



Business Valuation Theory: A Practical Perspective

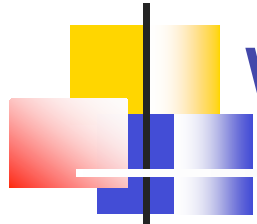
Idaho Society of CPAs
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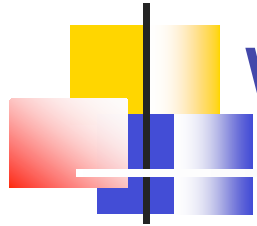
Learning Objectives:

- Need for and hidden benefits of a valuation
- Three approaches to valuation (by way of a detailed example)
- Discounts
- Valuations during the “Great Recession of 2009”
- Common errors in business valuation
- Business valuation controversies
- Buy-Sell DISagreements
- Appraiser penalties
- Question and Answer session



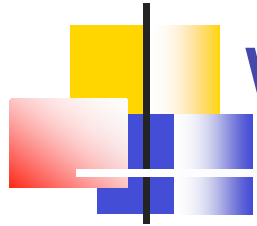
Why Value a Business? (Top 10)

- 10 - Marital dissolution
- 9 - Business disputes (Shareholder buyout)
- 8 - Estate tax filing
- 7 - Estate planning
- 6 - Estate gift tax filing



Why Value your Business? (Top 10)

- 5 – Employee stock ownership plan (ESOP) and Employee stock options
- 4 - Buy-Sell Agreement
- 3 – Purchase or sale of business (Fairness opinion)
- 2 - Financing



Why Value a Business? (Top 10)

- First Nine: All required – Event driven
- Last reason: Not required. But, benefits can be profound.
 - To gain insights on how to increase company value.

What is Involved in a Business Valuation?



- Business background/history
- Economic outlook
- Industry/competition outlook
- Nature of the business:
 - Management
 - Products/services
 - Operations
 - Marketing/distribution



What is Involved in a Business Valuation? (continued)

- Financial analysis
 - Trends and Ratios
 - Comparison within the company over time
 - Comparison across the industry
- Expectations for the future:
 - Earnings/dividend paying capacity

What is Value?

- The present worth of future benefits.
- A matter of opinion – judgment is involved.
- Buyer rarely buys what the seller thinks he is selling.
- In actuality, buyers want only one thing – future cash flow.



"Our employees are our greatest asset. I say we sell them."

Business Owners Should be

Asking:

- 1 – Cash flow: How do I increase cash flow?
- 2 – Risk: How do I mitigate risk to that cash flow?
- 3 – Growth: How do I increase the company's growth rate?



Basic Valuation Model

- Value = $\frac{\text{Cash Flow}}{(\text{Risk} - \text{growth})}$
- However, an action that increases cash flow and growth may also increase risk.



How is Value Determined?

- Three General Approaches:
 - Market approach
 - Merger and acquisition method
 - Guideline publicly traded company method
 - Income approach
 - Discounted cash flow (DCF) method
 - Income capitalization method
 - Asset approach
 - Asset accumulation method (Adjusted book value)
 - Practical example



Minority Interest Discount

- Discounts for Lack of Control (DLOC)
 - BVR/Mergerstat CPS
- Issues
 - FMV v. Investment/strategic value
 - Negative premiums
 - Poorly performing companies v. efficient/effectively run companies
 - Swing vote considerations
 - Are publicly-traded stock shares really minority interest positions?
 - Why don't more takeovers occur?
 - Under the GPTCM, do we add a control premium?
 - Did you also make controlling interest cash flow adjustments



Marketability Discount

- Discount for lack of marketability (DLOM)
 - Restricted stock studies
 - Timeline issues
 - Pre-IPO studies
 - Investor perspectives
 - Likelihood of liquidity event
 - Mandelbaum factors
 - Quantifying Marketability Discount Model (QMDM)
 - Sensitivities
 - Other methods
 - Option analyses and/or LEAPS
 - Gaining some recent traction



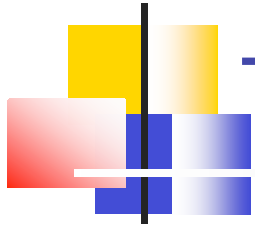
Marketability Discount: Mandelbaum Factors

- Financial statement analysis
- Dividend policy
- Amount of voting control
- Restrictions
- Holding period
- Put rights
- Presence of potential buyers
- Size of block
- Prospect of IPO or outright sale
- Information access and reliability



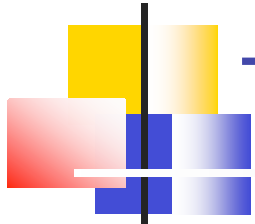
Marketability Discount: QMDM

- Expected holding period
- Projected interim cash flows (dividend yield)
- Growth in value until liquidity event
- Premium or discount upon exit
- Discount rate



The “Great Recession” of 2008 - 2009

- Income approach - Cost of Capital:
 - What risk-free rate should be used?
 - What equity risk premium (ERP) is appropriate?
 - What is the appropriate D/E ratio to be used in a world that is de-leveraging?
 - What is the hypothetical credit rating and interest rate for the assumed debt that willing buyers would be willing to obtain?
 - Book value of debt v. market value of debt



The “Great Recession” of 2008 - 2009

- Market approach
 - Not many transactions during “Great Recession”
 - What are the appropriate multiples?



A Hodgepodge of Potential Errors/Issues

General items:

- Hypothetical buyer **AND** seller
- Advocacy
- $1+1=3$
- Incorrect standard of value
- Incorrect level of value
- Overly dependent upon “Rules of Thumb”



A Hodgepodge of Potential Errors/Issues (continued)

General items:

- Failure to consider non-recurring, unusual events (losses, gains)
- Failure to consider certain assets
 - Excess assets
 - Non-operating assets
 - Work-in-progress
- Consider subsequent events?
 - Damages v. Lost Profits



A Hodgepodge of Potential Errors/Issues (continued)

Income Approach:

- Mismatch discount rate with projections
- Capitalization rate v. discount rate
- Growth rate: Local hardware store overtaking Home Depot



A Hodgepodge of Potential Errors/Issues (continued)

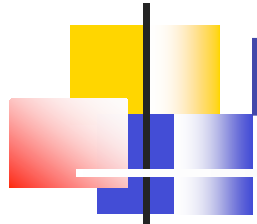
Guideline publicly-traded company:

- Poor guidelines
- Failure to make adjustments to guidelines
- Mismatched time periods
- Just use the mean or median multiple with no analysis



Business Valuation Controversies

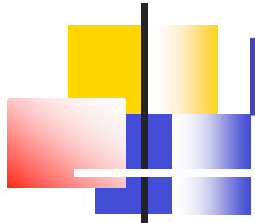
- S-corporation/LLC/Partnership valuations
 - Tax-affect earnings v. No tax-affect earnings
- Capital gains tax
 - Today v. Expected trading in future
- How good must the guidelines be?
 - Joyce C. Hall v. Commissioner
 - Greeting cards v. Beer, hamburgers, cosmetics, computers, etc.
- Personal v. professional goodwill
 - Stewart v. Stewart



Business Valuation Controversies

Discount rates

- Betas
 - OLS v. sum beta v. Adjusted beta
- Equity risk premium
 - Historical v. supply-side v. forward-looking
- Size premium
 - Duff & Phelps v. Ibbotson v. Neither



Business Valuation Controversies

Discount rates

- Company-specific risk
 - Subjective factor models v. BPM/BPC
 - No data v. empirical data

Butler Pinkerton Calculator Screenshot



[← back](#)
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Risk Free Rate:	3.70%
Equity Risk Premium:	6.30%
Effective Date:	4/22/2009 (157 weeks)

Ticker	FCN	HURN	CRAI	XPRT	NCI
Company Name	FTI Consulting, Inc.	Huron Consulting Group Inc.	CRA International, Inc.	LECG Corporation	Navigant Consulting, Inc.
Size Premium	0.00%	0.00%	0.00%	0.00%	0.00%
Weekly Standard Deviation	5.75%	6.34%	5.59%	9.06%	6.82%
Levered Beta	0.43	0.81	0.49	1.39	0.90
Correlation Coefficient (R)	0.22	0.38	0.26	0.45	0.39
Total Beta	1.95	2.15	1.90	3.07	2.31
Total Cost of Equity	15.98%	17.24%	15.64%	23.06%	18.26%
Company Specific Risk Premium	9.57%	8.41%	8.85%	10.59%	8.92%



BV Controversies: The BUM is Problematic

- Double counting size risk and industry risk?
 - Both based on actual returns compared to expected returns based on beta
- Size risk and CSR risk are next to impossible to separate
 - Is a company *risky* because it is *small* or is it *small* because it is *risky*?
 - Yes and Yes!
- Is there a liquidity premium in the size premium?
 - Highly likely
- Is there a liquidity premium in the industry risk premium?
 - Likely
- Industry risk premium may include questionable guidelines
- After you get through the gauntlet above; You still have to completely guess at the CSRP!



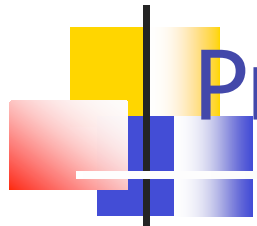
Buy-Sell Agreements: Potential Revenue Enhancement

- Fixed price agreements
- Formula agreements
- Process agreements
 - Single appraiser (recommended) v. Multiple appraisers
 - Value now (recommended) v. Value at trigger event



Buy-Sell DISagreement

- *The sole instructions to the appraisers rendering any valuation shall be as follows:*
 - *a) **Primary** reliance shall be on the income approach.*
 - *b) The income approach, to the extent used, shall give **major consideration** to **normal** current net operating income capitalized using a level perpetuity formula at the **prime (base) rate** on corporate loans at large U.S. money center commercial banks as published in the western edition of the Wall Street Journal most recently preceding the date of withdrawal.*
 - *c) No discount or premium shall be made based on the fact that the Withdrawing Member's interest in the Company may be **minority or majority** interest.*



Problems: Subjective and Out-of-Date

- What does “primary reliance” mean?
- What does “major consideration” mean?
- What does “normal” current net operating income mean?
- Prime rate in 1996 (when written) = 8.50%
- Prime rate in Nov 2009 = 3.25%
 - Is the formula out of date?
- Why are we valuing a risky income stream at a risk-free rate?
- Can we take a marketability discount?



Required Elements (From Appraisal Perspective):

 **Standard of value**

 **Level of value**

 **The "as of" date**

 **Qualifications of appraiser**

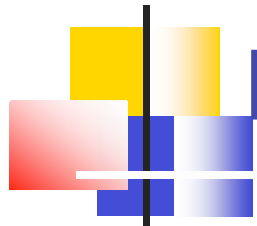
 **Appraisal standards**

 **Funding mechanism**



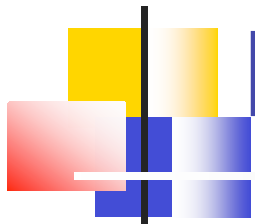
Life Insurance Dilemma

- Business with 2 Owners (50% each)
- Buy-Sell states the company will buy the stock of either @ FMV in event of death
- Company pays the premiums for term life policy on each with \$6 million face.



Life Insurance Dilemma (continued)

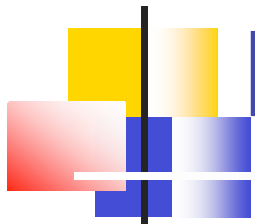
- Appraiser (properly) adds back insurance premium for deceased owner as non-recurring expense
- Appraisal indicates FMV of \$10 million for ongoing operations on date of death
- **But who owns the policy?**



Example (continued)

Proceeds Not a Company Asset


	Company	Jim (Deceased)	Jeff
Pre-Death Value of Operations	\$10,000,000		
Value of Stock	\$10,000,000	\$5,000,000	\$5,000,000
Life Insurance Proceeds	\$6,000,000		
Repurchase Liability	-\$5,000,000		
Post Life Insurance Value	\$11,000,000	\$0	\$11,000,000



Example (continued)

Proceeds Are a Company Asset

	Company	Jim (Deceased)	Jeff
Pre-Death Value of Operations	\$10,000,000		
Life Insurance Proceeds	\$6,000,000		
Value of Stock	\$16,000,000	\$8,000,000	\$8,000,000
Repurchase Liability	-\$8,000,000		
Post Life Insurance Value	\$8,000,000	\$0	\$8,000,000



Example (continued)

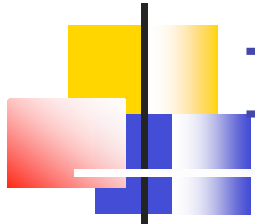
Comparison of Outcomes

		Amount of Payment to Jim's Estate	Value of Company to Jeff
Pre-Death Value of Operations	\$10,000,000		
Proceeds Not a Company Asset		\$5,000,000	\$11,000,00
Proceeds Are a Company Asset		\$8,000,000	\$8,000,00



Recommendations:

- Get the Buy-Sell Agreement
 - Read it
 - Review it with client, other shareholders and advisors
 - Make recommendations if problematic
 - Better now than in litigation later
- Appraisers can be very helpful in the initial draft of the agreement



IRC Section 6662: Client Penalties

- Client penalties for undervaluation on estate and gift tax returns:

Opinion/Final:	Penalty/tax due:
■ > 65%	0%
■ >40%<65% (Substantial)	20%
■ <40% (Gross)	40%



2006 Pension Protection Act: Appraiser Penalties

- Penalty will cost you the lesser of:
 - The greater of 10% of the underpayment, or
 - 125% of the gross income received by the appraiser
- May incur sanctions under Treasury Department Circular No. 230
 - Censure
 - Suspension
 - Disbarment from practice before IRS



Questions and Answers

