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VALUATIONS AND PROJECTIONS

VALUATIONS AND PROJECTIONS – An Ole Matter Revisited *Economist from Texas*

In many instances over the years, those involved in the financial / economic and / or legal professions have either seen or have helped prepare a corporate valuation or an economic cash flow projection for a corporate entity. In most instances, those involved in the preparation of a valuation have come to utilize and rely upon one or more of the “standard” valuation methods or techniques. These valuations might include, one or more of the – market approach, cost approach, discounted valuations, comparable analysis, excess earnings, capitalized returns, net asset value or a wide variety or mix of other approaches. While all of these approaches and others of similar nature are accepted and well tested over time, their continued use now requires some special attention and adaptation. It is to these “new” or “updated” versions we need to turn our attention.

In eras before what many now label “a period of modern technology”, an ongoing business, product or enterprise that was a combination of products and ideas tended to last for a significant period of time utilizing the same assets and concepts to generate an ongoing income stream. In effect, the life cycle of a business tended to be much longer than the current corporate life cycle. Under the prior corporate circumstances, an analyst was correct in utilizing a long-term trend analysis in many instances. What had worked in the past and the present was most likely to work in the future, especially for a period of roughly 5 - 8 - 10 years. Based upon this fundamental set of generally accepted assumptions, a whole body of economic / financial analysis was utilized for several decades.

While these techniques are still being utilized and are considered appropriate for corporate valuations and projections, TWO (2) major factors need to be reconsidered for these techniques and approaches to be valid in both today's corporate world and in the near term future. These two (2) factors are basically the recent changing nature for both innovation and our nation's business cycle. Both of these established concepts had remained rather well set in terms of time and magnitude since the end of the Second World War. However, within the past decade, based upon the rapidly changing fiber and levels of technology, the

time frames for technological innovation and the overall business cycle have undergone changes, changes that had not come onto the business scene since before the Second World War.

In concise terms, when a product or new idea came into being and was accepted by the overall marketplace in the 1950's or 1960's, the life cycle of that product was generally expected to be somewhat established in nature and time. In other words, the ability of the overall marketplace to either duplicate, supplant, replace or upgrade that product was limited in nature and a product had a reasonably well established life cycle expectation. However, as we have recently observed in the overall computer and technology industry sectors, ideas or products that enter into the overall marketplace are now made obsolete, perhaps in a matter of months. No longer can a great many ideas or products automatically be expected to have a sustained positive income producing “production run” of several years. Based upon the rapidly changing nature of technological
Continued on page 2

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innovation, an idea or product that once might have been projected to generate an income base for a decade or two, can easily be cut short in a matter of months, no less years.

Hence, the use and / or projection of an income stream for a good number of products can no longer be "presumed" of a long lasting nature. Products that were once accepted into the overall marketplace and fulfilled consumer, business or industrial requirements can be made redundant almost overnight. These changes can come from an overall blend or combination of - significant changes in technology, modifications in technology or products / ideas even from overseas. Thus, when an analyst is preparing a valuation or other financial analysis and utilizes a longer term cash flow projection, it is extremely important for both the analyst and those who will read and rely upon the output to remember that while an idea or product might be producing a significant and sizeable income stream at the present time, the assurances that the product's life cycle will continue, as did products in the 1950's and 1960's is clearly not nearly as well supported.

In addition to the rather significant changes that have come into being that effect and influence the income producing life cycle base of a product, one must also remember that the nature and economic fiber of the overall United States business cycle has also undergone some rather recent fundamental changes. In times past, the business cycle tended to be of a longer-term nature. In effect, it took time and dedicated effort for a specific policy to be implemented and placed into the overall stream of business and commerce. Once the general economy was on a specific path, may that path be a growth or decline curve, it was a reasonable underlying projection for that specific path of the economy to be projected out into the future for at least a medium term projection. While the tools were available to alter or divert the path of the economy, the implementation of these objectives took a reasonable or sustained period of time. This implementation time lag, thereby allowed for ongoing projections of the economy to follow its then present path and to be included and relied upon for a financial or economic scenario.

However, in recent periods, based partly on the growth and inclusion of technological means that allow for a more rapid alteration of our economy, the overall general business cycle needs to be more fully considered when creating longer term financial or cash flow projections. While the general business

cycle has become more moderated, the total ability of the economy to turn more quickly from one of growth into one of decline or visa versa has also come into fold. These directional changes are based in part on the economy becoming more and more international and global in nature. An economy that was once insulated from overseas events now reacts on almost a daily basis to scenarios that in times past would either have had no effect on our economy or would have taken a longer time to flow into the United States. A shrinking world economy when combined with instant complex telecommunications for governmental policy implementation, has, forever altered the nature of our business cycle.

Based upon the brief outline and descriptions above, when an analyst or other financial / economic professional decides to utilize and draw upon a medium or longer term cash flow or discounted cash flow projection as part of or in support of a valuation, care must be taken to include and consider both the rapidly changing nature of technological innovation and the overall changing nature and structure of our business cycle. No longer can the more or less standard approach of "steady as she goes" or linear projections be taken for granted. Economic / financial / product or corporate changes that had previously taken years or decades to evolve, can now come upon the business or commercial scenes in a matter of months or just a few years to totally alter the effectiveness of a medium or longer term set of cash flow projections.

It might be very wise for Economists to reflect and rely upon the thoughts of ole Ike as General Eisenhower once correctly denoted - "Ideas that were once good, are not always good" and contemplate and potentially include these thoughts into their medium and longer-term cash flow projections and valuations.