Valuation & Litigation Briefing

JULY/AUGUST 2019

# Industry experience is key when valuing professional practices

In litigation involving professional practices, many courts have recognized the importance of industry-specific valuation experience. A recent Nebraska Supreme Court case — *Fredericks Peebles & Morgan, LLP v. Fred Assam* — illustrates this point.

## Battle of the experts

The primary issue in this partner buyout case was the fair market value of a departing partner's 23.25% interest in the law firm Fredericks Peebles & Morgan, LLP (FPM) in late 2014. Both sides hired experts to value the interest:

**FPM's valuation evidence.** FPM hired a law firm management consultant who had worked with more than 500 law firms of all types and sizes over the last 25 years. As a specialist in law firm M&A, FPM's expert had previously performed around 25 law firm valuations. He also had published articles and spoken on law firm valuation and financial management.

After considering the asset-based, market and income approaches, FPM's expert used the discounted cash flow (DCF) method. He relied on five years of historical income statements adjusted for certain nonrecurring expenses and liabilities. His DCF analysis considered economic and government regulation risks, as well as firm-specific risks associated with sustainability, infrastructure, technology and data security.

The expert's discount rate was computed using a build-up method. Specifically, he started with a risk-free rate, and then added incremental amounts to reflect legal-industry-specific risk and firm-specific risk. The expert believed that FPM was riskier than other law firms because its collection rate was below average and its revenues were generated primarily by aging partners. After applying a 60% discount for lack of control and marketability, the expert valued the partner's interest at $590,000.

**Departing partner's valuation evidence.** The departing partner was a financial attorney who often dealt with business valuation matters. He testified that his interest was worth approximately $4.9 million, based on his own analysis. He also submitted valuation opinions from three external business valuation experts.

Two experts were from the same CPA firm and co-authored a calculation report in 2014 and a full valuation report in 2016. Though the experts had significant valuation experience in other industries, together they had previously valued only one law firm. Neither had published any articles or spoken publicly about valuing law firms.

Using the income approach, the experts valued the interest at roughly $3.42 million, based on average normalized annual pretax revenue over a four-year period. Their valuations also included a 10% discount for lack of control (due to nonoperating assets) and a 5% discount for lack of marketability (because FPM's partnership agreement effectively created a market for the partners' interests).

The third expert reviewed the other valuation opinions, and found numerous errors. He concluded that FPM's expert had *understated* the interest's

## Close-up on key people

Many professional practices are highly dependent on a founder, visionary leader, rainmaker or other key person. For some firms, a key person discount may be appropriate. The discount reflects the risk that the business would suffer a major financial setback if the key person died, retired or otherwise left the business. However, the mere presence of a key person doesn't automatically warrant a valuation discount.

To determine whether a discount is appropriate, a business valuation professional evaluates the potential impact of losing the key person. Important factors to consider include:

- The nature of the business,
- The key person's role,
- The individual's specialized technical knowledge and relationships with customers and suppliers,
- The quality and depth of the rest of the management team, and
- The strength of the company's succession plan.

Even when a key person discount is appropriate, it can be challenging to quantify. Experts may, for example, account for key person risks by reducing future earnings, increasing the discount or capitalization rate, or discounting their value conclusion by a certain percentage.

value by $1,235,000 and that, based on the 2014 calculation report, the departing partner's experts had *overstated* the interest's value by $1,275,000. Based on those adjustments, the departing partner's third expert believed that the value of the interest ranged from $1,825,000 to $2,145,000.

### A matter of credibility

The trial court adopted the valuation opinion of FPM's expert. On appeal, Nebraska's Supreme Court upheld that determination. Both courts stressed that expert's substantial, relevant experience and detailed analyses in finding him more credible than the valuation evidence submitted by the departing partner.

The judges criticized certain aspects of the co-authored valuation opinions. For example, the experts relied on only four years of revenue, disregarding data from 2010, a year with unusually low revenue. Also, they assumed that the buyer was FPM, rather than an objective hypothetical party — despite the use of the term "fair market value" in the partnership agreement. And they criticized the experts' upward adjustment in value to reflect the fact that, as a pass-through entity, FPM wasn't subject to corporate taxation.

### Experience counts

This case demonstrates the importance of industry-specific experience in establishing credibility for a business valuation expert. Because of his "vast" experience in valuing and managing law firms, the prevailing expert was able to show the court why his methods were appropriate and how the unique risks inherent in operating a law firm require an approach different from that used for other types of professional service firms. ■

# Quality counts in M&A due diligence

## Consider both quantitative and qualitative assessments

In mergers and acquisitions, the target company's financial statements provide the numbers to support the selling price. But how sustainable are those quantitative results? Increasingly, investors are obtaining quality of earnings (QOE) reports from independent business valuation experts to find the answer.

### Looking to the future

Buyers, sellers and investors must look beyond historical financial statements. QOE reports help identify internal and external trends that may provide value-building opportunities — or threaten a company's future performance.

Consider these examples: Fifteen years ago, there were roughly 9,000 Blockbuster Video stores worldwide. In the early 2000s, the founders of Netflix tried to convince Blockbuster to purchase their struggling start-up for $50 million. Blockbuster declined the offer numerous times, because the start-up was unprofitable.

Today, Netflix has grown to a market cap of roughly $150 billion by staying focused on market trends. In doing so, Netflix has capitalized on changes in technology and transitioned its distribution model from DVD-by-mail rental to on-demand Internet streaming. Perhaps a QOE report might have helped Blockbuster identify and capitalize on these trends?

Instead of choosing Netflix, Blockbuster chose to partner with Enron Broadband Services to launch a video-on-demand service. That deal fell apart in 2002 after news broke about Enron's scandalous financial statement fraud. Again, a QOE report might have revealed some alarming trends about this joint venture partner.

Eventually, Blockbuster filed for bankruptcy in 2010 and was bought out by Dish Network for $320 million a year later. Today, only one Blockbuster store remains open. A QOE report might have helped Dish Network recognize that Blockbuster's prospective earnings weren't sustainable in the 21st century.

These examples show how historical results are only relevant to the extent that they can be used to predict net free cash flow to investors in the *future*. QOE reports interpret the target company's historical results in the context of today's market conditions. This analysis can help identify trends that may cause future performance to differ from what's happened in the past.

### Digging deeper

QOE reports evaluate the details underlying the target company's earnings. For instance, gross profits may be broken down by geographic region, salesperson or product line to understand what's making money — and what's not. Examples of operating issues that may be unearthed in a QOE report include:

- Customer or supplier concentration risks,
- Seasonal cash or human capital shortfalls,
- Deferred equipment purchases and maintenance,
- Bad debts,

- Obsolete technology,
- Dependence on a key person,
- Capacity constraints,
- Undisclosed related party transactions,
- Pending litigation,
- Emerging competition and substitute products, and
- New government regulations.

Another important metric that may be evaluated in a QOE report is earnings before interest, taxes, depreciation and amortization (EBITDA). EBITDA isn't audited — and it can mean different things to different people.

In a QOE assessment, EBITDA is typically adjusted for such items as owners' compensation and other discretionary spending, nonrecurring revenue and expenses, and accounting methods that differ from industry norms. It's also important to recognize that depreciation and amortization may not approximate the amount that the company would need to spend on long-term assets.

In addition, the QOE assessment typically includes ratio analysis to identify trends and determine possible causes. For example, suppose a company's inventory has increased substantially over the last three years. The increase might be expected if the company's revenue is growing. But it might also be a sign of poor inventory management practices or obsolete inventory. The inventory turnover ratio (average inventory ÷ cost of sales × 365 days) can help determine what's happening.

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## Customizing a QOE report

A business valuation professional has been training to conduct an independent QOE report that suits your needs. These experts focus on what matters most to hypothetical buyers and sellers — expected net cash flow — and they're sensitive to the confidentiality concerns that may arise in M&A situations.

# How to value a start-up business

Established businesses have track records of earnings and cash flow that can be used to predict future financial performance and estimate value. Start-ups present valuation challenges because they lack such track records — but that doesn't mean they have no value. Business valuation experts must look to other factors, many of them subjective, to estimate value.

## Starting points

Compared to mature businesses, start-ups are generally perceived as riskier ventures. So, potential buyers or investors demand a greater rate of return to compensate for that risk.

Management's business plans and financial projections are critical when valuing a start-up business. No one knows the company's products and services, the industry and the market better than the company's founders and senior executives. If an entrepreneur hasn't prepared business plans and projections, it could raise a red flag that management hasn't thought through all the potential pitfalls of starting a new business in that industry.

To value start-ups, experts typically use management's projections, if they're realistic and based on reasonable assumptions. In some cases, a valuation expert may need to discount internal projections to account for management's natural optimism. Experts need to dig deep to fully understand what differentiates the start-up's products and services in the marketplace and how much growth potential the company has.

To this end, valuation experts also consider external factors. Examples include the experience and value of comparable companies, industry and market statistics, and the value of intellectual property or other assets that give the company a competitive advantage.

## Development stage

Another critical factor is time. How long will it take before a start-up is expected to become profitable? In general, the shorter the time frame, the lower the risk and the more valuable the venture is. That's because a buyer or investor need not wait as long to achieve an "exit."

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A related factor is the company's stage of development. For example, a company in the earliest stages of development — with little more than an idea and perhaps some "friends and family" financing — may be less valuable than one with well-developed products and services.

Financing from venture capital firms and other professional investors is another important indicator. These investors perform thorough due diligence in scrutinizing a company's management team, business plan and financial projections, providing greater confidence in a company's ability to succeed and meet its earnings targets.

## Balancing act

Understanding a start-up's value is critical when trying to attract potential investors. But the precursor to valuing a start-up is developing realistic business plans and financial projections. A valuation professional can help vet management's projections and identify potential threats and weaknesses that may present roadblocks to achieving management's financial projections.

An independent expert takes an unbiased look at the company's financial projections, using objective sources, such as industry publications, economic data, and business records of similar companies. Then he or she blends management's optimistic projections with the rational concerns of a hypothetical investor.

## The value of professional expertise

Even though start-ups have limited operating histories, they can sometimes have significant value. Business valuation experts can provide objective sources of market data and experience to keep entrepreneurs grounded — and help them reduce risk and build value.

*Namerow v. PediatriCare Associates*

# When was that buyout provision last updated?

The buyout provision of an owners' agreement must be carefully drafted and regularly reviewed. If it isn't, the buyout may not be legally enforceable — or serve the owners' current needs. Here's a recent case where a stale buyout provision came back to haunt a retiring owner.

## Retirement triggers buyout

In 2000, the members of PediatriCare entered into an operating agreement. It gave retiring members the right to have their interest purchased by the remaining members and the practice once they reach age 60 and have provided at least 25 years of service to the practice.

The agreement stipulated a fixed buyout amount of $2.4 million. It required the members to update the valuation annually, but they failed to do so. The agreement further provided that, if the parties failed to agree on a revaluation for more than two years, the practice's value would equal the last stipulated value, adjusted to reflect changes in "net worth" on the buyout date.

## Experts define "net worth"

The issue at trial was the buyout price for a retiring member's 25% interest. His expert defined net worth as "the excess of assets over liabilities." He assumed that the stipulated value in 2000 *included* goodwill beyond the book value of net tangible assets. The expert applied various metrics to value goodwill in 2016. He concluded that the practice's value ranged from approximately $5.6 million to $6.75 million.

On the flip side, the defendants' expert defined net worth as "assets minus liabilities as stated in the balance sheet," which typically *excludes* goodwill. He adjusted the stipulated value for changes in the book value of net worth between 2000 and 2016, and concluded that the practice's value ranged from about $2.8 million to $3.2 million.

## Net worth excludes intangibles

The Superior Court of New Jersey found that net worth should exclude goodwill. Based on the $2.4 million stipulated value and tangible assets ranging from about $590,000 to $973,000, the court stated that the plaintiff's expert "blindly assumes that the difference between the two figures must account for intangible assets." But the court explained that this assumption was "designed to inflate" the practice's current value.

Because the parties had failed to update the buyout provision, the court was forced to apply the original valuation formula from the operating agreement. However, the court awarded the retiring member an amount based on the high end of the defense expert's range of values.

## Seek valuation advice

The outcome of this case might have differed if the members had periodically consulted with a valuation expert and reviewed the buyout provision. It also might have changed if the buyout provision had required a contemporaneous valuation or provided a more explicit definition of the term "net worth." ■