

BDG Business Valuation Insight

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The art of quantifying company-specific risk

Company-specific risk (CSR) is one of the most subjective components of business value. According to Business Valuation Resources' 2009 *Glossary of Business Valuation Terms*, company-specific risk (also known as unsystematic or investment-specific risk) is "the portion of total risk specific to an individual asset that can be avoided through diversification." In other words, CSR represents the incremental risk an investor bears by investing in only one particular business.

Quantifying CSR can be tricky absent good empirical research or market data. This is where the "art" of appraisal comes into play.

Using CSR in valuation

A valuator typically assesses CSR when estimating a private firm's cost of equity — one component of the company's discount rate, or required rate of return. The valuator uses the discount rate as a variable in the income approach, which is one of the three generally accepted valuation techniques.

A valuator can observe other components of the cost of equity directly from public markets or empirical studies, such as data published by Morningstar/Ibbotson or Duff and Phelps. For example, the valuator might begin by measuring the risk-free rate per the return on a long-term U.S. Treasury bond.

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But virtually no published market data exists for private firm prices or financial performance. So quantifying CSR for a privately held company ultimately is left to a valuator's professional judgment.



A valuator usually captures CSR by adding a premium to the cost of equity. The riskier a business is, compared with a diversified investment portfolio, the higher its CSR premium — and the lower its value. Each business faces, and responds to, unique risk factors. The current sluggish economy has adversely affected many firms, increasing their risks and decreasing values. (See "CSR in an uncertain economy," on page 3.)

Demystifying CSR

It's important to note that valuers don't arbitrarily pull CSR premiums out of their hats. Rather, they use models and factor analysis to quantify CSR. A valuation expert's techniques vary, depending on

case specifics and personal (or firm) preferences. While the concept of CSR is widely accepted in valuation science, no consensus exists on *exactly* how to estimate it — or on the appropriate range of the CSR premium.

In general, however, some important qualitative factors a valuator addresses when quantifying CSR include:

Market risk. Macro- and microeconomic factors affect risk. To illustrate, a valuator considers the level of competition, relative market share, risk of product substitution, regulatory environment, and local and national economic conditions.

Business risk. Internal factors also impact CSR. Operating inefficiencies, insufficient plant capacity, dilapidated equipment, pending litigation and poor labor union relations add business risk, for example. Small firms and startups also may be riskier.

Management risk. Undue reliance on key persons increases CSR. Other signs of management risk include restricted access to accounting information and weak internal controls.

Concentration risk. When evaluating concentration risk, a valuator assesses the relative power of buyers and suppliers along the company's supply chain. If a customer (or supplier) represents 10% or more of the subject company's revenues (or purchases), that should raise a red flag — especially if there are no long-term contracts.

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Financial risk. Investors also consider the ratio of debt to equity. For example, investors prefer businesses with low debt levels and high credit ratings.

Another way a valuator tackles CSR is by analyzing a company's strengths, weaknesses, opportunities and threats — or SWOT. A SWOT analysis not only

CSR in an uncertain economy

Today's business landscape is markedly different than it was ten years ago. Evaluating company-specific risk (CSR) in an uncertain economy presents numerous challenges.

Value is a function of long-term future expectations, not historic results. A valuator must consider how current economic conditions affect the subject company's long-term operations, as well as how effectively management responds to these challenges.

Recessions and economic uncertainty are part of the business cycle. But a bad downturn can force many sectors, such as homebuilders, auto dealers and retailers, to radically rethink their business models.



On the other hand, a valuator needs to avoid double-counting risk factors when valuing a business. For example, he or she might factor economic uncertainty into income projections, marketability discounts, guideline company selection criteria, pricing multiples and CSR premiums. An experienced appraiser understands how to achieve balance — by equitably accounting for economic adversity in his or her valuation.

identifies pros and cons, but it also addresses how management responds to its environment. A strength or an opportunity only builds value if management capitalizes on it. Similarly, management can mitigate threats and weaknesses by taking corrective action.

Defending CSR

Like a work of art, a valuator's opinions sometimes need to be defended from critics. CSR premiums are an easy target for opposing counsel. A strong valuation report defines CSR, establishes the need to apply a CSR premium and details how the premium was quantified. On the stand, a valuation expert should be able to fully articulate his or her analyses and opinions. ●

Fatal flaws

Finding weaknesses in an opposing expert's opinion

A key function of a financial expert is to provide effective rebuttal to the opposing expert's analysis and opinions. Accordingly, counsel must gather foundational information about the opposing expert's opinions, including a complete understanding of their methodology, information, sources, authorities and assumptions.

Use the deposition to your advantage

To ensure your expert witness has full knowledge of your case, ask him or her to prepare questions for the opposing expert's deposition. You may even want your valuator to attend the deposition, in which case he or she should be familiar with, and be prepared to respond to, questions about the opposing expert's opinions.

If your expert doesn't attend the deposition, make sure he or she reviews the opposing expert's deposition transcript before trial to point out any weaknesses or inconsistencies with the expert's written report.

Connect with the case

Someone is bound to disagree with your valuation expert's opinions. But the key for an expert is to

connect his or her valuation opinions with the case at hand. The expert witness must show the judge and jury why a particular expert opinion applies to the case.

This may also involve showing why the opposing expert's views aren't relevant to the case. It may be clear that the opposing expert is unfamiliar with the plaintiff's industry, or that his or her expertise doesn't pertain to the business under discussion.

In addition to clarifying his or her own financial analyses, your valuator can also critique the opposing expert's report — either formally in a rebuttal report or informally in a verbal discussion or memo.

One valuable piece of information is the opposing expert's workpaper file. Time and money permitting, ask your valuator to inspect the other expert's files to



