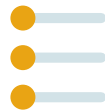


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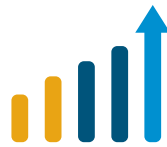
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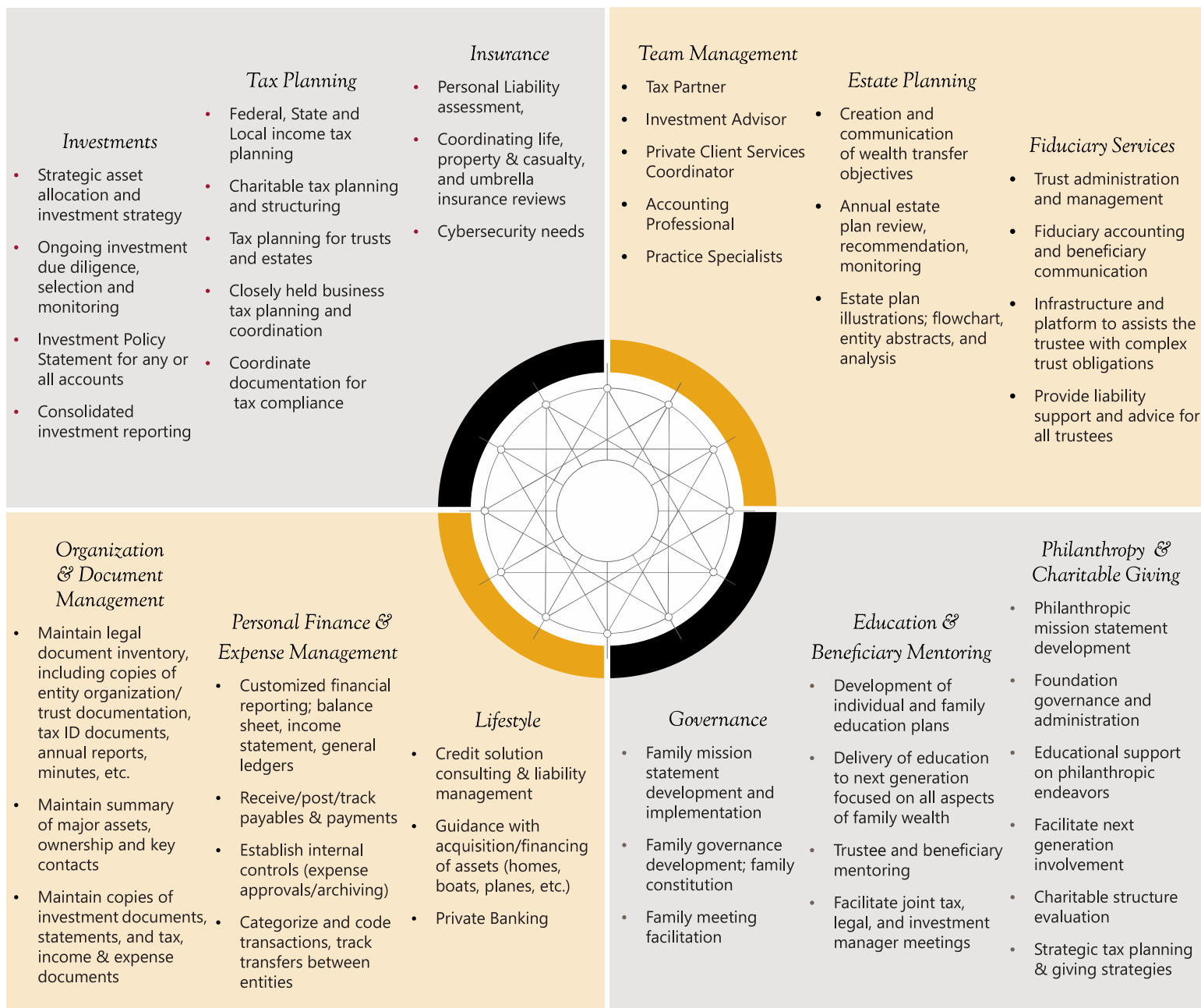
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Business Valuation: What an Attorney Needs to Know

Presented by:

**Michele Avery, CPA/ABV, CVA, MBA, MAFF
CRI Advisors, LLC / Carr, Riggs & Ingram, LLC
Partner, Forensic, Litigation and
Valuation Services**

Key Concepts of Business Value

- I. Business valuation professionals
- II. Three standards of value
- III. Three approaches to valuing a business
- IV. Normalizations
- V. Valuation discounts and premiums

I. Businesses valuation professionals

There are several different types of financial professionals who are involved with valuing businesses. These professionals include CPAs, Investment Bankers, Venture Capitalists, Private Equity Groups and Business Brokers. CPAs and business brokers are mostly focused on closely held businesses in traditional industries or “main street” companies. Private equity groups and investment bankers are mostly focused on larger companies with diverse ownership structures, professional management teams and national and/or international scope of operations. These types of companies are generally termed “Wall Street” companies and typically generate in excess of \$1 million in EBITDA¹. Venture capitalists focus on start-up ventures and are focused on quickly flipping their investment through either an initial public offering or a sale to a larger company.

CPAs involvement in business valuation grew from the role CPAs play as business advisors to their clients. CPAs were first involved in valuing companies for tax purposes and then branched out to transaction work, adversarial proceedings, management compensation and business succession planning. CPAs value businesses using comprehensive business valuation theory, empirical studies, case law and professional standards developed over the past 50 years.

Business brokers are primarily focused on sales of businesses to third parties. Business brokers value companies based on rules of thumb they have developed over years of transaction work. These rules of thumb are compiled annually in the Business Reference Guide published by the Business Brokerage Press. It is important to note that many of these rules of thumb are not supported by the returns earned by the business.

Private equity groups (PEGs) and venture capitalists (VCs) use valuation methods that are based on cash flow or revenue. Revenue or cash flow is multiplied by a valuation multiple. The valuation multiple and the cash flow projection time horizon are based on the return requirements of the PEG and VC funds. Pepperdine University’s Private Capital Market’s Report and Cambridge Associates Venture Capital Index and Private Equity Index provide benchmarks for rates of return required by PEGs and VCs.

¹ Earnings before interest, income taxes, depreciation, and amortization.

Investment bankers focus on valuation methods that are based on multiples derived from publicly traded companies and cash flow-based valuations using returns derived from publicly traded businesses. Investment bankers typically deal with larger companies.

II. Three standards of value

1. Fair Market Value - Origin in IRS rulings on appraisals of tangible assets from 1920s forward.
2. Fair Value - Origin in legal concepts of equity.
3. Investment Value - Origin in mergers and acquisition transactions.

Fair Market Value – The U.S. Treasury regulations define fair market value as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.

- Based on assumption of a hypothetical buyer and seller, neither of which is acting under compulsion, both are aware of all relevant information and are acting as rational actors trying to maximize their economic returns.
- Fair market value is the required standard of the IRS, ERISA, LLC Act and community partition statutes.
- Well established concept among appraisal professionals supported by IRS rulings, academia and case law.

Fair Value – Uniform Business Corporation Act defines fair value as 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.

- Determine a value that is fair to a party.
- Usually is interpreted as fair market value without discounts for lack of control or marketability.
- Fair value is the required standard of the LA Corporate Act, case law and statutory law in certain jurisdictions outside of Louisiana.

Note: Fair market value and fair value are not compatible. Fair market value explicitly requires a business be valued based upon the investment requirements of a hypothetical buyer/seller. Fair value requires a determination of what the business is worth to a specific individual. Consequently, fair value may not equate to the value that could be realized in a market transaction.

Investment Value - The International Glossary defines investment value as the value to a particular investor based on individual investment requirements and expectations.

- Investment value reflects value of a transaction to identified parties based on their investment criteria. Investment value is the standard used when valuing a business for a transaction. Synergistic value and strategic value are two value concepts associated with investment value.

- Synergistic value reflects value that will be realized from operational efficiencies such as consolidating office space or eliminating duplicative overhead positions and costs.
- Strategic value reflects the value that a purchaser will realize through increased opportunities. Examples of these opportunities include:
 - Being able to sell acquirer's products and services to the target's customer base.
 - Being able to sell target's products and services to the acquirer's customer base.
 - Enter new geographic areas.
 - Enter new industry niches.
 - Access to new suppliers.

Note: Fair market value and investment value are not compatible. Fair market value explicitly requires a business be valued based upon the investment requirements of a hypothetical buyer/seller. Investment value requires a determination of value based upon the investment requirements of an identified buyer and seller.

III. Three approaches to valuing a business

1. Asset-based Approach- A general way of determining a value indication of a business, business ownership interest, or security using one or more methods based on the value of the Company's assets net of liabilities. Includes adjusting a company's assets and liabilities to fair market value, then subtracting liabilities from assets to provide an adjusted net asset value.
2. Income Approach- Based on the assumption that business value is equal to the sum of the present values of the expected future economic returns of the business. Includes identifying on-going economic benefits of a company. Economic benefits are typically measured as net cash flow or earnings.
3. Market Approach— This approach assumes that the value of a business can be determined by reference to sales of reasonably comparable guideline companies that have taken place in either the public or the private marketplace. Includes identifying valuation multiples associated with recent sales of similar companies and applying those multiples to the company being valued. Valuation by comparison with transactions in similar businesses or business interests.

Asset-based Approach

This approach calculates the value of a business as the fair market value of its assets less the fair market value of its liabilities. This approach is most appropriate for:

- Non-operating companies.
- Asset holding companies for real estate, timber, mineral interests.
- Capital intensive companies like marine companies, machine shop, manufacturing companies.
- Companies with low or no earnings.

Note: Will often require the use of other appraisers such as real estate appraisers, timber specialists, oil and gas reserve reports. For a profitable operating company net asset value should be the floor value of the business. The capitalized or discounted value of an operating company's cash flow should be more than its net asset value. Consequently, the asset approach is generally understood to reflect a liquidation value for a company.

A weakness of this approach is that it relies on values of tangible underlying assets. So, it is only as good as real estate/timber/equipment appraisals it is based on. Another weakness is that it is based on tangible assets so intangible assets such as goodwill are not considered.

The underlying assets are often valued based upon a form of income approach with discount rates derived using theory different from business valuation theory. This sometimes creates a contradictory valuation when applying an income approach and an asset approach.

Income Approach:

The income approach is the most commonly used approach. It is based on the ability of a Company to generate on-going net cash flow. Net cash flow reflects cash flow available after the consideration of debt service and capital expenditures. Under the income approach there are two methods.

1. Discounted Cash Flow Method ("DCF") – Based on projections of future net cash flow. It is based on the assumption that the value of a business is equal to the present value of its expected future economic benefit stream.
2. Capitalization of Earnings Method- Based on historic net cash flow. This is an abbreviated version of the discounted cash flow method where both growth and the discount rate are assumed to remain constant into perpetuity. Usually based on capitalizing one year of estimated on-going cash flow.

The income approach includes identifying two key variables; the economic benefit stream and a company's weighted average cost of capital. As previously discussed, net cash flow is the most commonly used measure for the economic benefit stream.

The weighted average cost of capital ("WACC") is a method of calculating a company's overall cost of capital. The WACC is the cost of capital (discount rate) determined by the weighted average, at market value, of the cost of all financing sources in the business' capital structure. WACC is typically calculated as the summation of the cost of equity and the cost of debt, weighted for the perspective portion of debt or equity in a company's capital structure. Cost of debt is measured as a company's borrowing cost. It is usually calculated based on a Company's current interest bearing debt.

There are two primary methods for developing the cost of equity – the build-up method and the capital asset pricing model. The buildup method is most often used by CPA business appraisers. The build-up method calculates cost of equity as the summation of a risk-free rate of return and a risk premium. The risk premium includes equity risk, size risk and company specific risk.

The income approach is most appropriate for profitable operating companies. Professional service firms will almost always be valued using an income approach. Companies selling goods and services will also most likely be valued using an income approach.

The strengths and weaknesses of this approach are listed below.

Strengths:

- Most commonly used.
- Based on ability of subject company to generate earnings.
- Captures the industry, market, operating strengths, weaknesses and general condition of the Company.

Weaknesses:

- Future earnings are difficult to project.
- Calculation of terminal value and WACC are still evolving theoretically.

Note: Five years is the accepted look back and forward period. Most DCF projections are for five years and a terminal period. This method is only as good as the projection. Projection pitfalls include cost of goods sold fluctuations, changing lease terms and fair market compensation for shareholders/members. Future growth projections should be consistent with long-term projections for GDP growth, inflation and industry trends.

Market Approach

The market approach is a general way of determining a value indication of a business, business ownership interest, security, or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold. This approach requires the valuation analyst to research available sources of information to find similar investments that can be used for comparison purposes. The primary reason this approach is not used in every valuation is the difficulty of obtaining sufficient, reliable data concerning transfers of business ownership interests in the private marketplace. Valuation analysts generally consider three types of market transactions: 1) transactions in the subject company's, 2) merger and acquisition transactions involving comparable publicly traded or privately held companies, and 3) transactions involving stock in comparable publicly traded companies. From these transactions, valuation multiples are derived and applied to a financial metric of the company being valued. Most typically the financial metric used is revenue or earnings before interest, depreciation and amortization (EBITDA).

There are two primary methods under the market approach.

1. Mergers and acquisitions method – This is a method based on transactions of reasonably comparable private companies reported in various databases. These databases are described below.
 - Deal Stats is an online database that includes financial details of 58,700 acquired private companies.
 - Bizcomps is an online database that includes financial details of 17,600 acquired private companies.

- Business Reference Guide - This is published by the Business Brokerage Press. It provides valuation rules of thumb for pricing and structuring transactions for 700 types of businesses. It is based on experience of business brokers gained through actual transactions.
2. Guideline publicly traded company method—This method is based on identifying publicly traded companies that are reasonably comparable to the company being valued and deriving valuation multiples from the set of comparable publicly traded companies to apply to the company

In the market approach valuation multiples are derived from the following financial performance metrics:

- Revenue
- Gross Profit
- EBITDA
- EBIT
- Net Income

The strengths and weaknesses of this approach are listed below.

Strengths:

- Provides real world data on transactions so the estimates of value are based on actual transaction prices, not based on a number of assumptions or judgments.

Weaknesses:

- Guideline publicly traded company method has limited applications to small closely held business. The size and scope of most publicly traded companies greatly exceed small family-owned businesses.
- Data in transaction databases is unaudited and not always accurate.
- Transactions in databases reflected control and synergistic values.
- Business Broker rules of thumb are rarely supported by returns generated by the business.

III. Normalizations

A more accurate reflection of a company's financial position and potential can be seen after normalizations are made. Normalizations usually include the removal of non-recurring items, owner perquisites and adjustments to reflect fair market value. Adjustments to fair market value are most typically made to owner's compensation and transactions with related parties. Presented below are the more common normalizations made as part of the business valuation process:

- Owner's compensation/perquisites - Business owners have discretion over the amount of compensation they draw from their companies. Additionally, it's common for owners to expense personal items (or "perks") such as vehicles, cell phones, insurance, or travel and entertainment, through their company.

- Fair market value rent - Sometimes a company pays above- or below-market rent to a related party, such as a holding company or a family member of the owner.
- Non-recurring or extraordinary income/expense - A company may receive income or incur an expense as the result of an event that is abnormal, unrelated to the company's ordinary day-to-day operations, or unlikely to reoccur in the foreseeable future.
- Accounts receivables - Adjust so that net accounts receivable represent the market value (as of date of valuation) of such receivables.
- Inventory- Some private companies may account for inventory using the "last-in, first-out" (LIFO) method for the tax benefits it confers during periods of inflation. Under the "first-in, first-out" (FIFO) method, inventory is typically higher and more reflective of fair market value because the most recently purchased and higher cost inventory remains on the balance sheet. Therefore, appraisers sometimes make adjustments from LIFO to FIFO, which is typically accomplished by adding the LIFO reserve back to inventory on the balance sheet. Adjustments to the income statement are also made by subtracting the yearly change in the LIFO reserve from the cost of goods sold.

IV. Valuation discounts and premiums

- Discount for lack of marketability
- Discount for lack of control
- Pass through entity premium

The discount for lack of marketability ("DLOM") is derived from the fact that there is, generally, no ready market for the equity interest in a closely held enterprise. The concept of marketability deals with the liquidity of the interest—how quickly and certainly it can be converted to cash at the owner's discretion. The DLOM is calculated through the use of several methods with the Benchmark Studies method and the application of option pricing models being the most commonly applied methods. The Benchmark Studies method is based on empirical studies of discounts observed in restricted stock and before and after initial public offerings.

The discount for lack of control is related to the fact that a minority owner in a closely held enterprise has very few rights relative to the operation of that enterprise. The holder of a minority interest in a closely held business does not enjoy the benefits of control. Minority discounts arise from the inability of the minority owners of an entity to exercise voting control. Minority discounts are usually quantified using studies of premiums paid for controlling shares in publicly traded companies.

The pass-through entity premium captures the value of one level of taxation of a pass-through entity. Limited Liability Companies, S-Corporations and Partnerships are all classified by the tax code as "pass through entities". This means that tax attributes associated with income incurred by these entities pass through to the personal tax return of the entity's owners where it is taxed at the owner's individual tax rate. C corporations, on the other hand, are taxed twice, once at the entity level at a corporate rate and again at the personal level when the income is distributed as dividends to shareholders.

In addition to income tax benefits, owners of pass-through entities receive favorable treatment in regards to capital gains taxes as undistributed pass-through entity income increases the tax basis of an ownership interest, thereby reducing future capital gains taxes. These tax advantages have lead some valuation analysts to conclude that ownership interests in pass-through entities are more valuable than C corporation ownership interests. This premium is primarily used in valuations that are being used for tax purposes.



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