litigation Expert*, Issue 45, Oct./Nov. 2013, Valuation Products and Services, LLC, pp. 1, 3-7.

⁵ All SBBI data is now part of the Duff & Phelps data and has been renamed.

⁶ Bradford Cornell and Richard Gerger, “Estimating Terminal Values with Inflation: The Inputs Matter – It Is Not a Formulaic Exercise,” *Business Valuation Review*, vol. 36, no. 4, American Society of Appraisers, 2017, pp. 117-123.

⁷ *Ibid.*, p. 117.

⁸ The article implies that the inflation impact occurs in valuations using GAAP financial statements and GAAP financial forecasts.

⁹ Tax Cuts and Job Act, 2017.

¹⁰ Hitchner, pp. 125, 126.

¹¹ Hitchner, p. 125.

¹² VS Section 100, “Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset,” American Institute of Certified Public Accountants, Inc., 2015.