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Struggling Economy Presents Business Valuation Challenges

During an economic crisis, it's typical for many businesses to decline in value. But how does a struggling economy affect the business valuation process itself?

In one sense, the process doesn't change: Valuators continue to apply traditional valuation approaches and methods, and the results reflect current conditions. At the same time, however, valuations during tough economic times — particularly those involving distressed companies — present unique challenges.

Different approaches

Business valuations typically involve some combination of three general approaches:

Income. This involves various methods of converting anticipated economic benefits (such as earnings or cash flows) into a present value.

Market. This analyzes valuation multiples from acquisitions of similar businesses or from the stock prices of comparable publicly-traded companies and adjusts for the subject company's particular characteristics.

Cost. Also known as the "asset" approach, this uses various methods to determine the replacement cost or market value of a company's assets, net of liabilities.

For healthy companies, the income and market approaches generally are the best indicators of fair market value. And, in theory at least, the two approaches should produce similar values. Why? Because ultimately a business's value is based on the market's perception of its ability to generate economic benefits.

If the market is "priced" correctly, the value of a business under the market approach should be comparable to the value of its expected future earnings or cash flows, converted to present value using an appropriate risk-adjusted discount rate.

A disconnect

In bad times, there may be a disconnect between the income and market approaches, creating a wide gap between valuations using the two approaches. The challenge for valuators becomes reconciling these differences.

In a recession, it's likely that both the market approach and the income approach — such as the discounted cash flow (DCF) method — will yield lower values. For the market approach, lower values could result because a potential investor would likely assign less value to a business during recessionary times. The income approach will result in lower values because revenues and earnings are generally down and a business's overall risk may be higher.

To arrive at an accurate valuation, the valuator must dig beneath the surface to reconcile the values derived from the two approaches. If the market from which pricing multiples are derived is artificially depressed or has become inactive, DCF may be a more reliable indicator of value.

The profitable

Even when the subject company is profitable, the valuator should scrutinize cash-flow projections used in a DCF analysis, because the company's track record may no longer be an adequate

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guide to its future performance. Thus, it may be necessary to reflect this risk by adjusting cash-flow projections downward or by incorporating a higher risk premium in the discount rate.

That's not to say that a business can't continue to thrive in the current economy. But to support a valuation that's higher than other companies in the industry, a valuator should carefully evaluate the company's business plans and projections to be sure its cash-flow expectations are realistic.

The financially distressed

When the subject company is financially distressed, DCF may or may not be appropriate because its expected earnings may be insufficient to contribute to the business's value. The key is for the valuator to understand the reasons the company is troubled and its prospects for turning things around.

If the company is highly leveraged, for example, it may be able to solve the problem with an infusion of cash from its owners or other investors. But if such an infusion is unlikely or demand for the company's products has dried up, the income approach may be less meaningful. *(See sidebar on this page, for more.)*

Impact of a valuation's purpose

The purpose of a business valuation can have a big impact on the valuation methods that are used, as well as on the ultimate value conclusion. Is the business being valued for sale? Then its value to a strategic buyer — who may be more interested in acquiring market share, technology, or people than in the target company's earning potential — may exceed its fair market value.

Is the company being valued for liquidation, either in or out of bankruptcy? If so, an asset-based approach would likely be appropriate.

Is the company going through Chapter 11 reorganization? In that case, it may come out of bankruptcy looking very different — at least from a financial perspective — than it did going in. To value the business as a going concern, the valuator must carefully analyze the impact that bankruptcy would have on its future performance.

Due diligence required

The fundamentals of good business valuation remain the same in good times and bad. But tough times require valuation experts to exercise heightened due diligence to reconcile a company's internal characteristics with external economic forces.

Bankruptcy Court Rejects DCF Method

As a recent bankruptcy case illustrates, the relevance of the discounted cash flow (DCF) method is highly dependent on the validity of the valuator's assumptions. In *In re DBSD North America, et al.*, the U.S. Bankruptcy Court for the Southern District of New York rejected the use of the DCF method to value the reorganized debtors.

The debtors' expert projected cash flows using a business plan that required a $1.5 billion capital investment, a premise the court found unrealistic, at least based on the record before it.

A creditor's expert also used the DCF method, applying it to a consistently negative cash-flow stream. The court rejected this valuation as well, finding it "extraordinarily unlikely … that anyone would pay to secure a stream of uniformly negative cash flows…."

If a buyer were interested in such a company, the court explained, it would be for some other reason, such as the value of its assets.

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