



PAUL R. HYDE
EA, MCBA, ASA, MAI



APPRAISERS:
PAUL R. HYDE
BRIAN D. HYDE
JOSEPH PHELON

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Making a Profit is Not Optional

Occasionally, it seems obvious that some people forget that making a profit is not optional if a business (or any other investment) is to succeed and survive for the long-term. Value is based on the likelihood of return of the original investment plus a profit in the future. If no profit is expected, the value generally becomes a liquidation value; often much less than the amount of the original investment. This concept becomes most clear when looking at high-risk business investments:

“The value of shares of stock of a company with uncertain prospects is highly speculative. The appraiser must exercise his [or her] judgment as to the degree of risk related to all of the other factors affecting value. Valuation of securities is, in essence, a prophecy as to the future.”

Internal Revenue Service- Revenue Ruling 59-60, Section 3

This is a superb description of what business appraisers are supposed to do. As a colleague once put it, we are “risk assessors.” Risk and return are inseparable. Where the possibility of profit is high, the risk of failure is also high. (Stated simply, there is no free lunch.)

Every generation relearns this. Remember the investment crazes of the last 30 years:

- Conglomerate companies in the early 1970s,
- Then crude oil in the mid 1970s,
- Then collectibles and hard assets in the late 1970’s (remember shortages?),
- Then leveraged buyouts in the 1980s, and
- Then dotcoms, tech stocks and stock options in the 1990s; and
- The real estate market just before the recession in the 2000s.

Each craze lasted about five years. In the beginning (a biblical reference), innovative investors spotted opportunities. The speculative herd poured in money, driving up prices. After a bit, the bubble burst and stock prices (also real estate prices) collapsed. Business and real estate appraisers must look beyond these temporary phenomena. We ignore them if they are not “fundamentals” or “value drivers”.

I valued stock options for some private companies during the last craze. Public Stock Options have two value components: current and future. Current value is easy: if the stock today sells for more than the exercise price, current value is the difference. For example, if the stock sells today for \$20 and the option price is \$12, the profit per share or value of the option is \$8. (Exercise the option, pay the price (\$12), and sell the stock at \$20: pocket the profit--the option value--of \$8.) Future value for public shares is based on the Black-Scholes formula, which quantifies the probability of, and the amount that the stock price will exceed the exercise price when the option expires. A major assumption is volatility: how much will the stock price go up and down?

Volatility is easily measurable for public stocks with trading price histories. For private companies, however, there are no price histories. Many analysts assumed that private companies had volatilities comparable to those of public companies. Their fundamental error was the HUGE implicit assumption

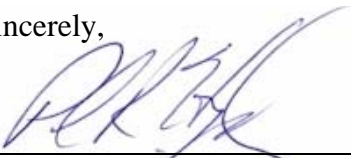
that the private companies would go public. That was beyond speculation and into the realm of the fantastic, as shown by the popping of the initial public offering (IPO) market bubble. Very few private companies actually go public! When valuing these private company stock options, estimating the level of volatility is challenging.

When valuing unique real estate investments, particularly those that are real property going concerns, the likelihood of future profits is key. Most of these types of real property investment improvements are single purpose properties, i.e. conversion to another use would be very difficult and expensive. I recently valued a high-end veterinary hospital. The real estate was excellent quality and very well laid out so that it was highly functional as a veterinary hospital. Determining the value of the real property was fairly straight forward, however, key to the value was the fact that the business of operating the veterinary hospital had to generate enough profit to provide a return on the real estate investment, i.e. could the practice pay the rent with a degree of safety and was that ability likely to continue into the future. If the practice could not pay for the real estate and continue to generate a profit into the future, the real estate value would largely disappear as the property really could not be used for any other purpose without an additional significant investment.

Valuation is indeed a prophecy. Nevertheless, it must be based on considered judgment, not foolish assertions.

Valuations play a part in all strategic transactions, tax, and many litigation matters. For additional information or advice on a current situation, please do not hesitate to call. **We value real estate, businesses, and personal property including livestock and machinery & equipment.**

Sincerely,



Paul R. Hyde, EA, MCBA, ASA, MAI
Enrolled to Practice Before the IRS (Enrolled Agent)
Master Certified Business Appraiser
Accredited Senior Appraiser – Business Valuation & Real Property
Designated Member (MAI) - Appraisal Institute
(Real Estate Appraiser)
Senior Appraiser – American Society of Agricultural
Appraisers (Machinery & Equipment and Livestock Appraiser)

