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Business Valuation – What You Need to Know

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Presentation Summary

- Overview of business valuation approaches
- Standards of value
- Valuation adjustments
- Using a qualified valuator

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What is a Business Valuation?

- The act or process of determining the value of a business enterprise or ownership interest therein
- Valuing a bundle of rights

When is a Business Valuation Needed?

- Gift, Estate, and Inheritance Taxes and Estate Planning
- ESOP's and Other Employee Benefit Plans
- Ad Valorem Taxes
- Selling Out, Merging, Acquiring, or Divesting
- Going Public
- Buy-Sell Agreements
- Marital, Partnership, and Corporate Dissolutions
- Damage Cases
- Bankruptcy Reorganizations
- Bankruptcy Insolvency Determination

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Who Needs Business Valuations?

- Attorneys
- Courts/judges
- Business owners
- Insurance companies
- Estates
- Additional users of financial statements

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Business Valuation Considerations

- Type of entity to be valued
- Purpose of valuation (examples)
- Valuation Date
- Standards of value
- Premise of value
- Level of Value

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Business Valuation

An Overview

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Business Valuation Approaches

- **Three basic approaches to determining business value:**
  - Income
  - Market
  - Asset (also referred to as Cost Approach)
- **Under each approach, there are multiple "methods"**
- **The use of one or several approaches (or methods) may be appropriate**

Asset Approach

- Based on the principal of substitution
- In other words, what a buyer would pay for a similar asset of equivalent utility
- Often the primary approach when the business has losses or nominal projected cash flow or is asset-intensive
- Can be used for both control and minority level valuations

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Asset Approach – cont.

- **Net Asset Value (NAV) Method – all assets and liabilities are adjusted to current values**
  - NAV = assets less liabilities
  - Pitfall – If done incorrectly fails to capture intangible and other unrecorded assets
  - Minority owners typically can't compel a liquidation

- **Excess Earnings Method – hybrid of the asset and income approaches**

Market Approach

- Also based on the principal of substitution
- A buyer would pay no more than the cost to acquire a substitute property with the same utility
- Can be used for both control and minority level valuations

Market Approach – cont.

Two methods generally used:

- **Guideline public company method; based on sales of similar publicly traded company shares**
  - Can be difficult to use for small and medium sized companies due to size, capital structure, and other differences

- **Merger and acquisition transaction data method; based on acquisition of similar privately held or publicly traded companies**
  - Works best when companies are sufficiently similar to the subject business
  - Positive correlation between price and multiples used is desirable
  - Exercise caution with dated transactions

Income Approach

- Value is based on the present value of expected future benefits to be derived from ownership
- Discounted or capitalized cash flow methods are typically utilized for operating companies
- Used for both control and minority level valuations

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Income Approach – cont.

Two methods generally used under the income approach:

- **Discounted Cash Flow (DCF) Method**
  - Projects future cash flows for a number of years
  - Terminal value
- **Capitalized Income Method**
  - Estimated future cash flow is capitalized
  - Often used for companies with stable growth rates

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Standards of Value

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Standards of Value

The standard of value answers the question, "Value to whom?"

- Fair Market Value
- Investment Value
- Intrinsic or Fundamental Value
- Fair Value under State Statutes
- Fair Value for Financial Reporting

Fair Market Value

Defined by the International Glossary of Business Valuation Terms as:

The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts

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Fair Market Value

Defined by Estate Tax Reg. 20.2031.1-1(b):

The price at which property or service would change hands between a willing buyer and a willing seller, neither being under compulsion to buy or sell and both having reasonable knowledge of the relevant facts

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Investment Value

- **Investment value is usually defined as the value to a particular buyer**
- **When analyzing investment value it must be remembered that said value often reflects scale economies and other synergies that can only be realized by that particular or specific buyer**
- **Certain underlying differences often arise when comparing investment value and fair market value appraisals, which generally include:**
  - disparate cash flow projections
  - dissimilar risk tolerance and/or required rates of return
  - contrasting debt structures and tax structures
  - the fact that under the investment value standard it is often possible to determine scale economies and synergies based on operations already controlled by a particular buyer

Intrinsic Value

- **Intrinsic value is the value based on fundamental financial analysis without consideration of the vagaries of the market**
- **It is an analytical judgment of value based on perceived characteristics inherent in an investment**
- **This value is the amount an investor considers the “true” or “real” value of an investment**

Fair Value - State Statutes

- **Fair value is primarily a legal standard of value used in specific transactions**
- **Fair value is used, without limitation, in dissenting shareholder and oppression suits and varies from one jurisdiction to another, depending on statute and case law**
- **In states that have adopted the Model Business Corporation Act, fair value is defined as follows:**

> *Fair Value, with respect to a dissenter's shares, means the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable*

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Fair Value - Financial Reporting

- **Despite the similarity in name, fair value for financial reporting is quite distinct from fair value in the context of state statues**
- **Fair value for financial reporting, which is required by generally accepted accounting principles (GAAP) and by the Securities and Exchange Commission (SEC), is defined by the financial accounting standards board's (FASB) Statement No. 157 as follows:**

> *Fair value is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability*

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Valuation Adjustments

Valuation Adjustments

- Key issue in many valuations
- A number of considerations, including subjective assessments, are considered when determining the appropriate discounts/premiums or lack thereof
- The standard of value will impact the discounts/premiums that may be appropriate
- Prerogatives of control of the ownership interest being valued will also impact adjustments

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Minority Interest Discounts/ Control Premiums

- **Controlling interest typically has a greater value (pro-rata)**
  - Control does not always mean more than 50% - can be defined differently in the entity's governing agreements
  - Large enough block to influence management decisions (e.g. swing vote)
  - State law can determine ownership level necessary for control
  - The potential benefits of optimizing the economic benefit stream

- **Minority interest is typically discounted**
  - Minority interest can generally be defined as less than 50%, or a lack of ability to affect management decisions

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Marketability Discounts

•Control vs. minority interest can make a difference

- The ability to affect a sale

•Expected holding period can impact size of discount

- Restrictions on transferability can be significant
- Pool of potential buyers?

•Mandelbaum Factors

- Financial statement analysis
- Company dividend policy
- The nature of the company, its history, its position in the industry, and its economic outlook
- Company's management
- Amount of control in transferred shares
- Restrictions on transferability of stock
- Holding period for stock
- Company's redemption policy
- Costs associated with making a public offering

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Other Potential Adjustments

- **Additional adjustments, which may be applied discretely or incorporated into other parts of the valuation analysis, such as the projections, discount/capitalization rates, or multiples:**
  - Key person discounts
  - Blockage discounts
  - BIG tax discounts
  - Voting v. Non-voting stock

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Using a Qualified Valuator

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Valuator Qualifications

- **Valuing a business requires a significant amount of experience and training**
- **Accredited in Business Valuation (ABV) Credential**
  - Backed by the American Institute of CPAs (AICPA)
  - Experience requirements
  - Education requirements
  - Training requirements
  - Comprehensive examination

Thank You!