

BUSINESS VALUATION UPDATE

TIMELY NEWS, ANALYSIS, AND RESOURCES FOR DEFENSIBLE VALUATIONS

Tales From the Trenches

Company Research: The Internet May Be Right, But It May Also Be Wrong!

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Editor's note: This is an article in a series of valuable lessons to be learned based on the experiences of seasoned valuation experts. While you may be able to find some of this advice in books, only real-life experiences can highlight the nuances that can only be found in the minds of the experts who have lived through many engagements. Do you have a lesson to share? Contact the editor at andyd@bvresources.com.

Business valuation today is a lot more complex than it was years ago. One of the dangers of this is that we can get lost in the complexity and lose sight of some of the fundamentals. One of these fundamentals is that the appraiser must have a very good understanding of the operations of the underlying business they are valuing. There are many ways to gain information on your subject company, including a site visit, interviews with management, as well as general industry data. Data on the internet also might be of value to the appraiser. However, as discussed below, relying simply on the internet for your company knowledge can lead to disaster.

Case in point. I was engaged to do a valuation of a 100-year-old-plus privately held company that produced well-known food products. Although the subject company has a national reputation, it is very small in relation to the many very large, publicly traded entities with which it competes. There

was also the issue that the physical location of the company was hundreds of miles from the jurisdiction of the lawsuit that triggered the valuation.

During the course of the engagement, it became clear that several issues were the basis for the significant difference between my valuation and the opposing expert's valuation. Some of those issues included rent paid to a related entity, maintenance costs, and a question of whether all the space was necessary for the operations of the company.

In deference to my opposing expert, his client would not incur the cost of a site visit and related interviews with management, so they relied only on data that were derived from searches of the internet, including the subject company's internet selling site.

Big differences. So how did the discrepancies play out? The first significant issue was the rent being paid on the new manufacturing facility. The internet indicated that a building was available in the same vicinity for as low as \$8 per square foot per year. The actual rent being paid was in excess of \$30 per square foot per year. When we visited the plant, we could see that the FDA requirements that had to be added to the new manufacturing facility included stainless steel plumbing, wall coverings, and special floor construction to prevent bacterial infection of the food product produced. The cost per square foot recognized these additional costs of construction and were apparent during the visit, while the internet only

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provided “comparable” size buildings that were not suitable to food production.

As to maintenance costs, we quickly learned that the company had two work environments. The first was the production floor and fresh product storage, which was maintained at a constant temperature from 35 degrees to 37 degrees and a humidity level of in excess of 85%. The other area, the freezer storage area, was maintained at a temperature of 20 degrees below zero with a humidity level of 5% or less. This meant that all the electrical equipment used in the food production arena was subject to severe wear and tear. The internet indicated that the useful life of electric motors used to run the production equipment and the electric forklifts were far greater than the actual life span of that equipment when used in the operating environment that existed in the subject company.

Lastly, as to the excess space, there were many thousands of square feet of space in the original 100-year-old-plus buildings. However, during the site visit, I learned from management that, due to a flood control project that the city conducted several years before the valuation date, the 100-year-old-plus buildings had been negatively impacted and could no longer support a usable load to allow for the space to be used for anything but storage of very low weight materials. Obviously, this fact was not apparent to anyone during an internet search.

Case settles. In the end, the case settled because the judge indicated that he was going to disregard the opposing expert’s report due to the lack of understanding of the operations of the subject company.

Of course, my case is not unique and published cases address this fundamental issue. For example, in the *Kohler*¹ estate tax case, the judge

1 *Kohler et al. v. Commissioner of Internal Revenue*, 2006 Tax Ct. Memo LEXIS 156 (July 25, 2006); available at [BVLaw \(bvresources.com/products/bvlaw\)](http://BVLaw(bvresources.com/products/bvlaw)).

made it a point to criticize the expert for the IRS for not understanding the business and spending only two and a half hours meeting with management. One of the experts for the taxpayer spent three and a half days at the company. This was one reason why the *Kohler* case was a total victory for the taxpayer.

Final thought. In my opinion, the internet is not now—and most likely will not be in the future—a significant source of information to replace an appraiser's responsibility to understand the actual operations of the subject company. I can only think of a very few situations where a site visit and an in-depth discussion of operations of the company with management are not an integral part of the appraisal process.

For more information, two of the business valuation profession's authoritative texts discuss site visits. Shannon Pratt's *Valuing a Business*²

2 bvresources.com/products/valuing-a-business-the-analysis-and-appraisal-of-closely-held-companies-5th-ed.

has a chapter devoted to the topic. *Understanding Business Valuation*³ by Gary Trugman has a section on the on-site interview that includes a list of questions to ask.

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3 bvresources.com/products/understanding-business-valuation-a-practical-guide-to-valuing-small-to-medium-sized-businesses-5th-edition.