

## **Valuing a Dream-Lost Profits Damages for a Development Stage Start-Up**

Tony Wayne CPA, CVA, CFF, CIRA, FCPA

December 8, 2014

**Executive Summary:** Imagine the extraordinarily unusual challenge of valuing a going-concern start-up enterprise yet to make their first sale which was completely destroyed by a casualty loss and never-reopened. Further complicated by the inherent ambiguity, risk and complexity of the embryonic development stage industry in which they were attempting to operate and succeed.

**Summary Conclusion/Foundational Premise:** From the extensive professional practice guide, expert literature and case-law research we completed, in our professional opinion the basis for loss quantification is the fair market value of the enterprise immediately preceding the date of the loss and not a lost-profits computation due to a business interruption.

**Situation/Background:** The primary facts and issues at play were as follows:

- Start-up enterprise yet to become commercially operational & viable.
- Alternative/renewable energy provider.
- Development-stage industry.
- Shake-down cruise – “weeks away” from production launch. Supposedly.
- Developing process capability, process experimentation at the date of the casualty.
- Only 50% of the equipment was functional at date of casualty.
- Under-capitalized. Attempted to sell test raw materials for initial working capital.
- Neither of ownership, directors or key associates had **any** experience in this space. No previous energy production & distribution success.
- Date of casualty-no customers, no sales, and no orders.
- Limited higher grade by-product market potential-primarily for animal & human grade consumption. Glut in market supply of lower-grade by-product. Substantial investment required in capacity/capability to process refined higher-grade by-product. Firm lacked capability and capital resources to invest in, develop this required capability.
- Business completely destroyed.
- After the casualty, the firm never rebuilt, never started operations.
- Lost profits insurance approaching \$ 15 million claim filed.

### **Plaintiff/Opposing Expert Primary Assumptions & Overall Approach (“The Dream”):**

In contrast to prevailing professional practice, case law and the professional literature recommendations, opposing experts opted for a lost profits approach, estimating damages using the following approach grounded in these foundational assumptions:

- A. Facility would be at full-production capability and operating at close to 100% of capacity within two weeks of the casualty.
- B. Purportedly, “general operating metrics” for the industry were obtained by opposing experts and analyzed from the date of the casualty (mid 2011) through 12/31/2014.
- C. Relying on an alleged “contract” (verbal) between the firm and the adjacent business where the casualty loss was triggered, they assumed that immediately upon commencement of operations at the date of the casualty, that 100% of the by-product would be purchased by this other business throughout the stated time-period.
- D. No start-up losses, inefficiencies, one-time impacts, or learning curve impacts were factored into the lost damage estimate.
- E. The opposing experts in fact assumed the firm would be immediately profitable, operating at full capacity with no start-up impacts whatsoever on day one and but two weeks from the date of loss. Even though:

- They had only produced but two batches of test product (100 gallons) and only 50% of the equipment was operational. Their annual capacity was 2 million gallons.
- The firm lacked a specific marketing plan, no marketing organization, or outside sales and marketing resources. They had no shipping or distribution arrangements in place, no working capital facility available.
- They had no raw material vendor relationships in place. No agreements, contracts or purchase orders in place prior to the casualty.
- They opted to include revenue streams from a variety of potential sources such as government incentives, rebates, tax credits, subsidies, etc. None of these potential streams were supported with documented and firm agreements from the providers.

### **The Wake-Up Call-“Reality:**

One essential question to be answered is the applicability of the known and/or knowable limitation commonly encountered in valuation- Moreover, given the challenges of applying reasonable certainty to a wish, a hope and an aspiration, must we rigidly adhere to the concept of “known or knowable” at the date of the casualty:

- ▶ Where there is total destruction of the business and a valuation approach is utilized and when years have passed since the date of harm, it is indeed appropriate to consider the events and experience after this date to, “correct uncertain prophesy”.
- ▶ Business valuation standards outside litigation employ a known-or-knowable concept, requiring a valuation professional to consider only information that is known or knowable as of the valuation date. However, a damages expert may very well consider subsequent information when estimating damages.

As such, additional critical facts, industry trends and post-casualty events were critical to analyze, but largely discounted or ignored by the plaintiff’s experts:

- ❖ This U.S. manufacturing industry includes about 300 companies with combined annual revenue of more than \$30 billion. The industry is highly concentrated and has experienced substantial consolidation over the time period in question: the largest 50 companies generate more than 75 percent of aggregate market revenue. The average commercial-scale plant produces about 8 million gallons per year; some 4 times larger than the capacity of the subject entity.
- ❖ For small providers, annualized revenue volume fell by 28% from 2010 to 2<sup>nd</sup> quarter 2013. This decline in volume and market share with smaller providers, coupled with the substantial consolidation of share and market growth with large providers (30 million+ capacity) contributed to an accelerated failure rate with smaller providers- **Startup Firm Cessation Rate: 46.67%**
- ❖ Just 38 producers in states well within the primary target account for over 50% of the total U.S. production capacity, averaging 30.2 million gallons annually per producer. This concentration of market volume and capacity with firms many times larger than the subject entity within their target geographical footprint demonstrates the challenges they would have had in getting established and remaining competitive, given their stated capacity of 2 million gallons annually.
- ❖ The alleged verbal contract between mother and son totaling & million pounds, \$ 2.6 million of assumed profit was readily disputed by the data and evidence. The mean average actual consumption of the by-product by the affiliate over the most recent 5-year period was 5553 pounds per year. As such, this contract would reflect a **360+ year aggregate demand** at an assumed annual purchase quantity of 2 million pounds. Moreover, the destroyed firm lacked the capability to refine the higher grade demanded by the commonly-owned affiliate, and lacked the capital and wherewithal to fund the substantial investment required to develop this enhanced capability.

### **The Standard of Reasonable Certainty:**

The standard of “reasonable certainty” is the prevailing industry standard in cases dealing with assertions of lost profits, in particular with start-up firms with no operating history in a development stage industry. Business valuation is almost always used in cases where there is “complete business destruction”. When there has been permanent

impairment/diminution in the value of the business, in cases where the business will never recover from the act of harm, the expert should strongly exercise caution and refrain from the use of a lost profits approach. Damages may not be awarded on the basis of wild conjecture; they must be proved to a reasonable certainty that is applicable to proof of damages generally. Whether or not a business was able to open and begin operations is a critical factor, along with whether the business was around long enough to be able to reasonably project profits. If the business never made profits while operating, this may preclude the ability to reasonably project future profits.

#### **Takeaways:**

- ▶ Lost profits damage claim litigation allows us to consider post—casualty date events, trends developments. Do your homework.
- ▶ Stick to your knitting, don't wander far from your comfort zone. We knew the alternative energy and traditional fuel distribution retail business. I served on the Advisory Board for the Center for Industrial Research & Service (C.I.R.A.S) at ISU in Ames for five years. The C.A.R.D agency was right down the hall. In addition, we have had other bio—fuel and ethanol clients. Reach out, connect with those in the industry who have successfully started-up ventures in your space. Confirm your own industry research with their direct experience. Consider engaging industry experts as well.
- ▶ The reasonable certainty standard can be quite tough-in particular absent any track record. Take extreme care with your assumptions, carefully document your analysis of evidence to support them, and be sure to thoroughly test them for holes.

#### **About the Author:**

Tony Wayne founded IronHorse LLC in 1998 with specialty practice concentrations in forensic and valuation services, litigation support, turnaround consulting, CFO services and due diligence. IronHorse has extensive expertise and experience in insolvency & restructuring, complex litigation, lost profits & other damage computations, and valuation. He is an adjunct professor of accounting at Rockhurst University and Johnson County Community College and is an active presenter and published author. He serves on the Fraud Task Force and Business Reorganization committee of the American Institute of Bankruptcy and is an Executive Fellow at Rockhurst.