5 Warning Signs A Business Valuation Is Bogus

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Business valuation should be based on qualitative and quantitative factors. Unfortunately, some valuators don't truly understand the qualitative nature of valuation. A such, CEOs, investors, and business owners often unwittingly rely on erroneous valuations. Any one of these five significant red flags should alert you to seek another opinion of value:

1. **A Perpetual Annual Growth Rate Larger than 5%**
Very few companies can outgrow GDP in the long-term in a competitive marketplace. The U.S. GDP growth rate has averaged 3.2% from 1948 through 2016. Anytime I see a projected long-term (perpetual) growth rate greater than 4% in a valuation I want to turn away and run. I recently reviewed a valuation report where the valuator used a 6% perpetual annual growth rate. Within two years of the valuation, the company was in financial distress due to changes in the competitive landscape. Beware unrealistic growth forecasts!

2. **Dependence Upon Forecasts From Industry Trade Groups**
Most trade groups use survey results from CEOs and other senior leaders in their industry to create sales growth forecasts. Unfortunately, many such forecasts are unreliable. A recent study revealed that CEOs over-estimate future revenue growth during economic expansion and underestimate growth during economic contraction. In short, the senior level people surveyed were biased by their emotions and ambitions. Beware forecasters wearing rose-colored glasses!

3. **Inadequate Assessment of Company-Specific Risk**
Too often, valuations are based on inaccurate estimates of company-specific risk. No CEO or company owner believes his or her company is riskier than the average company in that industry. The reality is that most small to middle market companies would not be rated as investment-grade, but rather on a par with junk-bonds. This statement is not intended to be insulting, but to point out that the average small to middle market company would have a Standard & Poor's bond rating of approximately a BB. Beware of blanket valuations that don't consider an individual company's risk!

4. **Comparisons with Firms That Are Only Superficially Similar**
Valuations often contain simple market comparables of recent transactions of companies with the same SIC code, but without an analysis of whether or not the potential transaction company is truly similar to the subject company. Good comparables are companies with similarities in operating characteristics, company-specific risk, customer base, and regulatory environment. Such companies may even be in different SIC codes than the subject company. Beware of valuation estimates that compare apples to oranges!

5. **Insufficient Knowledge of the Regulatory Environment**
Several months ago, I read a valuation report of a healthcare company prepared by a generalist valuation company. The value of the company was significantly overstated as it was based on erroneous projected Medicare and Medicaid reimbursement rates. Moreover, the valuator failed to consider pending state legislation to increase minimum wage rates and the impact of the Affordable Care Act on the health care provider company. Beware of valuators who don't know your industry!

Understanding how each of these red flags could impact the value of your company is an essential step in determining its true value.