

Rosen Seymour Shapss Martin & Company LLP  
 Certified Public Accountants & Profitability Consultants

# The Watchful Eye

*A Publication of the Business Investigative and Insolvency Service Group  
 of Rosen Seymour Shapss Martin & Company LLP*

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## Greetings!

**Welcome to *The Watchful Eye*** - a publication of the Business Investigative and Insolvency Services Group of Rosen Seymour Shapss Martin & Company.

RSSM's Business Investigative and Insolvency Services Group is comprised of five specialty units that work both independently and in support of each other.

- Bankruptcy and Insolvency
- Forensic Accounting
- Litigation Support
- Business Valuation
- Mergers and Acquisitions

We welcome your questions or comments about the topics discussed or related ones. Please feel free to contact me at 212-303-9027 or by e-mail at [rmodansky@rssmcpa.com](mailto:rmodansky@rssmcpa.com) or my partner and co-chair, Martin Leventhal at 212-303-9030 or by e-mail at [mleventhal@rssmcpa.com](mailto:mleventhal@rssmcpa.com). and let us know how we can be of assistance.

Sincerely,

Robert A. Modansky, CPA  
 Martin Leventhal, CPA

Partners and Co-Champions of the Business Investigative and Insolvency Services Group

## Valuing Customers

Valuing a company traditionally begins with a review of a company's cash flow and profits - the same indicators CEOs and investors use to gauge a company's performance. When a company is doing poorly, its cash flow and profits decline. However, falling cash flow and profits are merely symptoms

of a larger problem. Customer defection may be the root cause.

Losing customers today signifies lost revenues in the future. Therefore, customer defections are an important predictor of future performance and can affect a valuation. To make up for lost revenues, companies must acquire new customers. Unfortunately, attracting new customers is expensive and may be less profitable than exiting customers.

### **Studying Customer Defection**

Because of the high cost of attracting new customers, savvy managers continually study both the trends and the causes of customer defections. The goal of these ongoing studies is to minimize losses and, in turn, maximize company value.

### **Retaining Customers**

Although studying customer defections is valuable, the ideal situation would be to prevent customer defections in the first place. The best retention strategy is to provide customers with quality products and services in an efficient and reliable manner at reasonable prices. Satisfying customers one time is generally not enough to maximize value. The most valuable companies have loyal customers. Such loyalty creates a valuable intangible asset called "brand equity." Here are three other strategies that produce customer loyalty and, therefore, brand equity:

1. **Customer Complaint Management.** Customers who receive satisfying responses to their complaints are among those most loyal to a company. Unfortunately, few customers ever complain when they are dissatisfied, and even fewer complain to the right person. Instead, they silently choose another vendor for future purchases. To maximize customer loyalty, a company should give its customers a means to complain to the right person. Further, management should personally review and respond to the complaint. Unfortunately, such interviews often come too late and require a lot of effort from both management and the customer.
2. **Long-term contracts.** The existence of long-term contracts with customers can be another indicator of value worth investigating. Negotiating a long-term contract with a customer is a common way to ensure their retention for a finite period of time. In many industries, long-term contracts are commonplace and beneficial to both parties.

3. **Switching costs.** When it is difficult and costly for a customer to switch to a competitor, that customer is less likely to defect. A company that creates switching costs improves its chances of retaining customers. One example of creating switching costs is convincing a customer to buy a customized product, such as a computerized ordering system unique to that particular company.

Another type of switching cost is created when a company develops a "learning relationship" with its clients using information technology. As a company learns what each customer wants, it can customize its offerings, as well as make suggestions for additional products or services that match the customer's needs. If the customer switches to a competitor, the new company will not know as much about the customer. Consequently, the customer will lose out on the customization the original vendor provided.

The switching cost strategy works in only a few industries. Nevertheless, valuers would be wise to look at the existence and magnitude of switching costs when assessing a company's value.

### **Conclusion**

When valuing a company, its customer defecting experience should be considered. Whether the business implements customer retention strategies and the likely impact of those strategies should also be determined.

### **Discounted Cash Flow Analysis**

The underlying principle of a discounted cash flow ("DCF") analysis is that the value of an investment - be it a Treasury bond, a piece of equipment, or a business - is a function of its ability to generate cash in the future. Figuring the time value of money requires valuers to do more than simply total the incomes expected in the future years. Instead, the income stream is "discounted" to account for the opportunity costs and risks of the investment. Therefore, DCF analysis has two basic components: (1) income streams and (2) discount rates.

### **Income Streams**

A DCF analysis begins with estimating the investment's ability to generate cash in the future. Previous years' income statements are often used as a starting point. Accounting net income, however, should be adjusted into a more meaningful

measure called "net cash flow" or the net present value of a stream of expected future cash revenues and expenditures. For example, depreciation should be added back because it is a non-cash item that lowers net income without truly affecting cash. In contrast, capital expenditures should be subtracted because they are uses of cash that are not reflected in accounting net income.

Due to the nature of product life cycles, income streams generally stabilize at some point in the future. If the income stream in a particular case has already stabilized, the valuator will only estimate one year's net cash flow and value it as if it were a stream of annuity payments. On the other hand, if future income is expected to be erratic or to grow at unusually high rates for a period of time, the valuator's job is more complicated - each year's cash flow must be estimated until the income stream has finally stabilized.

In economic damage cases, however, the time frame of damages may preclude the income stream from ever stabilizing. In these cases, the valuator estimates cash flow for each period during which damages were incurred.

#### **Discount Rates**

Discount rates are the returns which investors (and lenders) require in order to commit their capital and are a function of risk taken. Investments with higher risks require higher discount rates. This results in lower investment values. While there are many ways to estimate a discount rate, most methods involve the yields of similar investments traded in public markets.

#### **Doing the Calculations**

Once the income stream and discount rate have been estimated, the valuator combines the two components to estimate the value of the investment. Stabilized income streams are valued like an annuity. For investments in which the income stream has not yet stabilized, each year's net cash flow is discounted using the discount rate. Once the income stream has stabilized, cash flows during the remaining periods are valued like an annuity.

Mismatching income streams and discount rates is a common pitfall. For example, pretax income streams should not be discounted using after-tax discount rates. When valuing equity, net cash flow available to equity investors should be discounted using the cost of equity. When valuing debt and

equity, net cash flow available to both equity and debt investors should be discounted using the weighted average cost of capital (a blend of the cost of equity and the cost of debt).

***Advantages/Disadvantages***

DCF analysis is one of the most technically sound methods of valuation. When deciding how much to pay for an investment, investors look at the cash they expect to receive in the future, as well as the risk of the investment. However, this method's perceived subjectivity and its technical nuances can make it appear less attractive than other more simple approaches. Using additional approaches or applying reasonableness tests often helps support a DCF analysis.

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