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Editor's Column – Forecasting Net Cash Flow

Paul R. Hyde, EA, MCBA, BVAL, ASA, Editor

Developing the income forecast and quantifying the appropriate risk of the company achieving the forecast are often the most difficult tasks of a business appraisal. Appraisers that have been involved in this business for many years typically see and have seen a wide variety of forecasts – from the wild, highly speculative, “shoot for the moon” management forecast to the very pessimistic, “the world is coming to an end because I’m getting divorced so the business is failing” type of forecast -- with all sorts of others in between. Obviously, some management forecasts are suspect due to special motivations that may drive the forecast to one extreme or the other.

Occasionally, we run into a management forecast that is well thought out, well supported, and ties in sufficiently well to historical results that it appears very reasonable. While, in my experience this is rare, it is also very refreshing when it occurs. When I find this type of management forecast, I am always quite impressed with the quality of management.

Absent the occasional well-prepared management forecast, I believe that it is the appraiser’s responsibility to glean what information can be obtained from management and then prepare their own forecast. Some appraisers routinely perform some weighted average of historical performance and call it a forecast — this is rarely adequate as a weighted average of historical performance seldom can be construed as a representation of what is likely to occur in the future.

The next major problem that needs to be addressed is what income stream to forecast. I see many appraisers forecast net income or pretax net income. While there may be instances when this is appropriate, I am appalled when I see statements such as depreciation equals capital expenditures and changes in working capital equal changes in long term debt.

**Capital Expenditures ? Depreciation
Changes in Working Capital ? Changes in Long Term Debt**

**These Items are Equal About as Often as
Book Value = Fair Market Value**

If the appraiser uses Ibbotson data in some type of build-up method to determine a discount or capitalization rate, net cash flow (usually net cash flow to equity) should be the income stream used in the income forecast. Of course, if the appraiser has chosen an invested capital approach, then net cash flow to invested capital should be developed and a weighted average cost of capital (WACC) used. Forecasting net cash flow either to equity or invested capital requires some effort and time. Shortcuts such as those referenced in the box above are simply not acceptable. The appraiser must take the time to investigate, calculate and support the compo-

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nents of net cash flow to equity or invested capital or modify the calculation of the discount rate so that it is applicable to some other income stream. The problem with this second option is how to support the size of the needed premium to convert the discount rate from that applicable to net cash flow to equity to net income or pretax net income? There are no empirical studies available to support such a premium. The only way to accurately support such a premium is to calculate net cash flow and compare it to net income or pretax net income. If you must calculate net cash flow to develop this premium, why do so unless you have decided to use such a tactic to value an 'S' corporation in order to minimize attacks from the Internal Revenue Service.

There is no substitute for a well thought out, well-supported income forecast. As more business appraisers do a better job forecasting net cash flow, less people will assume that forecasts are done in some mysterious way such as by using the "crystal ball" method.

Should you be interested in pursuing this topic at some length, The Institute of Business Appraisers, Inc. will introduce a two-day class next year called "Forecasting Net Cash Flow." I invite you to watch for it.

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