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Income Forecast Issues

While the topic of discussion is forecasting, precipitation, expected temperatures, or wind conditions will not be discussed! According to Revenue Ruling 59-60, long considered the appraiser's "Bible", value is based on future expected earnings. Estimating future expected earnings, i.e. developing a forecast for the entity, can be challenging, but is critically important.

A forecast of earnings or cash flow for either a business entity or income producing real estate should represent what an "informed willing and able buyer" and an "informed willing and able seller" would expect. Many people are concerned that a forecast incorporates unknowns or, after the fact, that the forecast did not exactly predict actual results. They miss the key issue. Forecasts are not a prediction or guarantee of future results; they cannot be and are not expected to be. Instead, they are expected to represent reasonable expectations of the future earnings as of a specific point in time – in this case, as of the effective date of the appraisal.

Forecasts are prepared by different parties, sometimes with different objectives. For example, when a company is put up for sale, often the forecast it prepares for potential buyers presents a rosy picture of the expected future. However, should the owner of the company be involved in a divorce, the forecast for the company often appears quite gloomy. The appraiser's job is to evaluate a company forecast or prepare his or her own forecast that is a fair representative of future expected profits.

Occasionally we see a "forecast" prepared for a company that uses an average of historical earnings, often a weighted average in which the more recent years are weighted more heavily than prior years. The statement is usually made that this represents a "conservative" estimate of future earnings. However, when considered carefully, unless we are expecting a future with no inflation at all, any average of historical earnings will result in a guaranteed undervaluation of the entity!

Analysis of historical results is important. Historical results provide indications and trends that can and should be incorporated in the development of a forecast. A forecast that differs widely from historical results generally is considered very optimistic and is often called a "dream sheet" as it typically has no basis in reality and represents what the business owner hopes might happen. This type of forecast, also occasionally referred to as a hockey stick forecast as it takes off towards the moon in similar fashion to the shape of a hockey stick, is not very useful. A forecast should carefully explain how each component has been developed so that the reader can understand and feel relatively comfortable that the forecast reasonably outlines the expectation of future results.

When developing a forecast, there are many items that must be considered. Among them are:

- The entities past stability
- Its growth rate
- The diversity of its operations
- The current and prospective economic and industry conditions
- Existing and prospective competition
- Management
- Financial condition and outlook
- Events in the past that are unlikely to recur in the future

When evaluating a forecast, the most important consideration is: Does it pass the "smell" test? If it just does not make sense, or seem reasonable, then it may not represent what an "informed willing and able buyer" and an "informed willing and able seller" would expect.

Another key factor that should be considered when evaluating an income forecast contained in an appraisal is the risk factor assigned to the likelihood of the forecast being achieved – i.e. the discount or capitalization rate applied to the forecasted income stream to develop the indication(s) of value. If the income forecast is considered "conservative," i.e. highly likely to be realized, the risk rate used to develop the value should reflect this lower risk which should result in a higher value indication. Conversely, if the income forecast is highly speculative and there is considerable risk associated with the likelihood of achieving the forecast, a very high risk rate should be applied to the income forecast effectively lowering the value indication. If done properly, the value conclusion should be very similar regardless of the optimistic or pessimistic nature of the income forecast - assuming that the appraiser correctly interprets the risk associated with achieving the income forecast actually utilized. This is why multiple valuation approaches, and often multiple appraisal methods within the approaches, are used and reconciled to arrive at the final value conclusion.

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.**

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