A Litigator's Guide To The Goodwill Valuation Report

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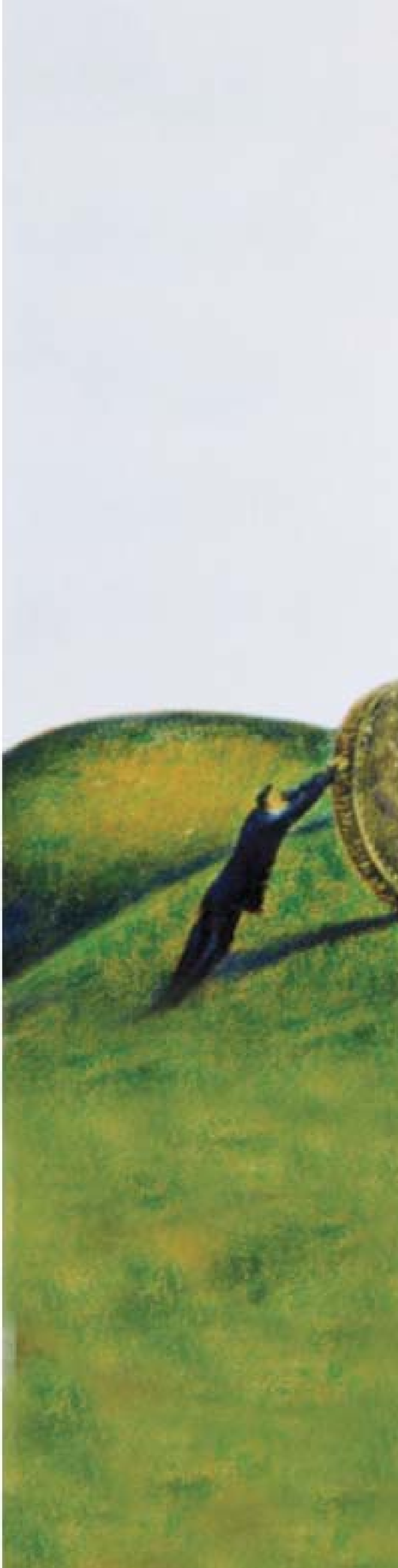

Eminent domain law allows a government agency to acquire property for public use provided the agency pays just compensation for the acquisition. In California and certain other states, business goodwill that is lost when a public agency condemns property is also compensable under the statute. The valuation of this compensation, however, can be a highly complex, subjective and contentious issue. It is not uncommon for experts on opposite sides to have vast differences in their opinions of value, sometimes in the tens of millions of dollars. ✦ Given the high stakes involved, it is essential that the litigator thoroughly understand what accounts for the key differences in valuation conclusions, as well as the merits and deficiencies of each. The following article provides a guide to assist the agency representative, business owner, right of way agent and negotiator in the critical review of a goodwill valuation report. While the article does focus on the potential concerns of the litigator, the observations should be useful for any party.

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The Goodwill Loss Calculation

Goodwill is defined in eminent domain law as "the benefits that accrue to a business as a result of its location, reputation for dependability, skill or quality, and any other circumstances resulting in probable retention of old or acquisition of new patronage." Economically speaking, goodwill is any business value over and above the business' working capital and the value of its tangible and identifiable intangible assets. In general, goodwill loss is computed as follows:

Goodwill Before – Goodwill After (Mitigated) = Goodwill Change (Loss), where:

Goodwill Before measures goodwill measurement in the absence of eminent domain,

Goodwill After (Mitigated) represents goodwill reduced by condemnation and the costs of mitigation, and

Goodwill Change (Loss) is the difference in goodwill between the "before" and "after" measurements.

Several observations follow. First, any loss of goodwill will be limited by the amount of goodwill computed in the "before" condition. For example, if goodwill before condemnation is appraised at zero, then no loss of goodwill can occur even if the business suffers a significant loss of profits due to condemnation. Second, the loss of goodwill subject to compensation must be attributable to the eminent domain action, which opens the door to heated attribution contests. Third, in order to be compensated, the business owner must demonstrate that reasonable efforts were made to preserve goodwill. Thus, mitigation analysis is also an essential element of the goodwill loss opinion.

General Issues To Consider

A litigator will want to keep the following general considerations in mind when analyzing the goodwill valuation report:

- Does the valuation analysis conform to accepted professional standards?
- Are accepted valuation methodologies used?
- Are facts accurate and properly disclosed?
- Are any significant and relevant facts omitted or underemphasized?
- Are hypothetical conditions and critical or extraordinary assumptions clearly identified?
- Does the person who signed the report possess adequate qualifications and experience to value business goodwill?

Specific Issues To Consider

In addition to the above considerations, the litigator will want to understand the specific reasons that most often account for the vast differences of opinion between goodwill valuation experts. Some of the more significant issues are described below.

Adjustments to Historical Earnings

A business appraiser typically bases value on representative expected earnings or cash flow. The higher the expected earnings or cash flow, the higher the business value and, other things equal, goodwill value. To arrive at this figure, the appraiser will make adjustments to historical earnings. Different adjustments often result in completely different conclusions from the same set of financial statements. Adjustments are typically made for nonrecurring items, officer compensation, discretionary items, fair market rent, and to remove the effects of condemnation.

- ***Nonrecurring Items.*** Examples of a nonrecurring expense item are large repairs and maintenance expenses in a given year and legal fees attributable to a prior litigation. *Sometimes, however, a business owner may attempt to categorize a periodic yet necessary expense as "nonrecurring" in an attempt to increase adjusted earnings. The litigator may want to ask detailed questions regarding these items at deposition.*
- ***Officer Compensation Adjustments.*** In some situations, a business owner might minimize corporate taxes by paying above-market officer compensation. Appraisers account for this by adjusting historical officers' compensation to fair market levels. Experts can disagree, however, as to what constitutes fair market compensation for the

individual in question. *The litigator should understand what specific activities the owner performed, how much time was spent performing these tasks, and what a third party would reasonably pay to replace these services.*

- ***Discretionary Expense Adjustments.*** Similarly, a business might incur discretionary or non-operating expenses, which can more accurately be characterized as a form of payment to the owners of the business. Expenses characterized as discretionary may include: administrative salaries, travel and entertainment expense, interest expense or auto lease payments. Experts will routinely disagree about the extent to which these expenses are discretionary as opposed to necessary for operations. *The litigator should understand the basis for any significant disagreement among experts regarding the level of discretionary expenses, and assess whether the available evidence adequately supports discretionary expense adjustments.*

- ***Fair Market Rent Adjustment.*** In certain circumstances, a business may operate under a favorable lease (incur below-market rent expense). While this situation can represent an economic benefit to the business, the value of this benefit, often called leasehold interest value, is contained in the appraised value of the underlying real estate. Thus, to prevent double counting the potential real estate and goodwill awards, leasehold interest value is eliminated from goodwill value. This is typically accomplished by substituting the business' contractual rent expense with fair market rent.

  Fair market rent is the link between real estate value on an income basis and the business goodwill value. A higher fair market rent results in a higher value for the underlying real estate. Yet at the same time, a higher fair market rent causes business goodwill value to decline, since the larger expense reduces the future benefits available to the subject business.

  As the real estate and goodwill values are linked through the fair market rent estimate, a consistent damage award requires that the same fair market rent be used in determining both real estate and goodwill value. However, eminent domain trials are sometimes bifurcated, whereby the real estate and goodwill compensation awards are determined separately. In those cases, a property owner may attempt to maximize total damages by using a relatively high fair market rent in the

real estate portion of the trial and a lower fair market rent in the goodwill valuation portion of the trial. (Conversely, an agency representative may try the opposite tactic.) Another strategy may be to use a fair market rent estimate favorable to the goodwill opinion but then giving the income approach very little weight in valuing real estate, effectively ignoring fair market rent. *The litigator should understand the interrelationship of goodwill and real estate value through fair market rent and be aware of the potential to manipulate the condemnation award through inconsistent application of the fair market rent estimate.*

- ***Condemnation Adjustments.*** Some of the most crucial adjustments made to arrive at representative earnings in the "before" condition are those made to remove any effects eminent domain proceedings may have had on historical revenues and earnings. Such adjustments typically increase historical earnings and appraised goodwill.

  Valuation experts will often rigorously dispute the magnitude of these adjustments. For example, one expert may attribute virtually all of a company's downturn in profitability to the eminent domain action, citing reduced traffic flows caused by project construction, disruptions to operational management due to relocation concerns, or loss of key customers caused by uncertainty regarding the subject business' long-term viability. In contrast, the opposing expert may attribute much or all of any perceived decline in the subject business' earnings to increased competition, unfavorable industry and economic trends, a decline in market prices, regulatory change, and other factors unrelated to condemnation.

  During the discovery process, the litigator should try to obtain as much information as possible to verify the appropriateness of condemnation adjustments. For example, if the business owner states that he suffered lost or reduced patronage from key customers and suppliers as a result of condemnation, the litigator should inquire as to the specific names of these individuals, conduct an independent survey of customers, and may consider taking their depositions, as well as the depositions of the business' key managers. In addition, it may be beneficial to construct a detailed timeline of events to help test the correlation between significant external events (such as the closure of a major street or the loss of a key customer) with any decline in the subject business' operating performance or financial condition.

Selection of Capitalization Rate

Another significant source of disparity between expert valuation opinions is the selected capitalization rate. Appraisers use a capitalization rate to convert representative earnings or benefit measure to a business value. A common use of the capitalization rate in valuation is as follows:

Business Value = Representative Future Cash Flow / Capitalization Rate

The above formula shows that, for a given level of expected cash flow, a lower capitalization rate will result in a higher business value, and hence in higher goodwill. Appraisers will often disagree on the applicable rate to apply to a given business.

Goodwill values can be extremely sensitive to these rates. For example, consider a business with expected cash flow of $100,000 and tangible assets of $350,000. Using the above formula, an appraiser assuming a capitalization rate of 20 percent may compute a goodwill value equal to:

$100,000/20% – $350,000 = $150,000

On the other hand, the same appraiser assuming a capitalization rate of 23 percent would calculate the goodwill as:

$100,000/23% – $350,000 = $84,783

The valuation of goodwill in the "after" condition reflects the condition of the business, taking into account the full effects of the eminent domain action.

In this example, increasing the capitalization rate by 3 percent decreases appraised goodwill by over 40 percent. The litigator should insist on a clear explanation of how the capitalization rate was calculated and the reasons supporting the selected rate, and assess the reasonableness of the rate in light of available evidence.

Guideline Company Multiple Selection

Appraisers will often also use a "market" or "guideline company" approach to valuation. In such an approach, valuation measures are developed from the prices of companies similar to the subject business and then applied to the subject business' financial or operational statistics. A typical formula used is:

Business Value = Representative Future Cash Flow x Valuation Multiple

As in the case of the selection of the capitalization rate, the goodwill value conclusion is highly sensitive to the selected valuation multiple. The savvy litigator questions the basis for any multiples chosen, and reasonableness of the underlying assumptions. In particular, the litigator will want to ask:

- Are the guideline companies relied upon reasonably comparable to the subject company?
- Is sufficient information available to reliably use the observed transactions as indicators of value?
- Were proper and consistent adjustments made to the financial statements of the subject and guideline companies to enable meaningful comparison?
- Was any observed market transaction omitted from the analysis? If so, why?
- Is the selected multiple within the range of the observed figures? If not, why not?

Mitigation Analysis

The business owner must demonstrate that a reasonable effort was made to relocate or reconfigure the business after condemnation and must address the economic feasibility of relocation or reconfiguration.

Businesses that are not geographically sensitive may be able to relocate relatively easily. Others, such as a neighborhood restaurant, may not be able to find a suitable relocation site within its market area. Other businesses may find relocation not viable due to lower sales, higher rent, and greater operating expenses at the new location. On the other hand, a business owner may claim that relocation is infeasible in an effort to maximize the potential compensation award. *It will often be prudent for the litigator to commission a relocation/mitigation analysis to independently verify whether any or all of a business' goodwill could have been reasonably preserved by relocation or reconfiguration, and to measure the goodwill loss assuming such mitigation had occurred.*

Goodwill Value Calculation: "After" Condition

The valuation of goodwill in the "after" condition reflects the condition of the business, taking into account the full effects of the eminent domain action. In reviewing this analysis, the litigator will want to explore the following issues:

- Are revenue declines or cost increases at the relocation site reasonably expected to be permanent, or short-lived in nature? Are growth projections in the "after" condition reasonable in light of the available evidence?
- Are there any benefits of relocation or reconfiguration to consider? For example, relocation may allow a business to improve the efficiency of its plant layout and to consolidate operations previously scattered among multiple locations.
- While many capital expenditures made at the new site may be necessary for relocation, some outlays may be discretionary in nature, and arguably not compensable. The litigator will want to inquire about the purpose and necessity of relocation expenditures, particularly if they are significant.
- A business appraiser may discount post-condemnation cash flows at a higher rate to account for greater business risk at the relocation site. However, if cash flows at the new site are already adjusted downwards, this calculation might double-count damages. The astute litigator will verify whether an adjustment to the discount rate is reasonable in light of available evidence.
- If the business is a retailer operating in multiple locations, are revenues being accurately represented on the financial statements, or are revenues from the impacted location being reallocated to another site to magnify calculated damages? The litigator may want to request sales and use tax returns, which report sales by location, to verify that revenues are accurately reflected on the business' financial statements.

Conclusion

The determination of compensable goodwill loss can be an extremely complex and contentious valuation issue. Understanding the goodwill report and taking proactive steps to gather information during discovery can maximize the litigator's probability of favorably resolving these disputes.