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Valuation Report

Business Valuation Trends and Strategies

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Litigation Update

DLOM at Issue in Recent Valuation Cases

While it's just one of several valuation adjustments, the discount for lack of marketability (or DLOM) often has one of the largest impacts on the determination of value. For this reason, it is one of the most frequently contested issues in valuation litigation.

Interestingly, DLOM was central to a number of recent dissenting shareholder cases in New York as the court ruled on the fair value of the dissenting shareholder's interest. Fair value is typically defined as the price a willing purchaser, in an arm's length transaction, would pay for a company as an operating business.

A DLOM is deducted from the value of an ownership interest in a company to reflect the owner's inability to sell — or "market" — his or her interest and convert it to cash as quickly as would be possible if that interest were publicly held.

The rulings in these cases address whether a DLOM is required or even applicable, and if applicable, to what value the discount should be applied.

Is a DLOM Required?

Zelouf International Corp. v. Zelouf: When their father died, the three Zelouf sons inherited a successful textile business: Joseph received 45 percent and Rony and Emil each received 25 percent, while Joseph's son Danny received 5 percent. Joseph died suddenly, leaving Danny with 50 percent ownership. Danny made himself president and appointed Rony vice president. Emil became incapacitated so his wife Nahal inherited his shares.

Danny and Rony looted the company by dramatically increasing their own salaries, taking interest-free loans from the company, and leasing a fleet of luxury cars for their personal use, among other contemptible deeds. Eventually, Nahal filed a shareholder derivative lawsuit against Danny and Rony for waste and misappropriation. But instead of settling with Nahal, Danny and Rony pursued a "freeze-out" merger, which would leave Nahal unable to pursue her derivative claims.

After Nahal rejected a buyout offer from the company, a neutral appraiser was brought in to estimate the fair value of Nahal's shares. Nahal's expert maintained that a DLOM was not applicable when calculating fair value. The company's expert contended New York law required a DLOM. The court determined that Nahal's expert was correct in this case and rejected the claim that New York law mandated a DLOM.

Source: Business Valuation Update

Is a DLOM Even Applicable?

Ferolito v. AriZona Beverages USA LLC: AriZona Iced Tea was founded in 1992 by equal partners John Ferolito and

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Technical Topics

The Importance of Challenging Projections with DCF

Depending on the purpose and nature of the valuation, analysts have many options to choose from in terms of the valuation approach and methodology to be used. The discounted cash flow (or DCF) method, which is part of the income approach, is used to determine the current value of a company using future cash flow projections discounted to reflect present value.

From an academic point of view, DCF makes sense because it is meant to quantify the expected future value of the investment in current dollars. But because DCF relies on future cash flow projections, the methodology begs some questions. Perhaps the biggest are these: Who prepared the projections, and are the projections valid, realistic and reliable?

The Problem with Assumptions

DCF is only as good as its inputs. It works well where there is a high degree of certainty or confidence in future cash flows. But DCF can be problematic because miscalculation in estimating cash flows, growth and discount rates — potentially difficult endeavors based on many assumptions — can result in significant errors in valuation. Therefore, as a rule, valuation analysts do not assume management-supplied projections are accurate.

Management projections might be off for a completely innocuous reason. For example, they might have been prepared by staffers with little experience. Or they might be off for a more strategic reason: Perhaps they were prepared with an "agenda" in mind; for example, to inflate or deflate the value of the company. Or maybe the math is just wrong and the projections are not reflective of the reality of the company's circumstances.

Countless court cases have illuminated valuation problems caused by one party or the other relying too heavily on management-supplied projections. For example, in *Adelphia Recovery Trust v. FPL Group,* the court ruled that management projections would be meaningless because the company's management was not trustworthy and any projections would have been "based on fraudulent information and would therefore be unreliable."

In another case, *In re Global Technovations, Inc.*, the court ruled that the sales forecasts used in the projections bore "no rational relationship to the [target's] historical results," and that the resulting DCF analysis was "unreasonable and unreliable."

Digging Into Financial Statements

For these reasons, it is imperative that all projections be carefully vetted by the valuation analyst. To ensure that the DCF-based valuation is credible, the valuation analyst must examine each line on the income statement and balance sheet to determine how the projections were derived and whether the supporting assumptions are correct and defensible.

What will the numbers look like in the next five years, and why? Revenue estimates, wages, capital improvements, debt structure, changes in working capital — all of these inputs are open to discussion and examination to ensure that the underlying assumptions are valid.

Because of these issues, it's not unusual for DCF valuations to be delivered in a "range" of value versus a single value. This range would reflect an optimistic, likely and pessimistic scenario based on various assumptions.

DCF works beautifully in many types of valuations. But in order for DCF-based valuation results to be credible, it is imperative to vet management projections. ■

If you have questions about DCF or how to prepare projections for an upcoming valuation, please contact us.

Litigation Update: DLOM and Valuation

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Domenick Vultaggio. But over the ensuing years, the two had a falling out. In 1998, for the sake of the business, they decided that Vultaggio would run the company. Further, they agreed to restrict the parties to whom they could sell their interests.

By 2005, Ferolito wanted to sell his stake. He initially went to court requesting that the sale restrictions be ruled unenforceable. When that didn't work, he sued to dissolve the company. Vultaggio decided to proceed with a buyout at fair value.

At the trial, Ferolito's expert's valuation reflected a zero percent DLOM because the company was successful and had attracted interest from potential buyers in the past. Vultaggio's expert weighed in with a 35 percent DLOM due to the transfer restrictions, the lack of audited financial statements, the fierce court battles between the parties, and the company's S corp status.

The court agreed with Vultaggio's expert that a DLOM was appropriate. However, the court lowered it to 25 percent, citing testimony from valuation guru Shannon Pratt that "smaller discounts are often appropriate for large and growing companies."

Some analysts believe the DLOM resulted in a "material windfall" to Vultaggio because the 25 percent DLOM resulted in Ferolito receiving less than half the value of the company in exchange for his half of the company's stock.
Source: BV Wire

What Is a DLOM Applicable to?

Wright v. Irish: Two brothers-in-law — Wright and Irish — started a solar energy company in the early 2000s and enjoyed initial success. But the competitive landscape changed and the company's market share dropped precipitously.

The relatives argued over the direction of the business and in 2014, Wright filed for dissolution of the company. Irish chose to buy out Wright at fair value.

Both parties hired valuation experts. Wright's expert used a 21.4 percent DLOM, but applied it only to the goodwill of the company rather than the company's overall value. Irish's expert proposed a 25 percent DLOM and applied it to the entire company.

The court rejected most of Irish's expert's conclusions, dismissing his report for "severe deficiencies." And while the court agreed with Wright's expert on most points, it questioned his application of the DLOM only to the goodwill.

The court eventually accepted Wright's expert's 21.4 percent DLOM rate, but found that there was no reason to limit the DLOM to the goodwill.

This ruling disappointed some who were hoping for a "bright-line" rule regarding the applicability of a DLOM in shareholder disputes. Instead, it reinforced the idea that whether a DLOM applies to an entire company or only goodwill is a case-by-case decision.
Source: BV Law

Key Points

These cases identify two key points regarding DLOMs. First, New York courts have ruled that a DLOM is not required but may be applicable in dissenting shareholder matters. Second, a DLOM may be applicable to total company value or just the portion representing goodwill, and that determination should be made on a case-by-case basis.

If a DLOM is applicable, reductions in value of 20 percent or more are not uncommon. Given that DLOMs can have such a material effect on the value of a dissenting shareholder's interest, it is critical for both sides in dissenting shareholder matters to get valuation professionals involved early in the case.

Experienced valuation professionals can help the parties develop their negotiating and litigation strategies by providing beneficial insight and advice regarding the effect a DLOM could have on the valuation. ■

Interested in finding out more about DLOM or these court cases? Contact our valuation team.

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Beware of Rules of Thumb

Everyone's heard the buzz: If you're in *fill-in-the-blank* industry, your business should sell for *fill-in-the-blank* number times *fill-in-the-blank* measure.

These types of guidelines are widely discussed and generally accepted. There's only one problem: They are rarely correct. Rules of thumb are not an accepted method of valuation and can be quite misleading if buyers or sellers look to them for valuation numbers.

The problem lies in the fact that they ignore some basic truths relevant to valuation:

Specific circumstances matter. Every business is different in terms of its characteristics, and every deal is different relative to what's included and the terms of the sale. One company may have great growth potential and profitability and another in the same industry might be dying. So to say that two businesses in the same industry will share calculation of value ignores the fact that value depends on the specific circumstances of each company.

Economic conditions count. How can the same rule of thumb apply today as it did during the recession? It can't. Economic conditions influence how much people are willing to pay for just about everything, from food and airline tickets to businesses. Rules of thumb ignore economic factors that influence pricing.

The world changes. But rules of thumb do not. Legal and regulatory requirements, supply and demand fluctuations, and social and political upheavals are just a few of the factors that can influence value. And while the world is always evolving, rules of thumb rarely adapt.

Most valuation professionals ignore rules of thumb except as a "sanity check." Even the authors of books about rules of thumb warn that they shouldn't be used as a primary method of assessment.

So forget what you hear from your friends and family. Rules of thumb are not reliable. ■

Ignore rules of thumb and contact our firm for reliable valuation input.

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