Fundamentals of Business Valuation

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Types of Business Entities

- Professional practice
  - McSparron, Wadsworth Grunfeld, Rubino
- Manufacturing
- Retailer
- Wholesaler
- Niche businesses
  - Stockbroker-Manufacturers Rep

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Standards of Value

- Book value
  - Accounting term
  - Balance sheet – assets less liabilities

- Fair market value
  - RR 59-60
  - Price between willing buyer and willing seller
  - Arm's length

Standards of Value

- Fair value
  - NY Business Corporation Law
  - Statutory for shareholder oppression and dissention

- Value to owner (holder)
  - In a professional practice or enhanced earning capacity

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Approaches to Value

- Income
  - Capitalization of earnings
- Asset-based
  - Net asset value method
- Market
  - Guideline company method
  - Transaction method

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Premise:

- *The present day value of an income producing asset is quantified in its future economic benefits.*

Capitalization of Income

- Overview
  - Converting a single level of expected income into value
  - Using a capitalization rate as a divisor or using a multiple
  - Application of the method requires an estimate of normalized income and a capitalization rate
- Normalized Income
  - Income after all reasonable and necessary operating expenses including reasonable compensation paid to the owner(s)
  - And that can be expected on an annual basis over the long term
- Income Adjustments
  - Owner compensation
  - Non-recurring and non-operating items
  - Cash to accrual

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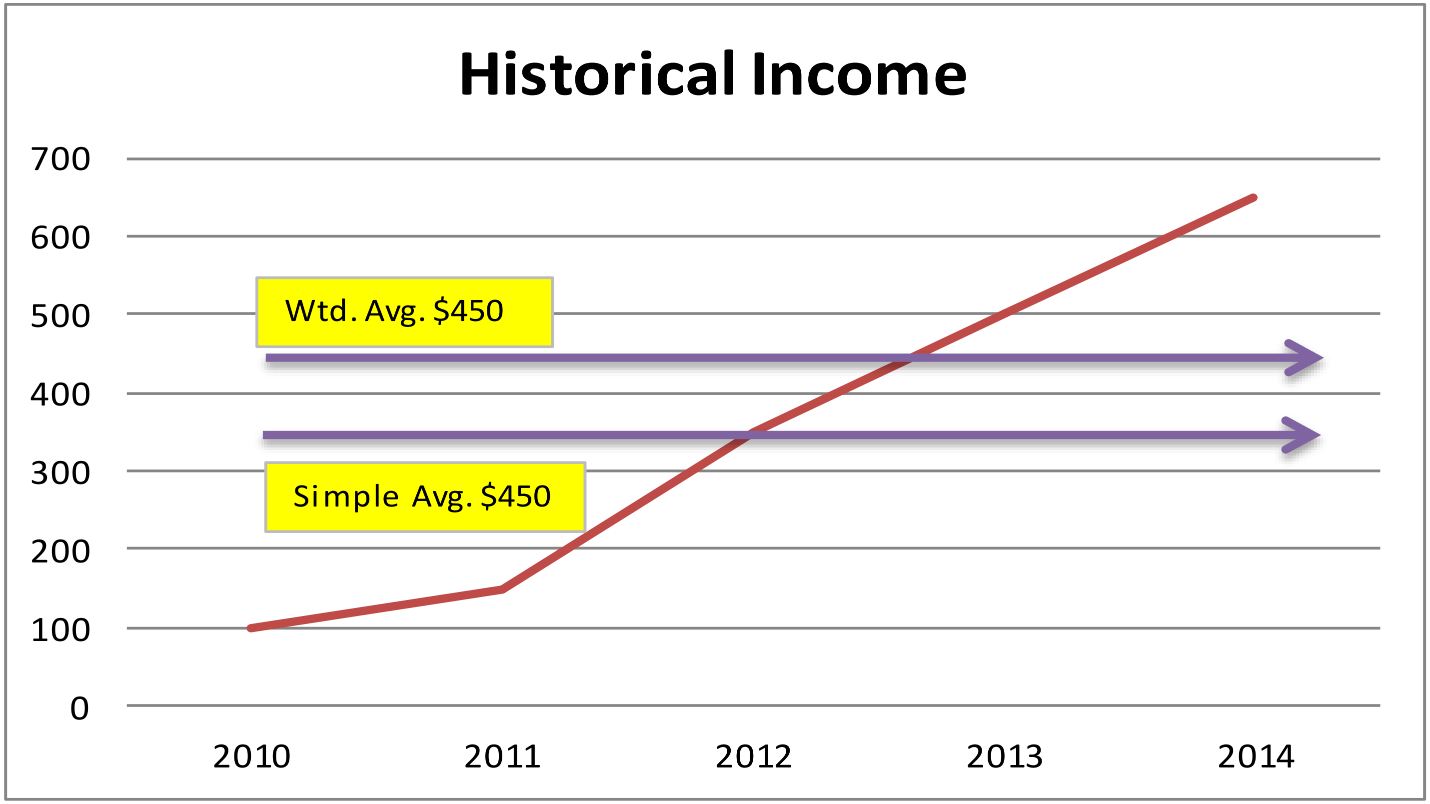
Normalized Income



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Discount & Capitalization Rates

- A discount rate is used to convert a series of future income streams to present value

- A capitalization rate is derived from the discount rate and is used to convert a single income stream to present value

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Discount & Capitalization Rates

- Reflect an investor's expected return on an investment in the business

- Based on risks above what might be earned in the public markets which are perceived as less risky

- Company specific risks include:
  - Lack of management depth
  - Customer concentration
  - Lack of diversity
  - Lack of capital
  - Industry and regulatory issues
  - Sensitivity to the economy

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Build Up Model

	%	X
U. S. Treasury Yield	4.0	25.0
Equity premium	7.0	
Size premium	6.0	
Market rate of return	17.0	5.9
Company specific premium	11.0	
Discount rate	28.0	
Growth	3.0	
Capitalization rate	**25.0**	**4.0**

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Owner Compensation

- Compensation for services rendered plus income as a result of ownership

- Often a significant adjustment and based on empirical data
    - Medical Group Management Association (MGMA)
    - Law Firm Economics
    - Compensation Survey of the American Dental Association
    - Robert Half Accounting & Finance Survey
    - Economic Research Institute (ERI)
    - Risk Management Associates (RMA)

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Owner Compensation

- Other Considerations
  - Duties & responsibilities
  - Age and health
  - Educational attainment and background
  - Work habits
  - Customer/client relationships

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Capitalization of Income

Income as reported	$	50,000
Owner compensation as reported		350,000
Replacement compensation		(225,000)
Accelerated depreciation		100,000
Straight-line depreciation		(35,000)
Personal expenses		62,000
Adjusted income		302,000
Income tax provision		(120,800)
Net income		181,200
Growth rate		3.0%
Normalized income		186,636
Capitalization rate		25.0%
Indicated value	**$**	**746,500**

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Excess Earnings Method

- Revenue Ruling 68-609
- Two components of value: tangible and intangible
- Estimated rate of return is applied to the fair market value of the net tangibles assets
- The amount of income over the fair return on tangible assets is considered the “excess earnings”
- The excess earnings are capitalized to arrive at the intangible value
- Intangible value combined with tangible value is the overall value of the subject business

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Excess Earnings Method

- Differs From Capitalized Income Method
  - Requires restatement of balance sheet
  - Estimate of fair return on the net assets
  - Capitalization rate based on the risk of the intangible assets only

- Disparaged by IRS
  - See RR 68-609
  - Only to be used when no other method is available

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Excess Earnings Method

Normalized income		$ 181,000
Tangible asset value	150,000	
Fair return	5.0%	(7,500)
Excess earnings		173,500
Capitalization rate		28.0%
Intangible value		619,600
Tangible asset value		150,000
Indicated value		**$ 769,600**

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Transaction Method

- Overview
  - Based on the premise that actual transactions of similar businesses can provide a relevant benchmark for value
  - Pricing multiple is applied to a measure of income to determine the "operating value" of the subject company
  - Measure of income most often used is revenues or owner cash flow (OCF)

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Transaction Method

Revenues	$	750,000
Multiple		0.80
Operating value		600,000
Cash		25,000
Accounts receivable		175,000
Inventory		50,000
Liabilities		(125,000)
Indicated value	**$**	**725,000**

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Guideline Company Method

- Overview
  - Based on the premise that the prices observed in the public stock market of comparable business entities can provide a relevant benchmark for value
  - A valuation multiple based on the stocks trading price is applied to a measure of economic income to arrive at an indication of value
- Challenges
  - Finding comparable and relevant companies
  - Time consuming and expensive

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Discounted Future Returns

- Overview
  - Used when current or historical results are not indicative of the future
  - Projection of income over a discreet projection period then capitalizing normalized income in the terminal year

- Challenges
  - Developing forecasts
  - Duration of discreet projection period

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Discounted Future Returns

		Year 1	Year 2	Year 3	Terminal Value
Projected income		$ 50,000	60,000	70,000	**327,727**
Discount factor	25%	0.80000	0.64000	0.51200	0.40960
Present value		$ 40,000	38,400	35,840	134,237
∑ Present Value (rounded)		$ 248,500			

<u>Terminal Value</u>

Projected income		$ 70,000
Increased by growth	3.0%	72,100
Capitalized at:		22%
Terminal value		**$ 327,727**

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Valuation Discounts

- Discount for Lack of Control
  - Minority shareholders lack the ability to appoint management, set compensation, sell assets, and declare dividends

- Discount for Lack of Marketability
  - When compared to the stock market, closely held business interests are not liquid

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