Top 10 Valuation Mistakes to Avoid – Especially in a Recession

Estimating the value of a company is a challenge, and this is especially true in a period of declining and uncertain economic conditions. In such times, it is more important than ever to consider how the valuation is prepared to ensure the process provides a reliable result. Below are the top 10 mistakes that should be avoided when valuing a business during such economic times.

1. USING AN UNQUALIFIED APPRAISER

The appraiser should not only have the qualifications and appropriate certifications for business valuation, but also should have adequate expertise in the type of valuation, the valuation purpose and potentially other specific experience and capabilities, such as experience in the industry.

2. RELYING ON A VALUATION PREPARED FOR A DIFFERENT PURPOSE

The purpose of the appraisal is especially important. For example, a valuation that was prepared for a potential sale with the goal of maximizing value in a strategic sale with synergies will generally not be appropriate to value a non-controlling interest for the purpose of ownership transition or estate planning.

3. RELYING UPON UNREALISTIC PROJECTIONS

Projections can be either overly optimistic or pessimistic, which can result in overstated or understated values. This can especially be an issue when one of the parties can benefit from the over- or understatement. The key is to have projections that are supported by reasonable assumptions based upon what is known and knowable as of the date of the valuation.

4. CALCULATING CASH FLOW INCORRECTLY UNDER THE INCOME APPROACH

An investor commits capital with the anticipation of generating a cash return. In the valuation process, the cash flow estimates should be reflective of the cash that will be received by an investor with an interest in the company. Common errors can include:

a. Considering net income or gross cash flow rather than net cash flow. The cash flows available to investors in a company may not, and are probably not, the same as net income or other income measures, such as earnings before interest, interest, taxes, depreciation and amortization (or EBITDA). Investors in equity will only be paid after such investments in and allowance for such items as working capital, capital expenditures and taxes. While EBITDA is often used in the market approach and in negotiations, that income measure does not typically reflect the cash flow available to equity investors.

b. Assuming the rights of ownership interests are the same. Different classes of ownership interests can have different claims to the cash flows. For example, preferred interests typically have a preference on return of capital upon the sale of the company and an annual dividend yield that is paid prior to other shareholders. Therefore, preferred owners have a different expected return than a class of stock with lower priority, such as common stock. The different claims to the cash flow should be factored into the valuation.

5. USING AN UNREALISTIC RATE OF RETURN

The investor in a company requires a rate of return that is consistent with market returns and also factors the risks associated with the individual investment. Estimating the appropriate rate of return for an investment in any company is a challenge, but that is especially true for a private company. The rate of return should be commensurate with the other forms of investments with similar risks and expected time horizon. In addition, the rate of return should factor in the risk inherent in the company and the form of investment in the company. A rate of return that is too high or too low can significantly under- or overestimate the value. This is only magnified when facing the uncertainty, market impact and disparity of impact the pandemic has had within the economy and different companies.

6. RELYING ON PUBLIC COMPANY MULTIPLES THAT ARE NOT COMPARABLE

Public company information is great for valuation purposes. The pricing information, company performance and valuation multiples are readily available, but the challenge relates to comparability. A large, public company often has very few similarities to a relatively small, privately held company. A public company may provide a similar product or service; however, the public company often has a diversified group of products and services. Furthermore, the public company has resources, such as management depth and access to capital, that is not available to the private company. As such, the public company information is often not appropriate when estimating the value of a privately held company.

7. RELYING UPON UNRELIABLE TRANSACTIONS

Transactions in privately held companies can be a great resource for estimating the company value. However, the results can be unreliable for several reasons. First, the transactions are often not timely, and the timing of the transaction can impact the valuation, as evidenced by the current events. Second, the calculated multiple can be unreliable. The reported price paid may or may not reflect the value of the transaction. The cash paid may be accurate; however, the non-cash consideration, such as earn-outs and equity in the acquiring company, may not be accurately reported. Finally, the transaction may or may not include certain assets, such as working capital, land and building, and can include other incentives, such as a large consulting contract for the owners. Therefore, transaction information can be used and referenced; however, they should be relied upon with caution, especially transactions occurring before start of the pandemic.

8. COMPARING INTERNAL TRANSACTIONS THAT ARE NOT COMPARABLE

One of the best indications of value is a transaction in an ownership interest in the company. However, the fine print needs to be analyzed, i.e., the terms of the interests that was purchased relative to the other ownership interests. If all the securities have the same terms, and the transaction was between unrelated parties, then the price paid can be easily translated into the value of the other ownership interests. However, if the terms are significantly different, especially the economic benefits such as liquidation preferences or guaranteed yield rights, the value of the transacted interest may have a significantly different value than the other ownership interests.

9. IGNORING OWNERSHIP RIGHTS THAT IMPACT VALUE

The ownership rights and any restrictions or limitations on selling an interest should be considered in estimating the value of an interest in a private company. This can include restrictions on transferability, the limitations of a non-controlling owner or the rights and benefits of a controlling owners. The key is to identify the limitations and/or benefits and appropriately quantify and support any adjustment to the value.

10. FAILING TO ADDRESS NON-OPERATING OR EXCESS ASSETS OR LIABILITIES

Companies often have excess cash, non-operating assets or liabilities that should be treated separately in the valuation process. This is especially true today when companies have loans that were issued under government assistance programs that have an unusually low interest rate and are assumed to be forgiven if certain criteria are met.

Estimating the value of an ownership interest in a company is a complicated process, and having a valuation that is not performed properly, is not supported and results in a materially misstated value can have significant consequences for the client. Ensuring the above issues are avoided can make all the difference, and it starts with having the right valuation professional to help – DHG is ready to answer your questions regarding valuation, so reach out to us at valuation@dhg.com for more information.

YOUR CONTACTS

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