

The Importance of the Subject Industry When Applying the Income Approach in a Family Law Valuation Context

Samuel Nicholls and Justin Nielsen

In a family law context, legal counsel (“counsel”) may retain a valuation analyst (“analyst”) to estimate the value of a closely held business ownership interest held within the marital estate. When estimating the value of this marital estate business interest, the analyst may apply the income approach, discounted cash flow (“DCF”) method. When applying the income approach, the consideration of the subject company industry is an important issue for the analyst. This is because the analyst should apply due diligence procedures when utilizing management-prepared financial projections in the analysis, including the comparison of the management-prepared financial projections to relevant industry data. Further, company management interviews may assist the analyst in performing appropriate diligence procedures with regard to the application of the income approach (including the application of management-prepared financial projections). This discussion summarizes the relationship between the income approach and the subject industry. And, this discussion provides practical guidance regarding the analyst’s role in (1) properly addressing the subject industry when applying the income approach and (2) conducting company management interviews in a family-law-related business valuation.

INTRODUCTION

It has been said that, “In the simplest sense, the theory surrounding the value of an interest in a business depends on the future benefits that will accrue to its owner. The value of the business interest, then, depends upon an estimate of the future benefits and the required rate of return at which those future benefits are discounted back to present value as of the valuation date.”¹

This means, in valuing any business, the income approach, discounted cash flow (“DCF”) method, is fundamentally based on the calculation of a current (i.e., present) value of the company’s anticipated future economic benefits, or income.

The two components of the DCF method are as follows:

1. The projection of future income
2. The estimation of an appropriate risk-adjusted required rate of return used to discount the projected future income back to present value

While many independent factors influence the estimation of both a subject company’s future income and appropriate risk-adjusted required rate of return (i.e., discount rate), an often under-analyzed component in applying the income approach is the subject industry. Therefore, this discussion summarizes the consideration of the subject industry in applying the income approach valuation of a marital estate business ownership interest.

While the Delaware Court of Chancery (the “Court”) often rules on matters related to dissenting shareholder appraisal rights and shareholder oppression, Court decisions may provide the valuation analyst (“analyst”) with guidance with regard to the application of the income approach within a family law context. With its significant influence on valuation-related matters, counsel and analysts frequently look to the Court for guidance regarding the appropriate methodology to value business ownership interests.

This discussion describes the role of the subject industry within the income approach, and specifically the process of aligning the subject industry with (1) company management-prepared projections and (2) the estimated long-term growth rate applied in the calculation of the company’s terminal value.

This discussion includes several industry-related issues that have been addressed by the Court in recent years. And, this discussion proposes procedures that an analyst can take to ensure the appropriate consideration of industry data when applying the income approach to value a closely held business within a family law context.

THE RELATIONSHIP BETWEEN THE DCF METHOD AND THE SUBJECT COMPANY INDUSTRY

Within the income approach, there are a number of generally accepted valuation methods, each based on the principle that the value of an investment is a function of the income that will be generated by that investment over its expected life.

There are a number of methods that can be used to estimate value under this principle, most of which are based on the estimation of an investment’s future income stream, and the application of an appropriate risk-adjusted, present value discount/capitalization rate.

The DCF method is an income approach method that may be used to value companies on a going-concern basis for family law purposes. It has appeal because it incorporates the trade-off between risk and expected return, a critical component to the investment decision and value calculation process.

The DCF method provides an indication of value by (1) projecting the future income of a business and (2) estimating an appropriate risk-adjusted required rate of return used to discount the estimated future income back to present value (i.e., discount rate).

In applying the DCF method, the analyst often assumes that the estimated future income will eventually stabilize. This long-term stabilized benefits stream can then be capitalized into perpetuity and discounted back to the valuation date. The value of the long-term stabilized benefits stream is typically called the terminal value (“TV”).

While there are many issues the analyst may consider in estimating the future income of a closely held business within a marital estate (and estimating an appropriate discount rate for a closely held business within a marital estate), the valuation analysis should consider the subject industry.

Specifically, the subject industry may be considered in:

1. assessing the reasonableness of company-management-prepared projections and
2. estimating the appropriate long-term growth rate used in the TV calculation.

A subject industry analysis can provide a useful portrait of how the company fits within an industry by considering (1) where the industry has been and (2) where the industry is likely to be going.

As presented in *Financial Valuation Applications and Models*, the following list presents some questions that can assist the analyst in developing a subject industry road map:

1. What are the prospects for growth?
2. What are the industry’s dominant economic traits?
3. What competitive forces are at work in the industry and how strong are they?
4. What are the drivers of change in the industry and what effect will they have?
5. Which companies are in the strongest/weakest competitive positions?
6. What key factors will determine competitive success or failure?
7. How attractive is the industry in terms of its prospects for above-average profitability?
8. How large is the industry?
9. Is the industry dominated by a few large companies?
10. Are there many public companies in this industry?
11. How much merger and acquisition activity is occurring?
12. What are the barriers to entry?
13. Is it a regulated industry?
14. Who are the customers? Is that base growing?²



2 About this Industry	19 International Trade	32 Technology & Systems
2 Industry Definition	20 Business Locations	33 Revenue Volatility
2 Main Activities	21 Competitive Landscape	34 Regulation & Policy
2 Service Industries	21 Market Share Concentration	34 Industry Assistance
3 Additional Resources	22 Key Success Factors	34 Key Statistics
4 Industry at a Glance	23 Cost Structure Benchmarks	36 Industry Data
5 Industry Performance	25 Barriers to Competition	36 Annual Change
5 Executive Summary	25 Barriers to Entry	36 Key Ratios
5 Key External Drivers	28 Industry Globalization	37 Industry Financial Ratios
7 Capital Intensity	29 Major Companies	38 Jargon & Glossary
9 Industry Outlook	29 Children's Hospital of Philadelphia	
11 Industry Life Cycle	29 Children's Hospital Boston	
13 Products & Markets	30 NYU Langone Medical Center's Hospital for Bone Diseases	
13 Supply Chain	30 Memorial Sloan-Kettering Cancer Center	
13 Products & Services	31 Operating Conditions	
16 Demand Determinants	31 Capital Intensity	
17 Major Markets		

www.ibisworld.com | 1-800-330-3772 | info@ibisworld.com

One of the analyst responsibilities when applying the income approach in a family law context is to align the appropriate income measure and risk-adjusted discount rate with the subject industry historical, current, and projected economic performance. This will, in effect, provide the court with a reasonableness test or “sanity check” with regard to the company-management-prepared financial projections

that are used in the DCF analysis of a marital-estate-owned closely held business.

The following section describes several resources that are available to the analyst to obtain industry data and information that can be used in an income approach analysis.

Sources of Industry Information

There are many sources of industry information and data, including fee-based, trade association, and free data and information resources. While it is not practical to list all available sources of industry data in this discussion, some of the sources of industry data and information include the following:

1. *Standard & Poor's Industry Surveys*
2. *IBISWorld Industry Reports*
3. *First Research Industry Profiles*
4. MarketResearch.com
5. Risk Management Association *Annual Statement Studies*

Some additional sources of industry data and information include the following:

1. Integra Information Benchmarking Data
2. Encyclopedia of Associations
3. National Trade and Professional Associations of the United States
4. Hoovers Company Database (Hoovers.com)
5. Factiva (factiva.com)
6. American Society of Association Executives

7. Various search engines such as Google (google.com), *The Wall Street Journal MarketWatch* (marketwatch.com), etc.

SUBJECT INDUSTRY CONSIDERATIONS AS PROFFERED BY THE COURT

As a large number of business entities within the United States are organized in the State of Delaware, the Court has become an influential voice in providing guidance related to business valuation issues. While these issues are typically related to dissenting shareholder appraisal rights or shareholder oppression matters, Court guidance may be meaningful to the analyst tasked with valuing a closely held business within a family law context.

One of those valuation issues is the appropriate use of, and reliance on, the subject industry when applying the income approach.

The Court has a consistent history of addressing subject-industry-related issues, and specifically the importance of analyzing the subject industry with regard to:

1. company-management-prepared projections and
2. the estimation of the long-term growth rate applied in a TV calculation.

The following two sections summarize several recent Court opinions that address subject-industry-related issues.

Industry Consideration—Management-Prepared Financial Projections

Based on historical and recent opinions, the Court expects the analyst to perform appropriate due diligence with regard to the subject industry, including the reasonableness of management-prepared projections when applying the DCF method.

The analyst may review management projections and confirm that the assumptions on which the projections are based are reasonable and appropriate given the historical, current, and future outlook of the subject industry.

As explained by the Court in *re John Q. Hammons Hotels Inc. Shareholder Litigation*:

In this case, it is undisputed that JQH operated in a very competitive industry

[emphasis added]—the hotel business. JQH had no competitive advantages, such as brand names or proprietary technology. Worse still, a large portion of its portfolio is located in secondary and tertiary markets, which have lower barriers to entry than primary markets. Hotels in secondary and tertiary markets face significant competition because of the lower barriers to entry. . . . And JQH’s hotels were even subject to competition from their own franchisors in many of the markets where JQH operated. Dr. Kursh’s expert report failed to take into account some of these factors affecting JQH, and his report is significantly impaired as a result.³

The above decision highlights the fact that by neglecting to appropriately consider the subject industry, the analyst is at risk of having the Court dismiss the opinion of value entirely.

In explaining the decision to disallow the application of the income approach, DCF method, in *Doft & Co., et al., v. Travelocity.com, Inc. et al.*, the Court relied on, in part, the state of the subject industry as testified to by Anwar Zakkour, the Solomon Smith Barney managing director:

Q. Did Salomon Smith Barney prepare a discounted cash flow analysis of Travelocity in connection with this transaction?

A. Absolutely Not.

Q. Why was no discounted cash flow analysis prepared in connection with this transaction?

A. Because this was an industry [emphasis added] that was in flux. And the management team itself, which should have been the team that was most able to put together a set of projections, would have told you it was virtually impossible to predict the performance of this company into any sort of reasonable future term. And they in fact had very little confidence with even their 2002 forecast numbers because of that.

September 11th didn’t help the pace of migration from off-line to online. It didn’t help. The airlines being very focused on cutting their distribution costs didn’t help. These were all things that were happening real time. Travelocity going from being the number one player to being very unfavorably compared to Expedia and certainly losing its number one position to them in a very short time didn’t help. These are all things that support that. And other than

maybe God himself, I suspect nobody could really predict what this business is going to do in the next five years.⁴

The Court further explains in *Doft & Co., et al., v. Travelocity.com, Inc. et al.*:

For these reasons, the court reluctantly concludes that it cannot properly rely on either party’s DCF valuation. The goal of the DCF method of valuation is to value the future cash flows. Here, the record clearly shows that, in the absence of reasonably reliable contemporaneous projections, the degree of speculation and uncertainty characterizing the future prospects of Travelocity and the industry in which it operates [emphasis added] make a DCF analysis of marginal utility as a valuation technique in this case.⁵

Industry Consideration—Estimated Long-Term Growth Rate in TV Calculation

The Court has opined on the proper subject industry consideration when estimating an appropriate long-term growth rate utilized in a TV calculation when applying the DCF method.

For example, the Court explains in *Towerview, LLC, et al., v. Cox Radio, Inc.*:

As noted, the rate of inflation generally is the “floor for a terminal value.” “Generally, once an industry [emphasis added] has matured, a company will grow at a steady rate that is roughly equal to the rate of nominal GDP growth.” Some experts maintain that “the terminal growth rate should never be higher than the expected long-term nominal growth rate of the general economy, which includes both inflation and real growth. Moreover, both experts in this case acknowledged that the expected long-term inflation rate in 2009 was 2%–2.5%. There also was some evidence that the expected rate of real GDP growth was between 2.5% and 2.7%, but this evidence was not particularly reliable. I find that the radio industry [emphasis added] is a mature industry and that CXR was a solidly profitable company. Thus, a long-term growth rate at least equal to expected inflation is appropriate here.⁶

The Court decision implies that the analyst should address (1) the profitability of the subject company and (2) the maturity stage of the industry

(i.e., the current and projected profitability of the subject industry) in order to appropriately estimate the long-term growth rate to be used in the TV calculation.

As further opined by the Court in *Merion Capital, L.P., et al., v. 3M Cogent, Inc.*:

Relying on historical GDP and inflation data, economic analysts projections, and the growth prospects of the biometrics industry [emphasis added], Bailey selected a perpetuity growth rate of 4.5%. The Gordian Experts, on the other hand, used a range of growth rates between 2% and 5%, and implicitly selected the midpoint of 3.5%. The Gordian Experts, however, provided no analysis or explanation in support of the number they chose for the terminal growth rate. Because Bailey was the only expert who sought to justify his conclusions, and his conclusion is within the range of rates identified by Respondent's expert and appears to be reasonable based on the evidence, I adopt Bailey's estimate of a 4.5% perpetuity growth rate.⁷

As opined by the Court in the above decisions, when applying the income approach, the state of the subject industry may be considered:

1. in assessing the reasonableness of company-management-prepared projections and
2. when estimating the appropriate long-term growth rate to be used in a TV calculation.

Further, neglecting to appropriately consider the subject industry may lead to the exclusion of the analyst's report in its entirety. This judicial guidance, while in an appraisal action context, may be relevant for analysts engaged in family law matters as well.

GUIDANCE FROM THE VALUATION PROFESSIONAL

It is intuitive that the value of a business is influenced by the operational efficiencies, products, and competitive advantage of the individual company within the context of the historical, current, and projected state of the subject industry.

It is important that the analyst not be myopic in estimating the value of a business. Rather, the analyst should cross-reference a detailed analysis of the subject company with a broader view of the subject industry, specifically highlighting where the subject business may fall within the industry, and why.

As previously mentioned, the Court has opined that, in applying the income approach to a subject company, the analyst's due diligence process should include consideration of the subject industry.

Additionally, the valuation profession also provides guidance with regard to the analysis of the subject industry. As presented in *Understanding Business Valuation*, several general factors that the analyst should consider in analyzing the subject industry may include the following:

1. Who makes up the industry? Are there many companies or are there very few companies that control everything?
2. Is it a cyclical industry?
3. Is it a new industry with many new companies entering it, or is it a mature industry that has reached its saturation point?
4. What are the barriers to entry, if any, into the industry?
5. Is this a self-contained industry, or is it dependent on another industry?
6. Is the industry dependent on new technology? If so, is the appraisal subject keeping up with the industry?
7. Is the industry expected to change? If so, how will that affect the appraisal subject?
8. What is the forecast for growth within the industry?⁸

As further presented in *Understanding Business Valuation*, Trugman reproduces a list from the American Society of Appraisers that presents industry factors that the analyst may consider in analyzing management projections within the context of the subject industry, such as the following:

1. Growth prospects for the subject company's industry at the national and local level
2. Demand factors
3. Maturity of the industry
4. Structure of the industry and level of competition
5. Technological or economic obsolescence factors
6. Barriers to competitor entry⁹

It is important that the analyst vet the assumptions used in the income approach to ensure they are reasonable as compared to the historical, current, and projected economic state of the subject industry.

Further, to help ensure the industry data obtained is applicable to the subject company, the

analyst may classify the business activities of the company. Two methods used to classify businesses are:

1. the Standard Industrial Classification (“SIC”) system and
2. the North American Industrial Classification System (“NAICS”).

Upon determining the appropriate classification of the subject company, the analyst may utilize the aforementioned industry resources to obtain data and information for companies or industries in the same classification.

Considering the data and information previously presented, valuation profession best practices require the analyst to appropriately consider the subject industry.

Therefore, the analyst may ensure the company management-prepared projections and estimated long-term growth rate applied in a TV calculation are:

1. consistent with the industry’s growth prospects;
2. reasonable as compared to the industry’s historical financial results; and
3. achievable based on the industry’s geography and expected future outlook of the regional, domestic, and international (if applicable) economy within the industry’s geographic outline.

As presented in item three above, the analyst may also consider the geographic economic influences on the subject industry historical, current, and projected economic performance. Namely, the regional, national, and international (if applicable) economy may have a direct impact on the subject industry economic performance. The analyst may consider and incorporate, as appropriate, geographic economic influences when analyzing the subject industry.

Company Management Interviews

In applying the income approach to value a closely held business within a marital estate (and based on guidance from the Court), the analyst may consider:



1. the subject industry with regard to management-prepared financial projections and
2. the subject industry with regard to the estimated long-term growth rate used in the TV calculation, as previously mentioned.

However, the analyst may also be aware of the facts and circumstances surrounding the family law assignment. Namely, the closely held business owner spouse may purposely provide inaccurate data, information, and management-prepared financial projections due to that spouse wanting to reduce the value of the closely held business ownership interest (thereby reducing any equalization payments required by the family law court in the equitable distribution of the marital estate assets).

Further, the closely held business owner spouse may purposely provide conflicting data with regard to the subject industry in order to paint a negative portrait of the future operations of the company.

The analyst may juxtapose any data and information provided by company management to:

1. industry data,
2. historical company data, and
3. data received from other interviews with company senior management.

In order to perform proper due diligence with regard to management-prepared financial projections that are utilized in a family law context, the analyst may interview relevant company leadership.

Incorporating the data and information previously presented, in general, valuation profession best practices suggest that the analyst assess the reasonableness of management-prepared projections by ensuring the projections are:

1. consistent with the company's growth prospects;
2. reasonable as compared to the company's historical financial results;
3. achievable based on the company's operating capacity and expected future capital expenditures;
4. reasonable as compared to the company's client and supplier projected financial results;
5. reasonable based on the industry's historical and projected financial results;
6. reasonable based on the expected future outlook of the regional, domestic, and international (if applicable) economy;
7. consistent with other company leadership interview results with regard to the company's historical, current, and projected financial results; and
8. extensively documented and justified if the projections have been amended by the analyst.

The analyst may vet the assumptions on which management projections are based. The analyst may document and justify any changes made to management-prepared projections due to the comparison between the data provided in management interviews, the data provided in the company management-prepared financial projections, and the data analyzed with regard to the subject industry.

SUMMARY AND CONCLUSION

In a family law context, counsel may retain the analyst to estimate the value of a private company ownership interest held within the marital estate. When estimating the value of this marital-estate-owned private company, the analyst may apply the income approach.

When applying the income approach to value a private company ownership interest (within a family law context), the analyst should ensure that appropriate consideration is given to the subject industry.

This is because, as proffered by the Court, when applying the income approach, the subject industry should generally be considered:

1. in assessing the reasonableness of company management-prepared projections and
2. when estimating the appropriate long-term growth rate to be utilized in a terminal value calculation.

While the Court typically rules on appraisal actions, the guidance from the Court may be meaningful to the analyst assisting with a family law matter. This is because the subject industry is a consideration in an income approach analysis conducted on a private company ownership interest held within the marital estate.

Further, the analyst may also consider valuation profession best practices, and—if possible—conduct due diligence company management interviews, in order to apply the income approach to the valuation of a private company ownership interest within the marital estate.

Notes:

1. Shannon P. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th ed. (New York: McGraw-Hill, 2008), 56.
2. James R. Hitchner, *Financial Valuation Applications and Models*, 4th ed. (New York: John Wiley & Sons, 2017), 64–65.
3. *In re John Q. Hammons Hotels Inc. Shareholder Litigation*, No. 758-CC, 2011 WL 227634 (Del. Ch. Jan. 14, 2011).
4. *Doft & Co., et al., v. Travelocity.com, Inc. et al.*, No. Civ.A. 19734, 2004 WL 1152338 (Del. Ch. May 21, 2004)
5. *Id.*
6. *Towerview, LLC, et al., v. Cox Radio, Inc., C.A. No. 4809-VCP*, 2013 WL 3316186 (Del. Ch. June 28, 2013).
8. *Merion Capital, L.P., et al., v. 3M Cogent, Inc., C.A. No. 6247-VCP* 2013 WL 3793896 (Del. Ch. July 8, 2013).
9. Gary Trugman, *Understanding Business Valuation*, 5th ed. (New York: American Institute of Certified Public Accountants, 2017), 263.
10. *Ibid.*, 263.



Sam Nicholls is a manager in our Atlanta practice office. Sam can be reached at (404) 475-2311 or at ssnicholls@willamette.com.

Justin Nielsen is a vice president in our Portland, Oregon, practice office. Justin can be reached at (503) 243-7515 or at jmnielsen@willamette.com.

