Business Valuation Fundamentals: Key Concepts, Nuances, and Take Aways

Business Valuation – The Basics & Beyond:
Key Concepts, Emerging Issues, and Common Errors

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Objectives

- Introduction and housekeeping points
  - Limited time may require us to skip some slides/content
  - Time for Q&A and follow up
- Briefly review the fundamental concepts
  - Standard and premise of value
  - Business valuation reports
  - Common errors
- Consider the three key areas requiring subjective judgment:
  - Financial statement normalization
  - Capitalization & discount rates
  - Adjustments for lack of control and lack of marketability
Objectives

- Overview of the three primary approaches to value: income, asset, market
- Emerging Professional Standards for Business Appraisal Work
  - AICPA Statement on Standards for Valuation Services 1 (SSVS1)
  - Uniform Standards for Professional Appraisal Practice (USPAP)
  - American Society of Appraisers (ASA)/National Association of Certified Valuation Analysts (NACVA)/Institute of Business Appraisers (IBA)
  - IRS Guidelines and the Pension Protection Act of 2006
- What does it all mean?

What Our Clients See.....

- Power of the Internet:
  - www.businessbookpress.com
    BizPricerW™ Business Valuation Software
    Normally $149.95, but reduced to move at $99.95 (plus shipping and handling), but for our special customers....."Immediate download for only $79.95!!!" ...operators standing by...if you order by midnight tonight you also get a fee set of Ginzo steak knives and a trip to Disneyland....
  - www.bizvalforless.com
    Limited Scope Asset Appraisal (Summary Report) $650 - $1,000 / Limited Appraisal Certified Appraisal (Limited or Complete) $1,500 - $2,500 $3,000 - $5,000
  - www.bulletproofbizplans.com/BallPark
    The #1 Selling Small Business Valuation Tool! Priced to sell at $29.95!!!
Steps in a Valuation

- Define the engagement
- Gather the information
- Analyze the information
- Value the company
- Issue an oral or written report
Elements of a Valuation

- Effective date
- Interest being valued
- Standard of value – Definition of value
- Premise of value – Status of the business
- Approaches/Methods/Procedures – How value is calculated
- Reconciliation of value conclusions using different approaches/methods/procedures
- The business appraisal report

Valuation Process

- History and Nature
  - Financial Performance
- Financial Condition
  - Industry Conditions
- Economic Conditions
  - Valuation Approaches/Methods

Valuation Synthesis and Conclusions
What does the word Value mean?

“All values are anticipations of the future”

Justice Oliver Wendell Holmes, 1904.

Without consensus as to the standard of value, the resulting valuation conclusion is without meaning.
Fair Market Value

Defined as the *price in terms of cash* at which a property would change hands between a *willing buyer and a willing seller*, both with *full knowledge of the relevant facts* and *neither being under compulsion* to buy or sell.

Fair Market Value - Other Considerations

- A *reasonable time* is allowed for exposure in the open market.
- Price represents *normal consideration* for the property sold, unaffected by special or creative financing or sales concessions.
- Fair market value is *specific* to a particular *valuation date* and not to any other date.
- *Most probable price* versus highest value.
Willing Buyer/Willing Seller = FMV

As stated by Dr. Shannon Pratt:

“in legal interpretations of fair market value, the willing buyer and willing seller are hypothetical persons dealing at arm’s length rather than any ‘particular’ buyer or seller. In other words, a price would not be considered representative of fair market value if influenced by motivations not characteristic of a typical buyer or seller.”

Fair Value – State Rights

Fair value is employed under the laws of most states as the statutory standard of value applicable in valuing dissenting and/or oppressed stockholders' appraisal rights.

In those states, if a corporation merges, sells out, or takes certain other major actions and the owner of a minority interest believes that he or she is being forced to accept inadequate consideration for the stock, the owner has the right to have the shares appraised and to receive fair value in cash.
**Fair Value – Financial Reporting**

Defined by FASB ASC 820 *Fair Value Measurements and Disclosures* as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

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**Investment Value**

Investment value is the specific value to a particular investor for individual investment reasons.

Unlike the fair market value buyer, the investment value buyer is not a hypothetical investor dealing at arm’s length, but rather is a specific investor with specific investment motivations. Specific buyers have numerous considerations that may influence the price they might be willing to pay for a property and cause it to be different from fair market value.
Investment Value - Investor Attributes/Perceptions

- Differences in estimates of future earning power.
- Differences in perception of degree of risk.
- Differences in tax status.
- Synergies with other operations owned or controlled.

Investment value is usually the appropriate standard of value in merger and acquisition analysis.

Methods to Derive Investment Value

- Focus on the economic benefit stream, adjusted for synergistic benefits
  - Improved margins due to buying power
  - Lower overhead burdens
  - Distribution and advertising efficiencies
- Assess impact on unsystematic (company specific) risk
  - Lower perceived risks due to size and diversification
Going Concern Premise

Going concern is not a standard of value. The term going concern refers to a business being valued as an ongoing operation, as opposed to being valued under a premise of liquidation. Going concern value provides a basis for valuing an entity under the premise of fair market value, fair value or investment value.

Liquidation Premise

- A Liquidation premise refers to the assumption that the business is going to be closed and the assets sold off.
  - Assemblage of assets looks at value of the mass asset assemblage, although not in current use.
  - Orderly liquidation provides liquidation values assuming a reasonable time to sell, trying to obtain the best price for each asset.
  - Forced liquidation provides liquidation values assuming the assets are sold as quickly as possible, frequently all at one time at an auction sale.
Example of Going Concern Company

Example of Distressed Company
Marital Dissolution “Standard” of Value

- Based on state by state case law
  - Colorado Re: Marriage of Huff, Martin and Graff:
    • Value in the hands of the owner
    • Notorious excess earnings/double dip state!
  - Lots of state specific case law & BIG differences between states for value determinations:
    • Texas – professional goodwill is not a marital asset
    • New Jersey - no adjustments allowed for minority interest/lack of control
    • California – dependent upon articulated factors
Valuation Methods

• **Asset based methods**
  – Rarely used for operating business enterprises, unless purchase price allocation
  – Useful for patents, trademarks, license rights
  – Real estate holding companies, etc..

Valuation Methods

• **Market based methods**
  – Rev Rule 59-60 advocates market based methods
  – Guideline company method
    • Often with reference to the public markets
  – Comparable transactions method
    • Availability of database transactions
Valuation Methods

• Income based methods
  – Capitalization of earnings
    • Useful when dealing with a steady economic benefits stream
  – Discounted future earnings
    • Becoming more accepted by IRS
    • Allows for measurement of varying growth patterns

Valuation Methods

• Excess Earnings method (Treasury Method)
  – Hybrid of an asset/income method
    • Widely used in divorce courts
    • Initially advocated in 1920 with ARM 34, subsequently restated with Revenue Ruling 68-609
    • Fundamental challenges in application
      – FMV and rate of return on tangible assets
      – Rate of return on “excess earnings”
Rules of Thumb

- Not a valuation method, per se
- Can be industry benchmark indicators of value
- Often used as a test for reasonableness
- Sources of the Rules of Thumb should be disclosed in the report

Cost of Capital

In economic terms, a present value discount rate is an “opportunity cost”, the expected rate of return that an investor would have to give up by investing in the subject investment – instead of alternative investments that are comparable in terms of risk and other investment characteristics.
### Cost of Capital

- Common methods to derive capitalization and discount rates:
- Build-up model ("BUM")
- Modified capital asset pricing model ("MCAPM")
- Weighted average cost of capital ("WACC")
- SWAG

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<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Company Size</th>
<th>Implied Portfolio</th>
<th>Premium over Risk Free Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book Value of Equity - (a)</td>
<td>&lt; $59 Mil</td>
<td>25</td>
<td>12.14%</td>
</tr>
<tr>
<td>5-Year Average Net Income - (a)</td>
<td>&lt; $3 Mil</td>
<td>25</td>
<td>12.97%</td>
</tr>
<tr>
<td>Total Assets - (a)</td>
<td>&lt; $104 Mil</td>
<td>25</td>
<td>12.37%</td>
</tr>
<tr>
<td>5-Year Average EBITDA - (a)</td>
<td>&lt; $12 Mil</td>
<td>25</td>
<td>12.93%</td>
</tr>
<tr>
<td>Sales - (a)</td>
<td>&lt; $91 Mil</td>
<td>25</td>
<td>11.98%</td>
</tr>
<tr>
<td>Number of Employees - (a)</td>
<td>&lt; 172</td>
<td>25</td>
<td>12.35%</td>
</tr>
</tbody>
</table>

Min 11.90%
Mean 12.41%
Median 12.36%
Max 12.97%

Indicated Ibbotson Size Adjusted Equity Risk Premium 12.92%

**Cost of Equity Calculation**

- Risk Free Rate - (c): 4.40%
- Equity Risk Premium: 12.36%
- Ibbotson: 12.92%
- Average: 12.64%
- Company Specific Risk Premium - (d): 0.00%

Cost of Equity 23.04%

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(a) Morningstar Inc., Duff & Phelps, LLC Risk Premium Report - 2008
(b) Ibbotson Associates - 2008, SBBY Yearbook - Valuation Edition
(c) 20 year T-Bill rate @ 4/1/08
(d) based on valuator judgment
Unsystematic Risk - Overall Characterization and Conditions

- The following presents both a summary description of the Company and its environment, and also the Valuator’s assessment of risk factors that must be considered in the development of any discount rates and capitalization rates for use in Income approaches for estimation on value.

- Note: Risk Ratings Are “High”, Medium” and “Low” and are the Valuator’s assessment of factors that a Valuator and a hypothetical Buyer must consider in assessing the risk of return on investment, rates for use in calculations, intangible values and other matters enumerated in appraisal guidelines such as IRS RR 59-60 and standard texts, appraisal society texts and standards of practice.

<table>
<thead>
<tr>
<th>Industry/External Factor</th>
<th>Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry Life Cycle: Industry generally has a moderate life cycle, with no long term projects, but recurring needs for product.</td>
<td>Med</td>
</tr>
<tr>
<td>Stability, change: Mostly the same products since inception but product preferences can change quickly.</td>
<td>Med</td>
</tr>
<tr>
<td>Competitiveness: Company is considered small in size for its industry sector with a large amount of competition from similar suppliers.</td>
<td>High</td>
</tr>
<tr>
<td>Ease of Market Entry: There are significant barriers to entry into the industry.</td>
<td>Med</td>
</tr>
<tr>
<td>Market: Customer Type: Company has a large customer base with no over reliance on any one customer.</td>
<td>Low</td>
</tr>
<tr>
<td>Market: Geographic Limits: Company currently services large metropolitan areas with only one physical location in state.</td>
<td>Med</td>
</tr>
<tr>
<td>Market: Size, trends: Relatively unstable market with constant changes. The industry is under the threat of greater federal regulation.</td>
<td>High</td>
</tr>
<tr>
<td>External Effect: National &amp; International Economy, Regional Economy: Company is not tied to any particular segment of the economy.</td>
<td>Med</td>
</tr>
<tr>
<td>External Effect: Government Regulation: The Company faces an ever growing threat of increasing governmental regulation</td>
<td>High</td>
</tr>
</tbody>
</table>
### Company

<table>
<thead>
<tr>
<th>Factor</th>
<th>Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Products/Services: Stable line of products and services.</td>
<td>Med</td>
</tr>
<tr>
<td>2. Years in Business: Company has been in business for almost 18 years.</td>
<td>Low</td>
</tr>
<tr>
<td>3. Stability, change: The Company has been providing the same basic products and services since inception.</td>
<td>Low</td>
</tr>
<tr>
<td>5. Product/Service Diversity: The company primarily offers compounded hormones to women with menopause and women who are trying to conceive. If these hormones become commercially available, the Company could experience a decrease in sales.</td>
<td>High</td>
</tr>
<tr>
<td>6. Key Personnel Dependence: Somewhat dependent on owners and key management for pharmaceutical expertise.</td>
<td>Low</td>
</tr>
<tr>
<td>8. Availability of New Employees: Qualified labor is plentiful.</td>
<td>Low</td>
</tr>
<tr>
<td>9. Relative Size of Company: Company is relatively small in relation to industry peers.</td>
<td>Med</td>
</tr>
<tr>
<td>10. Competition: General: Competition from local and national compounding pharmacies as well as commercially available drugs.</td>
<td>Med</td>
</tr>
</tbody>
</table>

### Company (continued)

<table>
<thead>
<tr>
<th>Factor</th>
<th>Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>13. % Sales Spread by Customers: Not overly dependent on any one key customer.</td>
<td>Low</td>
</tr>
<tr>
<td>14. Facilities Condition: Facilities are well maintained.</td>
<td>Med</td>
</tr>
<tr>
<td>15. Existing equipment condition, modernity: Company continues to update equipment on an ongoing basis.</td>
<td>Low</td>
</tr>
<tr>
<td>16. Name recognition, reputation: Well respected in market by current customers and physicians.</td>
<td>Low</td>
</tr>
<tr>
<td>17. Location vs. Market: Well positioned for customer base served.</td>
<td>Low</td>
</tr>
<tr>
<td>18. Growth Potential: Product/Services: Company has room to grow and ability to serve a larger customer base.</td>
<td>Low</td>
</tr>
<tr>
<td>20. Seasonality: Business is spread fairly evenly throughout the year.</td>
<td>Low</td>
</tr>
</tbody>
</table>
### Financial Risk: Current Status and Historical Trends

<table>
<thead>
<tr>
<th>Factor</th>
<th>Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current and Quick Ratios: Company has historically operated with a working capital surplus.</td>
<td>Low</td>
</tr>
<tr>
<td>Profitability Ratios: The Company has a higher gross profit margin and pretax earnings margin than the industry averages for companies of the same size.</td>
<td>Low</td>
</tr>
<tr>
<td>Debt/Worth Ratio: Company maintains no debt.</td>
<td>Low</td>
</tr>
<tr>
<td>Improvement possibilities in Gross Profit, operating expense reduction: The Company has lower total expenses as a percentage of sales than the industry average for companies of similar size.</td>
<td>Low</td>
</tr>
<tr>
<td>Books/Records, Quality, History: Company does not employ an outside CPA firm to prepare audited or reviewed financial statements.</td>
<td>Low</td>
</tr>
<tr>
<td>Historical Trends, Summary: Generally increasing gross revenues, gross margin and net income.</td>
<td>Med</td>
</tr>
</tbody>
</table>

### Management

<table>
<thead>
<tr>
<th>Factor</th>
<th>Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management experience: Veteran upper management with significant industry experience.</td>
<td>Low</td>
</tr>
<tr>
<td>Depth of management: Key employees with significant experience.</td>
<td>Med</td>
</tr>
<tr>
<td>Succession Plans and Systems: Company somewhat dependent on upper management.</td>
<td>Med</td>
</tr>
</tbody>
</table>
Analysis of the External Environment

- Economic
  - Interest Rates
  - Inflation
  - Unemployment
- Technological
- Legal/Regulatory
- International
- Cultural

Analysis of the Industry

- Barriers to Entry
  - Threat of New Entrants
- Industry
  - Suppliers: Bargaining Power of Suppliers
  - Rivalry: Rivalry Among Existing Firms
  - Buyers: Bargaining Power of Customers
- Substitutes
  - Threat of Substitute Products or Services
Analysis of Unsystematic Risk

Related Analytical Issues
Capitalization of Earnings/Cash Flow

- When applying the capitalized income method, the analyst should consider:
  - Normalization adjustments
  - Nonrecurring revenue and expense items
  - Capital structure and financing costs
  - Sustaining capital reinvestments
  - Noncash items
  - Discount and capitalization rate factors
  - Expected changes in future earnings/cash flow

Non-Operating or Excess Assets

- When valuing a controlling interest under the income approach, non-operating and excess assets should be excluded from the computation of value based on the operating assets and added to the value of the operating entity.
- When valuing a non-controlling interest under the income approach, the value may or may not be added back depending on the analyst’s assessment of the influence exercisable by the non-controlling interest.
- May not be separately considered in the asset approach.
### Levels of Value and Discounts and Premiums

Total of minority interest and lack of marketability discount equals a total discount of 58% from value of control shares.

<table>
<thead>
<tr>
<th>Value of Shares</th>
<th>Discount or Premium</th>
<th>Value of Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>$12 per share</td>
<td>Synergistic Premium</td>
<td>Synergistic value</td>
</tr>
<tr>
<td>$10 per share</td>
<td>Control Premium</td>
<td>Value of control shares</td>
</tr>
<tr>
<td>$7 per share</td>
<td>Minority or Lack of Control Discount</td>
<td>Value of marketable minority shares</td>
</tr>
<tr>
<td>$4.20 per share</td>
<td>Lack of Marketability Discount</td>
<td>Value of non-marketable minority shares</td>
</tr>
</tbody>
</table>

- $12 per share
- $10 per share (30% discount)
- $7 per share (40% discount)
- $4.20 per share
Discounts & Premiums

- **Minority Interest/Lack of Control Discount (DLOC)**
  - Applicability of this discount is dependent on the standard and premise of value
  - Availability of empirical evidence, such as Mergerstat and Houlihan Lokey studies, suggest **median discounts around 25 to 40%**
  - Learning Point: Be careful not to mix and match DLOC with risk assessment in cost of capital and market multiples

Discounts & Premiums

- **Lack of Marketability Discount (DLOM)**
  - All other things being equal, an interest in a business is worth more if it is readily marketable or, conversely, worth less if it is not.
  - Lots of empirical evidence to support the discount for securities in a closely held enterprise, with **median discounts in the 20 to 40% range**
  - Emerging issue: DLOM on controlling interests
### Other Discounts and Related Issues

- Key Person Discounts
- Blockage Discounts
- **Transactional Discounts**
- Built-in Capital Gains
- **Pass through entities** - Estate of Gross et al
  - S Corporation Models: Fannon, Treharne, Grabowski, Van Vleet, Mercer

### Emerging and Evolving Professional Organizations and Credentials for Business Appraisers
Professional Organizations

- American Society of Appraisers ("ASA", "AM")
- American Institute of Certified Public Accountants ("ABV")
- National Association of Certified Valuation Analysts ("CVA")
- Institute of Business Appraisers ("CBA")
- Other
  - Appraisal Foundation/USPAP
  - IRS
  - CFA Institute
  - The Alphabet Soup credentials
  - International Organizations

Valuation Credentials

- American Institute of Certified Public Accountants
  - **Accredited in Business Valuation** (~2,900/~80)
- National Association of Certified Valuation Analysts
  - **Certified Valuation Analyst** (~6,500/~250)
- American Society of Appraisers
  - **ASA BV discipline** (~900/30)
- Institute of Business Appraisers
  - **Certified Business Appraiser** (~500/8)
Professional Standards for Business Appraisal Assignments

Professional Standards for Business Appraisal

- Uniform Standard of Professional Appraisal Practice
- AICPA Statement on Standards for Valuation Services #1: Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset (SSVS1)
- NACVA, ASA and IBA Professional Standards
- IRS BV Guidelines and IRS Notice 2006-96
Applicability of SSVS1

Covers any service that estimates the value of a
– business,
– a business ownership interest,
– security or
– intangible asset, and
Uses valuation approaches/methods and professional judgment in applying them

SSVS1 Conclusion of Value

• Engagement calls for the valuation analyst to estimate the value of the subject interest

• The valuation analyst is free to apply the valuation approaches and methods he/she deems appropriate in the circumstances

• Valuation analysis results in a conclusion of value, either a single amount or a range of value
SSVS1 Calculation of Value

• The valuation analyst and the client agree on the specific valuation approaches or methods to be used or the extent of the valuation procedures the analyst will perform and

• The valuation analyst estimates the value in compliance with the agreement

• The results are expressed as a calculated value, either as a single amount or as a range
Recommended Resources

- **Guide to Business Valuation**
  Shannon Pratt, Jay Fishman, Practitioners Publishing Company
- [www.bvresources.com](http://www.bvresources.com)
- [www.valuationresources.com](http://www.valuationresources.com)

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