

IN THIS ISSUE

**Differing Expert Witness
Valuation Conclusions**

About Mercer Capital

Value Matters™

Issue No. 1, 2017

Differing Expert Witness Valuation Conclusions

Differences May Not Be the Result of Advocacy

by Z. Christopher Mercer, FASA, CFA, ABAR

Judges often make the assumption that business valuation experts always (or almost always) provide the opinions that their clients want and that explains the wide differences they see in valuation opinions. This judicial attitude is fairly widespread based on my experience, and accounts for many decisions where courts “split the valuation baby.”

Reporting on a recent case is illustrative. The **writer first stated** that the judge’s opinion disagreed with both experts, and that both of them had gotten it (their conclusions) wrong. He went on:

The judge here, Ivy Bernhardson, called these experts “unquestionably qualified.” The problem she identified is just the nature of expert witness assignment in lawsuits. They had been asked to sift through facts, tweak financial assumptions and construct a spreadsheet that gave their respective clients the valuation number they had hoped for.

The Court stated as follows (*Kim A. Lund, et al, v. Russel T. Lund, III, et al, County of Hennepin, MN, Court File*

No. 27-CV-14-20058, Memorandum of Law and Order on Fair Value..., June 2, 2017. Not available online):

Both experts are highly trained and experienced professionals. Both have testified and provided valuation reports in many trials and contested valuation situations. While the Court finds that both [Plaintiff’s Expert] and [Defendant’s Expert] are unquestionably qualified to testify on the issue of valuation, the obvious, zealous advocacy in which they engaged on behalf of their respective clients compromised their reliability in this instance.

Unfortunately for courts and for business valuation experts, the issue quite often is not nearly so neat and simple. Consider these possibilities:

- » The appraiser with the lower conclusion is reasonable, and the other appraiser has a much higher conclusion.
- » The appraiser with the higher conclusion is reasonable, and the other appraiser has a much lower conclusion.

Because of the large difference between the two appraisers in both instances, courts may assume that both are being advocative. This simply may not be the case. It would be better if all courts would look at the valuation process in its entirety before prejudging that all appraisers are advocates.

This article will not address the valuation issues of this recent case, nor will it address what the appraisers did. I'm simply using the announcement as a springboard to talk about the elements of substantial private company valuations that can cause differences in valuation opinions, and even significant differences in valuation conclusions between experts.

In the final analysis, courts must decide on valuations in litigated matters. I hope this article will be helpful for judges, attorneys, and appraisers as they look at different valuation opinions.

Six Sources of Differences in Expert Opinions

There may be more than six sources of differences in valuation opinions between opposing experts, but we will focus on the following six:

1. Differences in legal guidance or assumptions related to this guidance
2. Differences in information availability
3. Access to management and due diligence opportunities
4. Differences in valuation approaches or methods
5. Differences in appraiser judgments and assumptions
6. Mistakes

Let's talk about each of these categories of potential differences in opinions of business valuation experts. They may shed some light on how courts can look at valuation opinions of opposing experts without casting them in the light of "obvious, zealous advocacy."

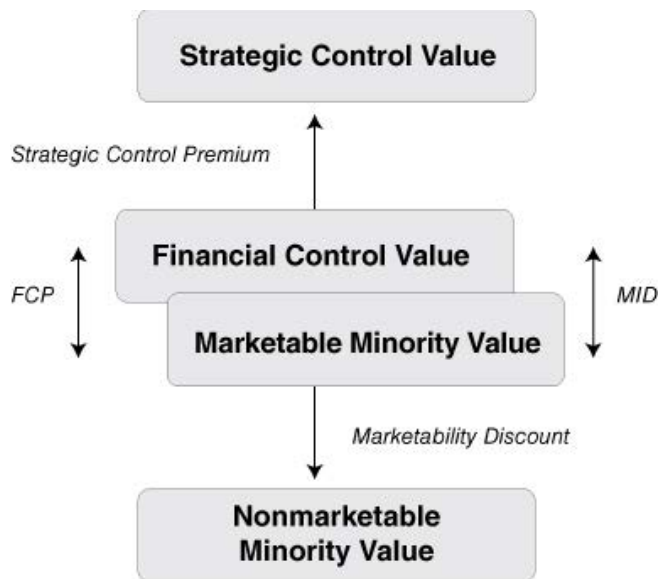
1. Differences in Legal Guidance and Related Assumptions

Differing legal guidance to appraisers can account for significant differences in valuation opinions. For example, there judicial guidance regarding the applicability of valuation discounts may not be clear in certain valuation situations. I recall a case many years ago when the law in a state was unsettled as to whether valuation discounts were applicable in statutory fair value determinations. I worked for counsel on behalf of a company. This counsel believed, based on legal research, that valuation discounts were not applicable. Based on this guidance, I presented the fair value of an asset holding entity based on its adjusted net asset value. Since I knew there was an open legal question, I also presented an opinion for the court's consideration if it concluded that a marketability discount was appropriate.

I got the clear impression that, rather than being appreciative of the complete story (with and without a marketability discount), the court somehow believed that I was biased in the matter. However, I was not biased. The applicability of discounts in fair value determinations is a matter of statutory guidance or, in absence of such, of judicial interpretation of available statutes. I made no such determination of applicability. I presented a control value (net asset value) based on legal guidance from counsel, and then a discounted value in the event the court decided that discounts were applicable.

Suffice it to say that, before examining the opposing real estate appraisals, there was a 30% percentage difference between my lower conclusion with a marketability discount and that of the other appraiser. There was no bias on my part, but nevertheless I was painted with that brush by the court, or at least it seemed so while I was there. Or maybe the court thought my client company was biased, and I was tainted because of my client. That hardly seemed fair.

This situation can arise at any time there are differing legal opinions about the appropriate level of value in a litigated valuation case. Look at the levels of value chart on the next page.



If one side has a legal opinion at one conceptual level of value on the chart above and the other has an opinion at a different level (higher or lower), and that guidance is provided to each side's business appraisers, there is a substantial (conceptual) difference in value at the outset that has nothing to do with appraiser bias. Note that I'm not talking about the *amounts* of any premiums or discounts, but just to their applicability (or not).

As a business appraiser, if I am provided with legal guidance at a particular level of value, I will reference that guidance and provide the desired opinion. If there is some debate on the issue, I have typically provided an alternate opinion at the other (lower or higher) level of value. That determination is a legal one and not one for business appraisers to make.

The point of this discussion regarding legal guidance is that business appraisers, following reasoned legal guidance from counsel, should not automatically be deemed as advocative for their client's interests. At least that's my opinion.

2. Differences in Information Availability

In an ideal valuation situation, both (or all) appraisers would have access to the same information. However, not all

situations are ideal. Differences in information availability can occur for several reasons, including:

- » The appraiser for the non-company side is not provided with full financial information that is provided to the appraiser for the company side. This should not be, but in litigation, some attorneys play hardball with information access for the "out" side.
- » Access to key non-financial documents is sometimes not shared with both sides.
- » The appraisal is historical in nature and there is limited access to historical financial data. Even in historical situations, there is often unequal information access because one side or the other has documents that the other does not have. These differences should be eliminated in discovery, but that is not always the case.
- » In some cases, both sides have access to key governing documents, but the documents themselves are subject to differing interpretations. This could apply to operating agreements, buy-sell agreements, legal contracts, and others.

Business appraisers must deal with information shortfalls in reasonable fashion. However, the existence of information differences, and the valuation assumptions these differences require, can be the cause for perceptions of bias for one side's appraiser or the other (or both).

3. Access to Management

In some litigated situations, the "out" appraiser is denied access to management or he or she is denied the same access to management as the "in" appraiser. Differing access to management can cause differences in valuation assumptions that can be interpreted by courts as advocative by one appraiser or the other.

In a fairly recent matter, counsel for the company refused to allow me to conduct interviews with key managers of a substantial business. We were required to conduct our

management interviews in the context of depositions. This was the first time in a long career that this has happened to me, but it did. Problems include the following:

- » Depositions are an awkward forum at best for management interviews. The appraiser is not asking the questions, but a lawyer is doing so.
- » Follow-up questioning is strained at best. It is difficult to anticipate all follow-up questions in the preparation phase, and even more difficult to coach an attorney on follow-up in a deposition setting.
- » It is easier for managers being deposed to answer truthfully but incompletely in a deposition without instant follow-up.
- » The “boss” may attend the deposition and have an intimidating effect on managers being deposed.

I could go on, but suffice it to say that it is better, in my opinion, for both sides to have equal access to management and to be able to form their own opinions.

As a basic protection, if I am being provided with limited or no access to management, I ask counsel to make a formal request for the interviews. Then, if there is a refusal, it should be in writing. That way, it would be difficult to hold their own refusal to visit with management against me in terms of information questions I might have asked if I had conducted a formal management interview.

4. Differences in Valuation Approaches or Methods

There are three basic approaches to valuation: (1) the asset approach, which focuses on the valuation of (usually) tangible assets; (2) the income approach, which deals with the capitalization of income or the use of the discounted cash flow (or future earnings) method; and (3) the market approach, which may include comparisons with transactions in public or private company interests.

For most profitable operating companies, the asset approach is of limited use. Appraisers may capitalize historical or anticipated earnings under the income approach or they may utilize the discounted cash flow method, with a forecast of future operations and the development of a terminal value.

For sizable private companies, it may be possible to make comparisons with publicly traded guideline companies. However, size differences alone will sometimes preclude the use of what is called the guideline public company method. In other cases, it is simply not feasible to identify sufficiently comparable public companies to use this method.

Sometimes, it is possible to value private companies based on comparisons with transactions in other private or public companies. However, this method is often not available because of limitations on comparable transactions

The bottom line is that appraiser judgment is required. Business appraisers should show that they have considered all three general approaches to valuation. They should then explain why each approach, and methods within the approaches, are used in their appraisals.

Suffice it to say that different decisions regarding valuation approaches and methods can cause some differences in valuation conclusions. Different methods used, however, should not be considered as a source of bias unless the appraiser(s) cannot convincingly explain why they have used (or not) particular methods.

We have now examined four broad categories of items that can cause differences, even significant differences, in valuation opinions between appraisers of the same asset at the same time. Now it is time to talk about the big fifth category.

5. Differences in Appraiser Assumptions and Judgments

Appraisers must make valuation assumptions and judgments in every appraisal. The following list is not complete by any means, but is indicative of the kinds of assumptions that must be made.

- » **Asset methods.** There may be differences in the appraisals of underlying assets used by different appraisers. Which appraisal(s) and which assumptions are the more reasonable?
- » **Earnings methods.** Earnings must be adjusted and analyzed. Valuation is a prophecy of the future. Which appraiser's analysis best captures the outlook based on historical analysis? Normalizing adjustments must make sense. Working capital requirements may impact expected cash flow.
- » **Forecast assumptions for DCF.** Appraisers must make assumptions regarding the outlook for the future when using the discounted cash flow method. Assumptions must be made about expected growth in sales and earnings. Margins must be examined. Capital expenditures and working capital assumptions should be reasonable. In the final analysis, how does the forecast look in light of a company's history and reasonable expectations for its future. This determination is in light of the expected operating and competitive environment.
- » **Terminal value estimation for DCF.** The terminal value in a DCF valuation method often accounts for 50% or more (or much more) of the value in a five year forecast of earnings. Is the terminal value multiple reasonable? Is expected growth reasonable, and are assumptions about capital expenditures and depreciation reasonable in the terminal value estimation.
- » **Sensitivity analysis.** DCF valuation conclusions are often quite sensitive to even modest changes in assumptions. Does the appraiser make the reader aware of the sensitivity of the conclusion to changes in assumptions?
- » **Guideline public company method.** Is the guideline public company method used? Should it be used? Are comparable companies realistically comparable? Are valuation inferences regarding multiples reasonable in terms of differences in expected cash flow, risk and growth between the guideline companies and the subject company?
- » **Guideline transactions method using private companies.** Is this method used? Should it be used? Are the comparable transactions realistically comparable in terms of business lines, size and timing? Are valuation inferences regarding multiples reasonable in terms of differences in expected cash flow, risk and growth between the guideline companies and the subject company?
- » **Weights assigned to methods in correlating conclusions.** Are the weights assigned in the process of reaching conclusions reasonable? Do they make sense in light of the overall analysis?
- » **Consideration of premiums and discounts at the enterprise level.** Does the appraiser use discounts or premiums that do not appear to be supported? Examples might include key man discounts or control premiums.
- » **Treatment of nonoperating assets.** The existence of nonoperating assets on a company's balance sheet can have a material impact on valuation. Are nonoperating assets identified and valued appropriately? Is the impact of nonoperating assets removed from the operating analysis?
- » **Consideration of valuation discounts at the minority interest level.** When the valuation subject is a minority interest, appraisers may use minority interest and/or marketability discounts. Are these discounts determined based on their impact on the expected cash flow, risk and growth from the viewpoint of minority investors? If not, there may be a credibility issue.

We have noted a number of possible assumptions that may be made in the appraisal process. This list is not meant to be complete but illustrative. Interestingly, in most valuation situations, the majority of the differences between the conclusions of appraisers in litigated situations can usually be boiled down to differences in two or three assumptions.

6. “Mistakes”

Sometimes a portion (or all) of the difference between the conclusions can be the result of a mistake or mistakes on the part of one of the appraisers. Mistakes are embarrassing, but they happen. Hopefully they have been discovered and corrected prior to trial. But they do happen.

Additional Filters for Courts

We have gone through a litany of items that can cause differences between the conclusions of appraisers in litigated valuation situations. I noted that, in most cases, the differences can be boiled down to differences in just a small number of assumptions. Courts do have additional filters that should be considered when looking at differing valuations. These filters include:

- » **The relative credibility of the reports.** Credibility can be judged in terms of writing style, tone, accuracy, content, and the like.
- » **Credibility of the respective testimonies.** All experts are not the same. How do they perform on direct testimony? Can they maintain their objectivity under cross-examination? Was opposing counsel able to elicit impeaching testimony?
- » **Consistency with prior writings and opinions.** As one who has written a great deal over many years, I am accustomed to having something I've written brought up as potential impeachment. I've been pretty consistent over the years and have a decent memory about what I have written. I'd recommend that other appraisers work on their historical record.
- » **Relative value in light of comparable valuation evidence.** This is a biggie. All valuation is relative. What are the implied valuation multiples of the respective conclusions. When compared with available market multiples, do they make sense?

Which conclusion makes the most sense. Too often courts assume that both experts are hired guns and never look at the relative comparisons of conclusions with market evidence.

- » **Equities of the situation from a court's point of view.** Most valuation disputes occur in courts of equity. The business appraisers cannot make “equitable” assumptions, but courts can reach what they believe are equitable decisions. Both appraisers can get burned when neither conclusion matches a court's view of the equities of the situation. And court decisions often say what they must say to reach equitable conclusions, regardless of the damage to appraisers. That's a risk of the game for business appraisers.

In addition to the valuation-related items we began with, we understand that courts do have additional filters through which to look at expert opinions.

Wrapping Up

The fact of differences in conclusions between business appraisers in litigated situations may not be the result of advocacy on both of their parts. I believe that courts should begin with an assumption of appraiser neutrality and move away from that assumption only when there is direct evidence that one or both appraisers are being advocative.



Z. Christopher Mercer, FASA, CFA, ABAR
mercerc@mercercapital.com | 901.685.2120

Mercer Capital

Mercer Capital's ability to understand and determine the value of a company has been the cornerstone of the firm's services and its core expertise since its founding.

Mercer Capital is a national business valuation and financial advisory firm founded in 1982. We offer a broad range of valuation services, including corporate valuation, gift, estate, and income tax valuation, buy-sell agreement valuation, financial reporting valuation, ESOP and ERISA valuation services, and litigation and expert testimony consulting. In addition, Mercer Capital assists with transaction-related needs, including M&A advisory, fairness opinions, solvency opinions, and strategic alternatives assessment.

We have provided thousands of valuation opinions for corporations of all sizes across virtually every industry vertical. Our valuation opinions are well-reasoned and thoroughly documented, providing critical support for any potential engagement. Our work has been reviewed and accepted by the major agencies of the federal government charged with regulating business transactions, as well as the largest accounting and law firms in the nation on behalf of their clients.

Contact a Mercer Capital professional to discuss your needs in confidence.

Contact Us

Timothy R. Lee, ASA

901.322.9740

leet@mercercapital.com

Nicholas J. Heinz, ASA

901.685.2120

heinzn@mercercapital.com

Bryce Erickson, ASA, MRICS

214.468.8400

ericksonb@mercercapital.com

Z. Christopher Mercer, FASA, CFA, ABAR

901.685.2120

mercerc@mercercapital.com

Matthew R. Crow, ASA, CFA

901.685.2120

crowm@mercercapital.com

Travis W. Harms, CFA, CPA/ABV

901.322.9760

harmst@mercercapital.com

MERCER CAPITAL

Memphis

5100 Poplar Avenue, Suite 2600

Memphis, Tennessee 38137

901.685.2120

Dallas

12201 Merit Drive, Suite 480

Dallas, Texas 75251

214.468.8400

Nashville

102 Woodmont Blvd., Suite 231

Nashville, Tennessee 37205

615.345.0350

www.mercercapital.com

VALUE MATTERS™. This newsletter addresses gift & estate tax, ESOP, buy-sell agreement, and transaction advisory topics of interest to estate planners and other professional advisors to business. For other newsletters published by Mercer Capital, visit www.mercercapital.com.

Copyright © 2017 Mercer Capital Management, Inc. All rights reserved. It is illegal under Federal law to reproduce this publication or any portion of its contents without the publisher's permission. Media quotations with source attribution are encouraged. Reporters requesting additional information or editorial comment should contact Barbara Walters Price at 901.685.2120. Mercer Capital's *Value Matters™* is published six times per year and does not constitute legal or financial consulting advice. It is offered as an information service to our clients and friends. Those interested in specific guidance for legal or accounting matters should seek competent professional advice. Inquiries to discuss specific valuation matters are welcomed. To add your name to our mailing list to receive this complimentary publication, visit our web site at www.mercercapital.com.