

INVESTORS & CAPITAL EXPERTISE

FINANCIAL VALUATION

The contribution of economic and sector analysis in the valuation of damages?

The strength and relevance of economic arguments are becoming increasingly important in valuations of damages, whether it involves a case as diverse as an intellectual property dispute, a failure to disclose by the seller, a violation of competition rules, or a wrongful termination of a contract.

ABOUT THE AUTHORS

Christophe Schmit and Xavier Chevreux are Associates of Accuracy, a corporate finance consulting firm. They are specialists in litigation support and are regularly involved in the financial and economic assessment of damages. Accuracy has 150 consultants, including 25 associates in Paris and abroad (Madrid, Amsterdam, Milan, Frankfurt, and Brussels).

In this context, litigant experts must establish business scenarios that rely on a detailed analysis of the industry in question, the competitive position, and the profitability of the players of this industry, as well as the particular situation of the company for which the damages must be calculated. But this step in demonstrating damages is most often overlooked or oversimplified by experts.

The principle of compensation in French law is that of compensation for damages incurred. This principle involves comparing two situations that differ in the occurrence of the incriminating act, for example, the alleged infringement of a patent or the wrongful breach of a contract. In all cases, the difference found between i) the situation as it is and ii) the situation as it should have been is the basis for assessing damages.

We thus encounter this logic of estimation of damages by difference when comparing, for example:

- The situation (price, margin, turnover, etc.) actually produced to what would have materialised without the event in question (“but for” logic) or,
- The situation that was presented by the seller through the information made available to the buyer to the situation that could have been anticipated with broader information available to the seller at that time.

This work of financial valuation of damages is often incomplete. Among the weaknesses regularly identified are, for example:

- Failure to take into account the characteristics of the business sector or the competitive situation; this lack of analysis of the economic environment often leads to a reproduction of the trends and ratios of the company observed historically without questioning their relevance.
- Use of “catch all” studies indicating market sizes or trends without actually presenting the bases of the calculations or forecasts.
- The absence of concepts such as price/demand or price/supply elasticity, often useful in writing scenarios.
- A non-dynamic view of the cost and margin structure of the company and its competitors, although modifying an assumption of winning a large contract may, for example, drastically change the relative competitiveness of a company in terms of costs.
- Allocations of costs to the product or business in question, often unjustified.

Another type of weakness is an academic analysis of a sector, which, although accurate and documented, ignores the particular characteristics and circumstances of the analysed company.

In reality, not all sectors of the economy look alike. For some, an analysis of historical behaviour will be particularly appropriate; for others, it is the supply/demand balance that will be critical; for still others, technological breakthroughs and substitution possibilities. For the demonstrative quality of the economic valuation of damages, it is therefore essential to:

- Understand and explain the workings of this market and the economic model of the players, justifying these choices, before creating a model; in this respect, the ability to demonstrate the relevance of the model developed on past assumptions will be an important test. For example, it is difficult to justify a scenario of gains on purchases if these gains were never recorded on the company's income statement in past years but were fully returned to customers through price reductions;
- Base the model's data on elements that are the subject of a clear qualification, whether assumptions about the market itself (e.g. market size) or internal to the company (such as modelling of its cost structure).

Any valuation of damages requiring the construction of a scenario should therefore include:

- A detailed description of the "functioning of the industry": industries with strong economies of scale, capacity industry, etc., which will determine the logic for construction of a market model.
- An analysis of past behaviour and the parameters of the activity and margin ("why and how this company is growing and why it make profits"); where appropriate, the reasons why past behaviour structures could be modified in the future.
- An analysis of the competitive field and its dynamics; breakthroughs, innovations, and size effects can have a decisive influence on the forecast scenario;
- An assessment of the relevance of the forecast and its sensitivity, taking into account the volatility of the business.

By presenting the academic foundations of arguments in an educational way, by explaining the quantitative analysis method(s) deployed, and by justifying the appropriateness of the assumptions adopted, the expert helps to inform judges and arbitrators.

By Christophe Schmit and Xavier Chevreux, Partners. **Accuracy**

KEY POINTS

The valuation of damages, for the assessment of the reconstitution cost, regularly involves the use of financial experts.

These assessments require an economic analysis of the sector (competitive dynamics, barriers to entry, value chain) and the positioning of the players involved on these dimensions.

The economic reasoning must be well founded, the adopted assumptions must be explained and justified, and the work must be pedagogical and have demonstrative power.