

Guidelines for Critiquing and Rebutting an Expert Report

Nathan P. Novak

This discussion focuses on the concepts related to reviewing an opposing expert's report in a litigation setting. Specifically, this discussion provides a process for preparing such a rebuttal. This discussion is presented for the purpose of emphasizing the critical lens that may be applied when reviewing an opposing expert's analysis. Five primary guidelines are discussed: (1) understand the opposing party's argument, (2) identify contradictions, (3) avoid self-contradictions, (4) provide alternatives to areas believed to be incorrect, and (5) verify suspect research or methodologies. In addition, an example is included to provide some context and to better illustrate the process.

INTRODUCTION

During the course of litigation proceedings, an expert witness may be asked to provide a rebuttal analysis and opinion (the rebuttal) to refute the position(s) of the opposing expert. The purposes of the rebuttal are two-fold:

1. To establish a solid foundation that can be used to discredit the credibility and accuracy of the opposing expert's position
2. To further establish and support the analysis, conclusions and opinions initially offered

A rebuttal can be a powerful tool when used correctly. Not only can it be used as a tool during trial, but a strong rebuttal frequently can be used as leverage for the purpose of reaching a favorable settlement.

This discussion provides general guidelines that can be followed when preparing a rebuttal or reviewing a rebuttal in a litigation context. While the context is for the purpose of preparing or reviewing a rebuttal in a litigation setting, the following guidelines are applicable when simply completing a

review of another expert's analysis and report in a nonlitigation setting.

Whether rebutting an expert analysis in a litigation setting or reviewing another expert analysis or report, the guidelines offered should help clarify the critical lens that one may look through when considering financial expert opinions prepared by a qualified professional.

UNDERSTAND THE OPPOSING PARTY'S ARGUMENT

While this may seem obvious, understanding the opposing party's argument is the first step in preparing a rebuttal. An analyst cannot begin writing a critique or preparing a counter argument if he or she does not fully understand the opposing expert's analysis and conclusions.

Read and Recreate

The first step is reading and rereading the opposing expert's report. The analyst should not simply read the report—the purpose of this exercise is to critically analyze the opposition's analysis. While



reading, the analyst should view through a critical lens, focusing in on areas of weakness. It helps a great deal to read with pen and highlighter in hand, marking any areas of contradiction, questionable logic, or doubtful facts. The analyst should think of the first pass through the opposing expert's report as an outline to his or her own rebuttal.

Critically reading the opposing expert's report also helps to identify areas of agreement between the two sides. It is sometimes helpful to identify all the key ideas, methods, and assumptions used throughout an analysis, and then one by one compare them to the client's position. Identifying areas of agreement from the beginning can help focus the argument and can help the valuation analyst or litigator identify the key areas to attack.

After reading and annotating the opposing expert's report, it is often helpful to attempt to recreate the opposing expert's analysis. This is useful for two reasons. First, this exercise can serve as a means toward identifying any calculation errors within the opposing expert's analysis. Second, recreating the opposing expert's analysis better enables the analyst to more fully understand the logic (or lack thereof) within the analysis, as well as to prepare for alternative scenarios, as discussed further below.

Test Assumptions

Within any analysis, there are generally two types of assumptions that an analyst may incorporate. The first type of assumption is explicit—the assumptions that are directly identified and supported within the appraiser's analysis. Explicit assumptions may include the estimation of the subject company's weighted-average cost of capital, the estimated long-term growth rate, or the identification of other companies in the public marketplace assumed to be

similar enough to the subject company for comparative purposes.

The second type of assumption is implicit. Implicit assumptions are "embedded" within an analysis, and may not even be mentioned anywhere within an analysis. An implicit assumption is one that may not be directly identified, but still should be true based on various conclusions presented throughout an analysis.

For example, let's assume that the analyst estimated the market value of equity for a company at \$100 million based on a discounted cash flow model. However, the subject company reported only \$3 million in earnings over the latest 12-month period. This implies a price-to-earnings multiple of over 30 times for the subject company.

The reasonableness of this implied assumption may be checked by comparing it with industry price-to-earnings multiples, and/or price-to-earnings multiples for reasonably comparable publicly traded companies. The reasonableness of the implied profit margin (i.e., earnings to revenue ratio) for the subject company may be checked through similar comparisons.

Initially, the implied price-to-earnings multiple may seem "too high," and it is possible the analyst may have overestimated value. However, there may be a good reason for the high multiple, such as a subject company that is relatively young with great growth prospects and a new management team with an excellent historical track record.

Ultimately, step one is to test implicit assumptions that are based on various conclusions throughout an analysis (e.g., implied multiples, implied rates of return, etc.) and see if they make intuitive sense. If the assumptions do not make sense, then step two is to check and see if there is a good explanation or context for any seemingly unreasonable assumptions. If there appears to be no reasonable explanation for a seemingly unreasonable implicit assumption, then it may be the case that the analyst erred somewhere within his or her analysis.

IDENTIFY CONTRADICTIONS

One of the strongest rebuttal arguments (aside from factual or calculation errors) is that the opposing expert contradicted himself or herself within the analysis. Identifying contradictions, or inconsistencies, can help greatly in challenging the legitimacy of the opposing expert's arguments. Contradictions can occur in several forms, including (1) inconsistent use of inputs, (2) inconsistent methodologies, and (3) reliance on selective quotes.

Inconsistent Use of Inputs

One relatively simple contradiction to identify is the inconsistent use of inputs throughout an analysis. For example, let's say the opposing expert utilizes the risk-free rate in estimating a weighted average cost of capital for the subject company. Consistency requires that the selected risk-free rate typically should be the same everywhere else in the analysis in components that require the use of a similar risk-free rate.

The analyst should focus on similar inputs that recur throughout an analysis, and identify any that seem to be used inconsistently. Of course, he or she should fully understand the analysis to ensure that any seemingly similar inputs truly should have the same value, and are not different in any way.

Inconsistent Methodologies

Another common contradiction is the inconsistent use of methodologies throughout an analysis. For example, perhaps the opposing expert uses both the guideline publicly traded company method and the guideline transactions method to complete the analysis of a food manufacturer. However, while the expert screened companies in the food service industry when searching for guideline publicly traded companies, he screened transactions in the food distribution industry when searching for guideline transactions. This would be a methodological inconsistency, due to the fundamentally different screening criteria used.

The analyst should focus on any areas in the analysis that seem similar enough to warrant similar methodologies. If the opposing expert does not seem to apply parallel logic to areas that seem to warrant it, he may have contradicted himself.

Reliance on Selective Quotes

Perhaps the most common contradiction is the use of selective quotes throughout a report. Often, an analyst will quote from a well-known and respected publication to support a particular method or conclusion. Analysts will sometimes emphasize a single quote as the “glue” for an analysis, attempting to link all aspects of the analysis with an authoritative statement. Whenever this appears to be the case, the analyst should closely review the referenced source material to identify other statements or concepts that may contradict the conclusions developed by the opposing expert.

For example, the opposing expert may cite a book that claims the capital asset pricing model is the appropriate method for estimating the cost of equity capital. However, one page later, the same book may

also state that, in particular situations, a build-up model is more appropriate. The analyst should focus on any instances where the opposing expert relies on selected quotes to establish a level of certainty with regard to any aspect of the analysis.

AVOID SELF-CONTRADICTIONS

When preparing a rebuttal opinion, it is important to avoid contradicting the client's position and report. This is more often an issue when the rebuttal opinion is prepared by a third-party analyst (i.e., not the same analyst who completed the original analysis in the submitted report). In such a case, since the third-party analyst did not complete the original analysis, there may be certain contested areas where he or she is in agreement with positions adopted by the opposing expert. Or, even if the original analyst is preparing the rebuttal opinion, reading the opposing expert's report may bring to light other issues that had not been considered during the original analysis.

When such a situation arises, it is generally best to refrain from commenting in written form. The purpose of the rebuttal is to critique the opposing party's analysis, not the client's analysis. Rebuttals of weaknesses in the opposing expert's report that represent positions also taken by the client's expert typically should not be published in a rebuttal opinion. However, such items—and the estimated impact of correcting the item(s)—should be identified and shared with the client's counsel so that counsel is prepared to address the issue(s) and present the best case possible.

Ultimately, an informal cost-benefit analysis should be completed when deciding whether to rebut any aspect of an opposing expert's analysis. It may be as simple as asking the question, “Will including this argument do more harm than good to the client's cause?” If the answer is yes, or even maybe, it is probably the case that the particular point should be excluded from a rebuttal. Most of the time, there will be other stronger points to make against an opposing expert's analysis that clearly will be beneficial to the client's cause.

PROVIDE ALTERNATIVES TO AREAS BELIEVED TO BE INCORRECT

Generally, it is not enough to only describe the “how” and “why” an opposing expert's analysis is deficient or incorrect. An analyst should also include the “now what” within a rebuttal or counter argument. Triers of fact ultimately must make decisions. Reliable guidance is required regarding the



appropriate process and conclusion, rather than a laundry list identifying inappropriate processes and incorrect conclusions.

The recreation of the opposing expert's analysis is an extremely valuable tool that facilitates an expert's ability to provide alternative outcomes to triers of fact. By adjusting various inputs, assumptions, and calculations, an analyst may ultimately arrive at different conclusions from those offered by the opposing expert.

Whenever possible, it is best to provide alternative assumptions that align with the assumptions incorporated in the client's original report (to the extent that there is one). Once again, it is important to avoid self-contradictions. An analyst should not suggest assumptions or methods in a rebuttal that differ significantly from assumptions or methods that were incorporated in the original analysis.

Clearly, recommended changes to assumptions or methods should either (1) be supported by the original analysis or (2) be supported by relevant research and facts. However, as a note of caution, a rebuttal often will not meet certain requirements of various professional standards.

For example a rebuttal may not meet the requirements of a "review appraisal report" as defined by the Uniform Standards of Professional Appraisal Practice. Ultimately, an analyst should recommend alternative conclusions within a rebuttal report, but should also consider a disclaimer statement regarding reporting requirements based on applicable professional standards.

VERIFY SUSPECT RESEARCH AND METHODOLOGIES

An expert report should be supported by research. While there is a certain amount of judgment incor-

porated within any analysis, generally, a strong analysis will employ generally accepted professional standards and methods and empirically supportable evidence whenever possible. Therefore, it is important to identify the usage of unconventional methodologies or reliance on unsubstantiated research when reviewing the opposing expert's report.

Even if an opposing expert cites extensive research throughout his or her analysis, it is important to verify that it has been applied correctly. Similar to selectively quoting, analysts may pick and choose certain parts of a study that support a desired conclusion, without considering the study as a whole. Also, it is often the case that two analysts may read about a study and come to two different conclusions regarding the ultimate meaning and relevance of the study.

One analyst may believe that a study is relevant and supports his conclusion, while another may feel it is not relevant with regard to the subject matter for various reasons. In particular, whenever an analyst relies extensively on one or few studies to support an analysis, those studies should be read thoroughly and understood. It may be the case that the opposing expert used certain aspects of a study incorrectly, or there may be other credible studies available that refute the studies relied on by the opposing expert.

Along with using research inappropriately, an appraiser may also incorporate unconventional methodology(ies) within an analysis. While unconventional does not necessarily mean incorrect, it should raise a red flag whenever an analyst has used a method that is either new or not widely used within the valuation profession, especially if the method has not been previously accepted in court.

If a method seems unconventional, make sure that it is understandable and logically explained throughout the opposing expert's report. If the explanation is vague and assumptions are left unsupported, further research may be necessary to check the validity and reliability of the method. Also, there is usually more than one way to complete an analysis. Even if an opposing expert's method seems logical, there likely will be another method that could be used to support the conclusion. If the conclusion is left without support by a corroborating methodology, it may be a sign of weakness.

AN EXAMPLE

In order to explain some of the points described above, the following sections present an example of some items that may be present in an opposing expert's analysis. The example is not based on a

full analysis, but rather on a nonexhaustive sample of certain items that may be present in a valuation report, including representative assumptions, conclusions, and company information.

Suppose that John, an analyst with National Analysts, Inc., was hired by a law firm to provide expert testimony in court. The case relates to a dispute in which partners of Retailers, LP (Retailers), a privately held partnership, are attempting to buy out a major limited partner, and there is disagreement regarding the value of the company. These are some of the items presented in John's analysis and/or narrative:

Company Background

Retailers is a furniture retailer. It has long-term contracts with several widely respected furniture distributors. However, it recently lost one of its primary distributors to competition.

There have been four prior transactions in the partnership shares over the past five years, all between existing partners. The partnership is operated entirely by an outside managing company, which owns 100 percent of the general partnership units. Distributions are under the control of the general partner, and there have been only minor, sporadic distributions during the prior 10 years.

Retailers operates a total of 20 stores in a few regional markets throughout the midwestern United States. These markets are not expected to experience much population growth over the next decade, and housing sales have been poor recently.

Retailers historically has been more profitable than many of its industry peers. Retailers reported latest 12 months revenue and operating income of \$50 million and \$5 million, respectively.

Analysis and Assumptions

John relied on two valuation approaches to complete his analysis:

1. A market approach, relying on two identified guideline publicly traded furniture retailers
2. An income approach, relying on the discounted cash flow method

To complete his market approach, John applied revenue multiples to the most recent period historical revenue, as well as to projected revenue over the next two year periods.

To complete his income approach, John created a five-year discounted cash flow model based on operating projections that were provided to him by Retailers management. The following is a list of a

few assumptions incorporated in John's discounted cash flow analysis:

1. A weighted average cost of capital of 14 percent; this was based on a weighting of the partnership's capital structure of approximately 30 percent debt and 70 percent equity
2. A long-term growth rate of 4 percent
3. A levered beta of 1.1, which was based on cited research material that identified the median levered beta for the furniture retail industry

John's Conclusions

John concluded a value of \$30 million based on the market approach and \$60 million based on the income approach. For his market approach, John applied pricing multiples that were below the average pricing multiples of the guideline companies.

Within his discounted cash flow model, \$10 million of value was attributable to expected cash flow generated in the discrete projection period, and \$50 million of value was attributable to cash flow relating to the estimated terminal value.

John averaged the two approaches to conclude on a value of \$45 million for the total company equity, and then applied a discount for lack of control of 10 percent. John did not apply any discount for lack of marketability based on consideration of the recent historical transactions.

Rebuttal Analysis

Now, let's suppose it is necessary to rebut John's analysis in a litigation context.

As one of the first steps, and as a part of recreating John's analysis, a rebutting analyst should conduct his or her own search for guideline publicly traded companies. It should stand out that John relied on only two guideline publicly traded companies. Typically, when an analyst relies on a very small number of guideline companies, it may be an indicator that either (1) potential guideline companies were inappropriately excluded from the data group, or (2) the number of truly "comparable" companies is so limited that reliance on the guideline publicly traded company method is questionable.

Another red flag is the significant variance between the values of the partnership concluded by the income approach relative to the market approach. Generally, the use of multiple methodologies is completed for the purpose of providing corroborating evidence with regard to the value conclusion (i.e., the indications of value should be mutually supportive).

Theoretically, a sound analysis that incorporates multiple valuation approaches and methods should produce reasonably comparable indications of value. The fact that the indication of value produced by John's income approach is twice as high as the indication of value produced by his market approach suggests that one, or even both, of the methods contains inappropriate assumptions or possibly errors.

Further review and research should be completed in order to identify the primary reasons why the values are so different. This can be accomplished through the process of recreating John's analysis.

Another aspect is the seemingly inconsistent use of information relating to the two guideline publicly traded companies selected. Generally, if an analyst is comfortable using guideline companies for the completion of the market approach, he or she also should be comfortable relying on the financial information of those same guideline companies elsewhere in the analysis.

The fact that John used an alternative source for his industry beta, rather than relying on, for example, the average beta of the two guideline companies, could be a sign of inconsistency that opens his analysis and conclusions to attack.

Also, John's application of a 4 percent long-term growth rate may not be supported by the facts of the case. The partnership recently lost a major distributor and only operates in regional markets with low long-term growth prospects. Similarly, the terminal value John estimated implicitly assumes an exit pricing multiple of 10 times current earnings.

This multiple should be checked against earnings multiples throughout the industry to see if it is reasonable. Based on the facts of the case and checks on implied assumptions, it may be the case that John's long-term growth rate is too high.

In addition, John only applied revenue multiples in his market approach analysis. Generally, it is common practice for an analyst to attempt to apply multiples to more than one type of financial fundamental in order to better support a conclusion (e.g., revenue multiples, earnings multiples, or cash flow multiples). Again, this is done in order to provide corroborating evidence to support a concluded value. Furthermore, John's application of relatively low revenue multiples may not be supported by the facts, given that Retailers has sustained better-than-average industry profit margins for several years.

Finally, John applied a discount for lack of control in his analysis, but not a discount for lack of marketability. Again, the circumstances of the case may in fact support the application of a discount for

lack of marketability to the units of Retailers. The fact that there have been a few recent transactions in the units of Retailers does not necessarily mean the units of Retailers are fully marketable, particularly since all the transactions have been between existing partners.

Additionally, Retailers does not have a good history of paying distributions to the partners. Further research should be completed to determine if John's conclusion regarding the discount for lack of marketability is truly supportable.

Of course, the final step of the rebuttal analysis would be to develop alternatives to each of the issue areas identified. For example, the rebutting analyst may find four publicly traded companies she feels are similar enough for comparison, or she may complete economic and industry research to support a 2.5 percent long-term growth rate instead of the four percent growth rate proposed. These new assumptions should be used to develop new conclusions that the rebutting analyst believes to be more correct and appropriate.

The above example identifies just a small fraction of the many twists and turns a rebuttal analysis can take. It is simply meant to illustrate a few of the more common issues that often are identified when reviewing an opposing expert's report (e.g., contradictions, supportable facts and research, and implicit assumptions).

SUMMARY AND CONCLUSION

The guidelines discussed are by no means exhaustive. Rather, these guidelines are ideas to consider when developing a rebuttal or reviewing an opposing expert's report. They are a good place to start and are meant to help enhance the critical lens that may be used when reviewing an opposing expert's analysis.

Once again, simple but effective guidelines include the following:

1. Understand the opposing party's argument
2. Identify contradictions
3. Avoid self-contradictions
4. Provide alternatives to areas believed to be incorrect
5. Verify suspect research or methodologies

Nate Novak is an associate in our Chicago practice office. Nate can be reached at (773) 399-4325, or at nnovak@willamette.com.

