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ADVOCATE'S EDGE

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Growth plays a critical role in DCF valuations

When appraising a new or growing business, valuators often turn to the discounted cash flow (DCF) method. This technique, which derives value from a company's ability to generate cash flow in the future, allows for significant flexibility in assumptions about growth. So, it also can be useful when valuing struggling companies that are in a state of flux. Here's more on this method — and how growth factors into it.

The DCF method in a nutshell

The DCF method falls under the income approach, one of the three broad approaches to valuing a business. Under this method, a valuator generally projects a company's cash flows over a discrete period of time, and then, at the end of that period, he or she assumes the company's cash flows will stabilize and estimates a terminal (or residual) value. Next, the cash flows during the discrete period and the terminal value are discounted to their present values. Finally, the sum of those present values equals the company's value.

Growth comes into play when a valuator (or management) projects future cash flows. It also factors into the determination of the proper discount rate. For example, growing businesses are generally more risky and would typically call for a higher discount rate.

Qualitative factors

Valuators consider several qualitative factors when assessing growth. Examples include the quality of management, capacity to form partnerships and marketing abilities.

A valuator also should assess the potential growth from the company's existing assets. Relevant factors include overall industry growth, the company's market share and the growth of assets in previous periods.

Of course, a company could also develop new assets. If the development of new assets is a significant part of a

A closer look at growth and the terminal value

When applying the discounted cash flow method, valuators assume that the company's cash flows will eventually stabilize at a growth rate that's sustainable over the long haul. Usually, this long-term growth rate is more conservative than the growth rate assumptions made during the discrete discounting period.

The rate of inflation is a good starting point for the long-term growth rate. But some businesses also may be able to sustain a *reasonable* amount of real growth over the long term. Other businesses, including those that rely on wasting assets such as minerals or coal supplies, may grow at a rate that's below inflation.

Valuators often estimate terminal value using the capitalization of earnings method. This technique assumes that cash flows in the final year of the discrete discounting period will grow at the long-term growth rate into perpetuity. Long-term growth also factors into capitalization rates that are used in this method. So, small changes in the long-term growth rate can have a big impact on a company's terminal value.

company's business plan, a valuator must take into account both the potential growth from such assets and the costs and risks related to achieving that growth.

In addition, a valuator must assess the likelihood of acquisitions and the amount of growth that will result. A valuator will look at the company's history of acquisitions and the level of acquisition activity in the industry, as well as the company's projected financial ability to successfully carry out acquisitions.

Quantitative factors

Valuators consider quantitative growth factors, too. Historical data is particularly valuable if the company has been functioning under consistent business conditions — and expects to continue to do so in the future. In such a situation, any recent trends upward or downward in cash flow are insightful, unless they're caused by a temporary change in operations, such as a short-term plant closure. Such trends require more in-depth analysis before a valuator can assume they'll continue.

If management projections are available, they also will be considered. These projections can provide a valuator useful insight on the economic forces influencing the business's growth. Management projections are especially important in two scenarios: 1) when the company is relatively new and lacking in historical financial data, and 2) when the company has recently undergone, or is expected to undergo, a material change. Examples of material changes include the introduction of a new product line or service offering and the closure of a facility. When such events occur, historical data usually becomes less relevant because it reflects substantially different circumstances.

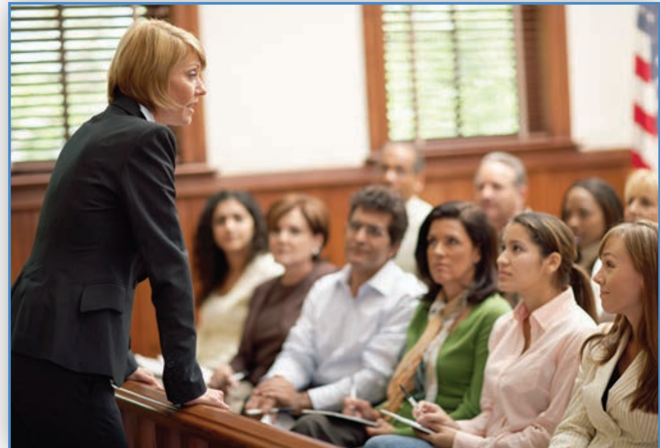
Management projections can't be accepted on their face, however. Valuators must question the assumptions and consider the purposes for which the projections were originally prepared. For example, projections may be more reliable if they're prepared in the ordinary course of business than if they're prepared for litigation.

Temper the growth

Because growth influences both cash flow projections and the determination of the appropriate discount rate, valuators (and attorneys) must stay vigilant to ensure the effects of growth aren't exaggerated. If growth, including any of the qualitative and quantitative factors, is incorporated into cash flows and the discount rate without being appropriately tempered to account for such double consideration, a valuator risks significantly over- or undervaluing the business. ■

Getting into the nitty-gritty when it comes to punitive damages

Determining appropriate punitive damages is challenging for judges and juries. What amount is enough to effectively punish wrongdoers — and deter them from committing similar acts in the future — but not so much that the punishment outweighs the crime? Whether working for the plaintiff or the defense, damages experts can help judges and juries understand the details underlying punitive damages to help ensure that the award is appropriate.



Who's responsible?

Experts consider several questions when building a framework for punitive damages, starting with the person who is responsible.

An expert witness for the defense can break a company into its components, providing jurors with a proper perspective on the division or department most directly responsible for the wrongdoing. Jurors can be shown that the division they have determined to be culpable can be adequately penalized even if the award won't significantly affect the bottom line of the overall company.

> While net worth may give a general idea of the defendant's ability to pay, the defense's expert can show jurors that the specific assets that contribute to net worth also must be examined.

Breaking down a company also can help humanize the defendant. The jurors might begin to see that the defendant isn't an unfeeling corporate entity but an organization made up of many individuals. Jurors may identify with innocent bystanders — including shareholders and employees — who will be adversely affected by a disproportionate punitive damages award.

A plaintiff's expert, on the other hand, can help overcome juror resistance by highlighting the layers of financial resources available to a corporate defendant.

What were the profits?

Damages experts also ask how the defendant profited from the alleged wrongdoing. Profits gained as a result of the defendant's misconduct often play a central role in determining an appropriate award. Jurors, however, might not understand that revenues or sales aren't the same as profits.

Experts, therefore, demonstrate the actual or expected profits from the misconduct. An expert for the defense will take into account any expenses the defendant incurred as a result of claims that grew out of the transgression, including those associated with recalls or redesigns.

A plaintiff's expert can highlight costs that the defendant avoided because of its wrongful conduct. Or the expert might show how the defendant

could have precluded recall or redesign costs by acting properly.

How deep are the defendant's pockets?

Another critical question addresses the defendant's resources. Plaintiffs frequently cite the defendant's net worth to support their contention that only a large award will prove punitive.

While net worth may give a general idea of the defendant's ability to pay, the defense's expert can show jurors that the specific assets that contribute to net worth also must be examined. Experts may advise jurors to consider the form the assets take — for example, the percentage in cash. Fixed and other noncash assets might not be easily converted to cash, or their conversion might even make it difficult, if not impossible, for the business to continue operating.

The plaintiff's expert, on the other hand, might emphasize the defendant's ability to generate cash in the near future. A company that has a negative net worth because of high initial costs could produce impressive cash and profits later on.

Also, by the time a particular claim reaches the punitive award stage, the defendant may have already lost judgments for substantial sums. An expert testifying for the defense can explain how these liabilities affect the defendant's financial statements and overall financial status.

Expertise needed

The issues surrounding punitive damages are complex. If you have a case involving punitive damages — whether you're counsel for the plaintiff or for the defense — make sure you contact a financial expert. ■

"Double dipping" might sometimes be OK in divorce cases

What's known as "double dipping" is generally understood as the double counting of a marital asset in a marital dissolution — once in the property division and again in the spousal support award. Typically, courts frown on double dipping. But not always. For example, in the recent case *Gallo v. Gallo*, the Ohio Court of Appeals rejected not only this definition of "double dipping" but also its previous holding prohibiting double dipping.

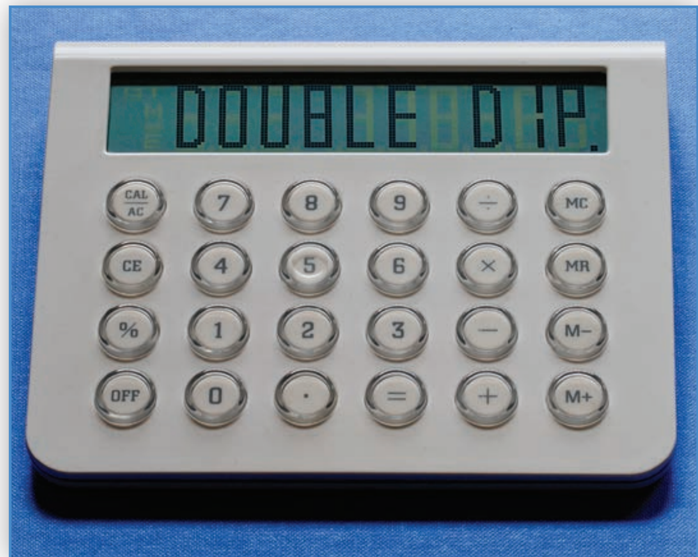
Husband challenges double dipping

The husband in the case had an ownership interest in a business, and the parties stipulated to its value. But, on appeal, the husband argued that the trial court had erred in valuing the marital interest in the business using its future earnings and then also including the distributions from its earnings as part of his income to determine spousal and child support. Citing the Ohio Court of Appeals' 2008 ruling in *Heller v. Heller*, he contended that the court could rely on the earnings only to determine the value of the marital assets *or* his income for setting support payments.

Court reconsiders

In *Heller*, the court had defined "double dipping" as the double counting of a marital asset. It explained that "where a court uses a business

owner's 'excess earnings' to value the interest in a business and also fixes support on that spouse's total income (inclusive of the 'excess earnings' used to value the business), a 'double-dip' occurs." It declared that a trial court can treat a spouse's future business profits either as a marital asset subject to division or as a stream of income for spousal support purposes — but not both.



In *Gallo*, though, the appellate court changed its position. It clarified that a double dip occurs when a court twice counts *a future income stream* — once when valuing the marital asset and again when determining the economically superior spouse's ability to pay spousal support. According to the court, it's the future income stream — not the marital asset — that's the subject of the doubling.

Therefore, the court found, if the marital asset is valued using a method that doesn't specifically rely on a future income stream (for example, a market- or asset-based approach), no double dipping occurs. The court also noted that business valuations may be premised on future income streams even if the valuation method doesn't include a calculation of excess earnings. Thus, it said, double dipping isn't limited to situations where excess earnings factor into the valuation.

> A trial court could determine that some circumstances, such as a disparity in income between the parties, override the unfairness in double dipping.

In the present case, the appellate court deduced that the value of the business was computed using the capitalization of earnings method. Then it determined that double dipping had indeed occurred when the trial court awarded the husband his share of the business in the property division and then considered his income from that asset, which was derived from the business's future income stream, in setting support.

But the appellate court then overruled *Heller* to the extent *Heller* prohibited double dipping in any circumstances. The appellate court held that, in the interest of equity, trial courts should factor the effect of double dipping into their property division and spousal support decisions.

The appellate court said that a trial court "may ameliorate the inequity inherent in double dipping" by splitting the income-producing asset between the parties, thereby ensuring that each spouse shares in advantages and disadvantages associated with that asset. Alternatively, a trial court could determine that some circumstances, such as a disparity in income between the parties, override the unfairness in double dipping.

Reversed course

The case was remanded but only because the appellate court found that the trial court hadn't considered the double dip. The appellate court took pains to make clear that the lower court didn't necessarily have to change the current property division or support award. Ultimately, the husband may just have to live with the double dipping if the trial court decides the overriding principle of equity warrants it. ■

Do you have clients who are victims of elder fraud?

Elder financial abuse has been on the rise, and, with Baby Boomers aging into senior citizen status, that increase is likely to continue. Fortunately, qualified fraud experts can help uncover such schemes before they inflict devastating damage.

Vulnerable targets

Older individuals with retirement savings, accumulated home equity and other significant assets make appealing targets for unscrupulous family members, caregivers, financial advisors, fiduciaries (such as those with power of attorney and guardians) and random scam artists. They are often vulnerable due to isolation, cognitive decline, physical disability, health problems or the recent loss of a spouse or other loved one.

Exact statistics on elder financial abuse are hard to come by, largely because victims hesitate to report it for fear of embarrassment. They also might suffer from cognitive impairments that prevent them from even realizing they've been victimized. But a study published in the *Journal of General Internal Medicine* in 2014 found that one in every 20 elderly American adults is being financially exploited, often by their own family members.

Signs of elder fraud

Fraud experts look for several signs of potential elder fraud, including:

- Frequent large withdrawals, including daily maximum currency withdrawals from an ATM,
- Sudden nonsufficient fund activity,
- Uncharacteristic nonpayment of bills, which might indicate a loss of funds or access to funds,
- Uncharacteristic debit transactions,
- Uncharacteristic attempts to wire large sums of money,
- Closing CDs or accounts without regard to penalties,
- An unusual degree of fear or submissiveness toward a caregiver or an expression of a fear of eviction or nursing home placement if money is not given to a caretaker,
- Moving away from existing relationships and toward new associations with other "friends" or strangers,
- Sudden change in financial management, such as through a change of power of attorney to a different family member or a new individual, and
- Lack of knowledge about his or her financial status or a sudden reluctance to discuss financial matters.

A caregiver or other individual who shows excessive interest in the elder's finances or assets, doesn't allow the elder to speak for himself or is reluctant to leave the elder's side during conversations also can signal elder fraud. Another red flag is a new caretaker, relative or friend who suddenly begins conducting financial transactions on behalf of the elder.

Help them help themselves

If you have elderly clients, with or without significant financial resources, they could be the target of a fraud scheme. When suspicions arise, turn to a qualified fraud expert to investigate. ■

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