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How to factor cybersecurity concerns into a business valuation

Rarely a day goes by without a headline about a major data breach or ransomware attack. Amid the COVID-19 pandemic, cyber risks will likely continue to grow as businesses increasingly rely on remote workers and cloud-based technologies. So, it's critical for business valuation professionals to assess such risk when valuing businesses.

Although hackers often target large businesses because "that's where the money is," the threat of cyberattacks is an issue for businesses of all sizes. In fact, smaller businesses are increasingly targeted because they tend to have less robust cybersecurity programs.

Think beyond direct costs

The potential impact of weak cybersecurity on business value is far-reaching. It extends beyond the expense associated with responding to and mitigating breaches. For example, a cyberattack can destroy the value of intellectual property that relies on secrecy, such as customer lists, know-how, designs, R&D documents, manufacturing processes and business plans.

Likewise, organizations that possess sensitive customer or patient data — such as Social Security numbers, addresses, credit card accounts and health information — can face devastating liabilities if this information is stolen. A significant data breach can also damage a company's reputation, reducing the value of its goodwill. A cybercriminal can even create a risk of physical injury or product defects by tampering with machinery or equipment.

Evaluate cybersecurity measures

When gathering data about a business, valuation experts ask questions about cybersecurity protocols. A logical starting point is determining whether the business has conducted a risk assessment and adopted a cybersecurity framework. The National Institute of Standards and Technology (NIST) and similar frameworks provide checklists of best practices to assess cyber risks.

For example, consider ransomware attacks in which cybercriminals encrypt or steal a company's data and hold it for ransom. The threat is so serious that the NIST has developed a separate Cybersecurity Framework Profile for Ransomware Risk Management. It outlines basic preventive steps that companies can take to protect themselves against ransomware, such as:

- Always use antivirus software,
- Keep computers fully patched,
- Block access to ransomware sites,
- Allow only authorized apps,
- Restrict personally owned devices on company networks,
- Educate employees about social engineering, and
- Develop and implement rigorous backup and incident recovery plans.

Valuation experts can use this framework to gauge cyber risks. All else being equal, a company that's effectively implemented these steps is worth more than one with less effective controls in place — or none at all.

Quantify the impact on value

Once potential cyber risks are exposed, the expert must quantify their impact on business value. This can be handled in various ways. For example, under the income approach, the discount rate may be *increased* to the extent that the subject company has weak or missing cybersecurity protocols. Alternatively, an expert may *lower* the subject company's projected cash flows to reflect the elevated risk.

Under the market approach, it may be appropriate to adjust pricing multiples *downward* to reflect excessive cyber risks relative to the guideline companies. However, it may be difficult to evaluate the control environment of the guideline companies based on the limited information provided in guideline company databases.

When using the cost approach, a valuator might consider adjusting the market value of intangible assets, such as goodwill or intellectual property, for potential cyberthreats. Or the risk could be reflected in a contingent liability account on the adjusted balance sheet.

Risky business

Cyber risks are among the biggest threats businesses face today. A valuation that fails to evaluate them and incorporate their impact into the conclusion of value is unlikely to withstand scrutiny. ■

Spotlight on discounted cash flow

As businesses pivot to market changes during the pandemic, valuation experts are increasingly likely to turn to the discounted cash flow method to estimate value. This method is advantageous in times of economic uncertainty because it provides flexibility if management expects short-term fluctuations in growth, revenue and expenses, leverage, working capital needs, and capital expenditures.

The *International Glossary of Business Valuation Terms* defines discounted cash flow as "a method within the income approach whereby the present value of future expected net cash flows is calculated using a discount rate." This method entails the following three basic inputs.

1. Cash flow projections

When applying the discounted cash flow method, the first step is to project the company's cash flows over a discrete period of, say, five or seven years.

There are no prescribed rules for determining the duration of the discrete projection period. Its length is largely determined by the volatility of the subject company's cash flows and discount rate. The end of the discrete projection period may coincide with stabilized business operations or a sale of the company.

Court considers COVID-19 effect on cash flow projections

The discounted cash flow method was used to value a business in a recent bankruptcy proceeding that would determine the amount of the main creditor's secured and unsecured claims. The U.S. Bankruptcy Court specifically addressed the impact of the COVID-19 pandemic on business valuations in this case.

In re Kinser Group LLC involved a debtor who bought two hotels in a college town in 2017. At the time, there were approximately 1,000 hotel rooms in the city, but that number had grown to about 2,900 by late 2020, when the debtor filed for bankruptcy.

The hotels' performance was adversely affected by increased competition in the city's hotel market. The situation worsened during the pandemic, as many students returned home for online education and most sporting events and other college gatherings were canceled.

In determining the value of the hotels, the court rejected much of the testimony by the creditor's valuation expert. It found the expert's cash flow projections — which assumed the hotels' occupancy rates would stabilize in three years — to be overly optimistic. The court determined that "post-COVID-19 stabilization" isn't likely to occur for either hotel until four or five years after the valuation date.

The expert also valued the hotels under the assumption that they would be sold on the valuation date. The court disagreed, noting that the debtor's reorganization plan called for it to retain and operate the hotels.

When projecting cash flows, the expert considers several factors, including:

- The past financial performance of the business or of similar companies,
- Prevailing economic and industry conditions,
- Anticipated costs,
- Working capital needs, and
- An expected growth rate.

Often, experts rely on projections that management has prepared in the ordinary course of business. Many courts find such projections to be the most reliable predictors of future cash flows, given management's intimate knowledge of the business, the industry and the market. But courts may be skeptical of, and may even reject, management projections prepared outside of the ordinary course of business — particularly if the likelihood of litigation creates an incentive to manipulate the results.

2. Terminal value

Terminal (or residual) value is the value as of the end of the discrete projection period in a discounted cash flow model. This amount represents how much the business could theoretically be sold for after that period. (In reality, the company probably won't be sold at that time.) The terminal value also must be discounted to its present value using the discount rate.

Terminal value is typically estimated using the capitalization of earnings method. Here, the expert computes cash flow for a single representative future period and then divides that amount by a

capitalization rate. The theory is that cash flows eventually stabilize once a business matures. In many cases, terminal value represents a large chunk of the cash flows that are discounted to present value under the discounted cash flow method.

3. Discount rate

Once expected cash flows have been projected — including the cash flows for the discrete projection period and the terminal value — the expert adjusts them to present value using a discount rate that's based on the risk of the investment. If the expert projects *equity* cash flows, they're discounted using the cost of *equity*. Conversely, if the expert projects cash flows to *both* equity and debt investors, they're discounted using the *weighted average cost of capital*.

The discount rate — though based on market rates of return — does require a certain level of subjective judgment. Small variations in the discount rate can have a major effect on the expert's conclusion.

Essential expertise

The discounted cash flow method is often difficult for laypeople to understand. An experienced business valuation expert can help you determine whether this method is appropriate for your situation and, if so, how it works and the reasoning behind the underlying assumptions. ■

Hartman v. BigInch Fabricators & Construction Holding Company, Inc.

Court allows valuation discounts under shareholder agreement

The Indiana Supreme Court recently held that the language of a shareholder agreement controlled the application of valuation discounts under its mandatory buyback provision. The agreement called for the buyback price for an ownership interest to be based on the interest's "appraised market value" as determined by a third-party valuation firm.

Background

The plaintiff, an officer and minority shareholder, was terminated for cause, triggering the company's obligation to buy back his shares. The company hired a business valuation professional who valued the interest at roughly $2.4 million.

This estimate included discounts for lack of control and marketability. The undiscounted value of the interest was approximately $3.5 million. So, the combined discount was roughly 31%.

Legal saga

The minority shareholder sued the company, arguing that discounts were inappropriate because the agreement didn't "contemplate a fair market value standard." The trial court upheld the application of valuation discounts. However, the court of appeals reversed this decision. It found that marketability and control discounts "have no application in compelled transactions to a controlling party."

Ultimately, the state supreme court reversed this ruling, reinstating the discounts. It rejected the shareholder's argument that, as a matter of law, minority and marketability discounts don't apply when selling shares to a controlling interest in a

closed-market sale. The court reasoned that the discounts "improperly punish minority shareholders and create a windfall for majority shareholders."

The case law cited to support this proposition involved a company's purchase of a minority shareholder's stock in a compulsory *statutory* buyout. The court distinguished *contractual* buyouts, such as the one involved in this case. It explained that a "blanket rule" that disallows valuation discounts in closed-market transactions, irrespective of an agreement's terms, is "incompatible with basic contract-law principles."

The supreme court recognized the parties' freedom to contract according to whatever terms they see fit. It held that the state legislature didn't control the valuation method for selling a former officer or director's shares to the company. In addition, the court found that the plain language of the agreement — which priced the shares at their "appraised market value" — contemplated a fair market value standard, under which discounts for lack of control and marketability were appropriate.

The last straw

The state supreme court also observed that the minority shareholder failed to exercise his contractual rights to obtain an additional third-party appraisal or to offer evidence to challenge the valuation obtained by the company. This finding underscores the importance of obtaining an independent second opinion, rather than leveraging the expert witness hired by the opposing side. The cost of hiring your own expert is usually money well spent. ■

Strategic M&A due diligence should look to the future

The business world has changed dramatically over the last two years. While some changes brought on by the COVID-19 pandemic are expected to be only temporary, others are expected to last indefinitely. When buying a business, it's imperative to evaluate its expected future performance, rather than focus on its historical results. While the future can't be predicted with complete accuracy, analysis of historical trends and other information that is known or knowable about the company at the present time may be helpful in projecting future cash flows. Strategic due diligence can help vet an acquisition's potential success or failure.

Adding a layer of assurance

Legal, financial and operational due diligence help determine value, uncover risks and establish a fair purchase price. But *strategic* due diligence specifically addresses whether a deal is realistic and not simply overly optimistic on the buyer's part. It should be considered additional to the usual screening processes.

Strategic due diligence evaluates a deal and explores its rationale from the following four angles:

1. The market. The success of a merger or acquisition will depend largely on the health of the target company's market. For example, is the market expected to continue growing at its current rate or is it maturing? And how will technological advancements affect market activity?

> *The success of a merger or acquisition will depend largely on the health of the target company's market.*

During the market investigation, it's important to determine current market size and its competitive characteristics and drivers. Then segment growth must be forecast. Rather than relying solely on data from the target company's management, consider talking to customers, competitors, industry observers, suppliers and regulators for an unbiased perspective.

2. Customers. If the target company has an up-to-date customer database, a five-year study can help clarify trends and potential risks. This analysis starts by identifying major customers and analyzing their key purchase criteria. Is their business based on personal relationships with key personnel? Also consider negative indicators, such as service or product complaints, low loyalty rates, or delinquent payments. This data is essential to determining how well the company is currently meeting its customers' needs — and how well it will sustain growth and revenues in the future.

3. Competitive positioning. It's important to evaluate whether the target company has successfully

differentiated itself from others in the market. Does it have adequate resources and capabilities to stave off the competition? What is the competitive edge of new market entrants? What type of consolidation or divesting activity has recently occurred in the industry? Sometimes sellers' motivations stem from impending competitive threats that won't be obvious from your due diligence.

4. Management. Ideal market conditions and a differentiated competitive position will be all but lost on an ineffective management team. Assess the capabilities of individuals and groups to determine what — and who — is working.

It's particularly important to ask whether the current management team will be able to deliver on the deal's anticipated value. Regular management due diligence, such as background checks, is a necessity. But consider conducting competency-based interviews, too. Look for managers who can adapt to change and implement decisions quickly. These characteristics will be crucial during the integration period.

Inspiring confidence

Buyers who dig deeper into a target company's strategic operations may be able anticipate post-acquisition risks and opportunities, helping them maximize their returns on investment. Unfortunately, most buyers have limited M&A experience.

But there's a silver lining: You don't have to conduct strategic due diligence alone. Consider hiring an experienced outside financial expert to help vet a deal. The right expert can perform extensive research that considers not just the past, but also the future. ■

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