



AN INTRODUCTION TO BUSINESS VALUATION

The following outline provides a broad overview of Business Valuation and identification of key aspects of this specialized body of knowledge.

1. REASONS FOR HAVING A BUSINESS VALUED

- Estate Tax and Gift Tax Compliance
- Estate and Gift Tax Planning
- S Corporation Election
- Valuing a Marital Estate
- Litigation Support including Economic Damages and Lost Profits
- Planning the sale or purchase of a business
- Buy-Sell Agreements
- Intangible asset valuation: non-compete agreements, personal goodwill, franchise blue sky
- Business and Strategic Planning

2. WHAT TYPES OF BUSINESSES ARE VALUED?

- C and S corporations
- Limited liability companies
- Limited partnerships
- General partnerships
- Sole proprietorships
- Undivided interests in real estate

3. BUSINESS VALUATION STANDARDS & GUIDELINES

- Various business valuation societies have business valuation standards
 - Performance standards of business appraisal, providing guidance on valuation techniques, methods and conduct of business appraisers
- As in law, accounting, medicine and other professions, qualified business analysts have extensive training and expertise and prepare a value analysis in accordance with professional standards
 - Professional appraisal standards set forth guidelines on research, analysis, valuation methods and report writing

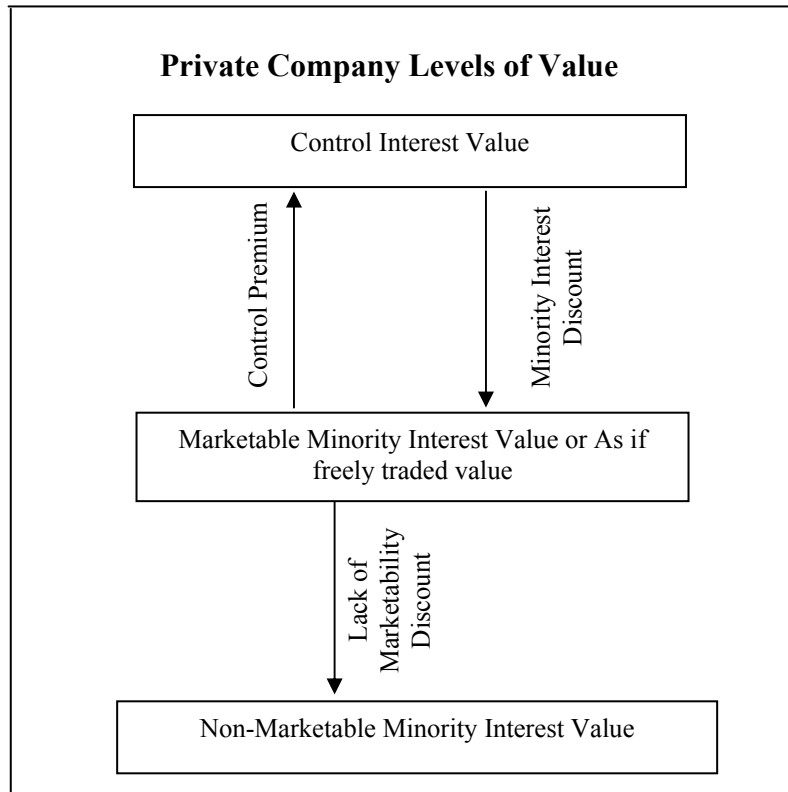
4. STANDARDS OF VALUE

The standard sets forth certain assumptions that guide analysis and impact the conclusion of value.

- **Fair Market Value** is the standard of value required in all IRS valuations, and is defined as “the cash or equivalent price at which property would change hands between a hypothetical willing buyer and a hypothetical willing seller, neither being under compulsion to buy or sell and both parties having reasonable knowledge of relevant facts”.
 - Hypothetical Buyer - The buyer (and seller) under Fair Market Value standard is hypothetical rather than a specific individual or entity who analyzes and transacts in a well-informed and totally rational manner. Except under rare circumstances, the hypothetical buyer is considered to be a “financial” (an investor, not an exceptional business manager) and not a “strategic” buyer (see “strategic value” below); therefore, the standard excludes the extraordinary buyer who because of other business activities brings some “value-adding” benefits or expertise to the company being valued. This also excludes buyers who are already a shareholder, creditor, or a related or controlled entity that might be willing to acquire the ownership interest at artificially high or low prices due to considerations not typical of the motivation of the arms-length financial buyer. *The hypothetical buyer has knowledge of the relevant facts and influences on value exerted by the market, including: the risk and value drivers specific to the company, the investment quality of the company, the ownership interest’s degree of control and degree of marketability.*
 - Hypothetical Seller - The seller is also hypothetical and is rational and motivated by seeking the highest return. Like the hypothetical buyer, the seller is knowledgeable about factors determining value.
 - Absent a trading market, the valuator stands in for both hypothetical buyers and sellers; therefore, maintaining objectivity and independence are critical in determining a reasonable and reliable conclusion of value.
 - The determination of Fair Market Value, as defined above, mandates an estimate of what the seller and buyer could be expected to do in the marketplace, as of the valuation date, in a sale and purchase of the subject interest.
- **Investment Value, or Strategic Value**, is defined as the value of an investment to a particular investor based on specific investment requirements and, in some cases, other business interests, economies of scale and the perceived strategic benefits of combination with existing capacity. For the same company, investment value is expected to exceed Fair Market Value. A business owner planning to sell 100% of a business should investigate investment value.
- **Fair Value** is normally the applicable standard of value used in litigation by non-controlling shareholders claiming to be dissenters or oppressed, or in marital estate valuations. It is also relevant to valuing intangible assets.

5. LEVELS OF VALUE IN CLOSELY HELD BUSINESSES

- *The same business has a range of values; and a rational, prudent investor will only pay a premium per share price for a controlling ownership interest, but not for a lack of control interest.*
- **Appraised value should make economic sense.**
- There are three different **Levels of Value** common to the valuation of private companies:
 - **Control** value – *Highest Value*
 - Marketable minority value
 - Non-marketable **minority** value – *Lowest Value*



- Control over corporate/business authority increases per share value relative to a *minority value*, or lack of control value. This increment of higher value is considered a *control premium* over minority value. The minority shareholder lacks the benefits and perquisites of power; and this *lack of control is reflected in a lower-than-control per share value*.

- A *Control interest* is a greater-than-50%-voting authority in the closely held company. The control interest possesses the power to make and carry out major decisions, such as authority over management, compensation, cash flow for owner distributions, and sale of the company.
- A *Minority interest* lacks such control, power or authority. In addition to lacking control, the minority owner in a private company lacks an active, liquid stock market.
- The absence of a market in which to liquidate the minority interest creates a lack of marketability, or liquidity, and prolonged holding periods are market factors that drive down minority interest value.
- It is common for lack of marketability to be further increased by shareholder agreements that restrict the transfer of minority shares. In contrast, having an active, liquid market for *public* company stocks greatly enhances their minority value relative to private, minority interest holdings.
- An investor in private company minority interests must be compensated for the risks associated with lack of control and liquidity. Compensation is in the form of a lower, *discounted price for the minority interest*. **Herein lie the tremendous planning opportunities when considering transfers among different levels of private company value, i.e., from control owners to non-control owners.** As the current Fair Market Value of one share of stock may vary significantly depending on whether the owner is a controlling or minority shareholder, transferring the share to the minority shareholder also removes future appreciation in value from the control owner's estate.
- **Discounts to Shareholder Value (Refer to the Levels of Value Chart)**

The estimation and quantification of an appropriate minority or marketability discount is done with in-depth study and analysis of capital market data and the relevant facts and circumstances of the interest being valued.

- Converting a Control value to the lower marketable Minority value requires the application of a minority interest discount to reflect the minority lack of control and impairment of value. This discount is commonly referred to as a **minority interest discount, or a discount for lack of control**.
- The marketable minority level of value assumes the minority interest can be freely traded on an active stock exchange. We know that the value "as if freely traded" condition does not exist for private companies. Empirical evidence indicates that investors in minority interests in private companies require a downward adjustment in price to compensate for this lack of an active market and other liquidity risks.
- Converting a marketable minority value to a non-marketable minority value requires a **discount for lack of marketability**, or discount for lack of liquidity. The IRS has repeatedly failed in court to refute the overwhelming evidence substantiating the existence of lack of marketability in minority ownership interests. The challenge for the valuator is to determine well-reasoned and thoroughly substantiated discounts based on the facts and circumstances of the subject interest. Minority interests in

operating companies or family limited partnerships are valued at the non-marketable minority interest, or lowest, level of value; thus, the value of transferred shares from a control interest to non-marketable minority interest may decrease substantially.

- **The key factors affecting the lack of marketability discounts are:**
 - Lack of an active, liquid market
 - The uncertainty of the holding period
 - The amount and frequency of cash distributions to the minority shareholder during the holding period
 - The minority shareholder's required rate of return
 - Size and decision-making ability of the minority interest

6. DISCOUNT RATES AND CAPITALIZATION RATES

- The **Discount Rate** is defined as the rate of return required to attract equity capital to the company being valued. The use of the income approach to valuation requires the valuator to estimate an appropriate and reasonable discount rate.
- The **Capitalization Rate** is a divisor used to convert an expected, annual benefit stream (earnings, cash flow) into an indication of value.
- The essence of business valuation is estimating an appropriate, risk-adjusted rate of return based on private company risk, expected returns to shareholders, and growth potential, if any. The Valuation Process is a study and analysis of the investment quality of the private company being valued.
- Small private companies are expected to have substantial business and financial risks that justify relatively high discount rates, or rates of return. Mechanically, application of "high" discount rates to value private companies results in "low" valuations.

Discount Rate:

- To estimate a private company's risk and return for valuation purposes, the conventional valuation technique is to develop, or build up, the discount rate using observed rates of return historically paid in the *public capital markets*; market returns reflect historical returns paid by large and small public companies; then risk factors specific to the subject company are added to the public company rate of return.
- **Specific Company Risk Analysis:** What increase in the rate of return would the marketplace (i.e., hypothetical investors) require for accepting the risk associated specifically with the subject company? It is commonly a positive additional increment often including factors such as: 1) small size, lack of resources and diversification, 2) high concentration of sales with one or a few customers; 3) high debt and/or low operating liquidity; 4) lack of product, service or geographic diversification; and 5) thin management or dependence on a key person.
- For purposes of this outline, we will assume the valuator, after careful analysis, estimated the total specific company risk component at 5%.

- The *Discount Rate for Equity*, or the cost of equity capital, in the example below is 25%, implying (based on the facts, circumstances and professional judgement of the valuator) hypothetical investors demand a 25% return to invest in the small closely held company that often lacks high growth potential and diversity against economic and industry risks. A minority investor can expect roughly a 13% return over and above the long-term from investing in S&P 500 companies. Higher risk requires higher return.

Capitalization Rate and an Example of Calculating Value

- Assuming the long-term sustainable growth rate of the company is 4%, the related capitalization rate is the result of subtracting the long-term sustainable rate from the discount rate, or 25% less 4.0% equals a 21% capitalization rate.

A simple value calculation: To estimate the present value of a business expected to generate \$100,000 of free cash flow *next year* (\$96,000 this year) and to grow going forward at a constant 4% in perpetuity, the \$100,000 is converted to value by dividing it by the capitalization rate of 21%. This results in estimated value of \$476,190 ($\$100,000/.21$).

- Securities analysts use a common method of valuing public companies which multiplies an estimated benefit stream (for example, earnings) by a valuation multiple. The valuation multiple is merely the inverse of the capitalization rate.
- Dividing 100% by the capitalization rate above of 21% yields a valuation multiple of 4.76 times. Assuming our benefit stream is \$100,000, multiplying by the valuation multiple yields an indication of value of \$476,000.

7. TYPES OF VALUATIONS AND REPORTS

- **Formal Valuations** - The objective of a *formal valuation* and report is to express an unambiguous opinion as to the value of the business, business ownership interest, or security, and the value conclusion is supported by all valuation methods the valuator deems to be meaningful and relevant to the assignment. *A formal valuation is required for most tax-related matters.* It is recommended for all others where the client needs a highly reliable opinion and wants a clear complete report on how the value was determined.

The results of a *formal valuation* are commonly reported in a formal report; however, the results can be reported orally or in *summary form*.

- **Summary Valuation Reports** - The objective of a *summary valuation* is to express an opinion of value of a business interest. It does not include all the information considered and the reasoning that supports the analyses, opinions, and conclusions leading to the opinion of value; such reports require less time than a formal valuation.
- **Calculations** - The objective of a *calculation* is to provide an approximate indication of value based upon the performance of limited information gathering and limited analytical

procedures agreed upon by the client and valuator. A calculation is not an independent opinion of value as would be arrived at in a full valuation.

8. EXTERNAL AND INTERNAL FACTORS CONSIDERED BY APPRAISERS

1. **Economic conditions** at the time of the appraisal and expected economic conditions going forward.
2. **Industry and market conditions:** What are the trends and conditions in the industry in which the company operates? What is the health, and what are the opportunities, in the markets into which the company sells? What are the growth prospects for the company's markets?
3. **What are the strengths and weakness of the company?** What is the quality of management? Does the company have strategic or competitive advantages? What are the growth opportunities for the company? What are the primary threats to the company's future profitability? Who are key personnel?
4. **Is there reliable and consistent evidence of profitability** without regard to tax planning implemented in the past? In other words, has the company consistently generated earnings (beyond a return on labor or market-based rents) evidenced by free cash flows that may be removed from the business without impairing financial position or operations?
5. In the absence of free cash flow consistently driving operating value, what are the market values of tangible assets?

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The business valuation profession is attempting to spread the word that valuation knowledge and methodologies can be powerful business planning and problem solving tools. HBK business valuation experts are using valuation techniques and resources to add value to existing client services.

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