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CPAs & Advisors

Basic and Intermediate Valuation

Hoosier Hills Estate Planning Council

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Value

"In the simplest sense, the theory surrounding the value of an interest in a business depends upon the future benefits that will accrue to its owners.   The value of the business interest, then, depends upon an *estimate of the future benefits* and the *required rate of return* at which those future benefits are discounted back to future value as of the valuation date."

[Pratt, et. Al, "Valuing a Business", p. 56}

Executive Summary

Understanding the conclusions reached in a Business Valuation report requires a basic understanding of the economic theory underpinning the generally accepted valuation approaches.

Familiarity with the concept of “Levels of Value” will also aid in understanding the conclusions reached by the BV professional.

By becoming familiar with the professional environment for BV services – and combining that knowledge with a basic understanding of BV concepts – attorneys and their clients can critically evaluate and understand the valuation conclusions reached in their reports and better understand their ownership succession options.

Evolution and Growth

- Need for BV services has grown
- Increased Legal Requirements
- Increased Regulatory Requirements
- Milestones:
  - USPAP Standards
  - Business Valuation Standards
    - (American Society of Appraisers)
  - AICPA “Statement on Standards for Valuation Services – 1” (SSVS)
  - Pension Protection Act (2006)

Business Valuation Theory and Principals

Business Valuation Guidance

- Revenue Ruling 59-60
  - Issued for tax related valuations
  - Referenced today for most valuations
  - Accepted and referenced regularly in the court system for all types of valuations

Revenue Ruling 59-60

- 8 Factors to Consider
  - Nature of business and history
  - Economic outlook overall and for specific company
  - Book value of the stock and financial condition of company
  - Earning capacity of company
  - Dividend paying capacity of company
  - Potential goodwill or other intangible value
  - Sale of the stock and size of block to be valued
  - Market price of public stocks in the same/similar line of business

What is Value?

Fair Market Value Definition:

> The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties have reasonable knowledge of the relevant facts. (Revenue Ruling 59-60)

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Valuation Approaches

- Income Approach
- Market Approach
- Asset Approach

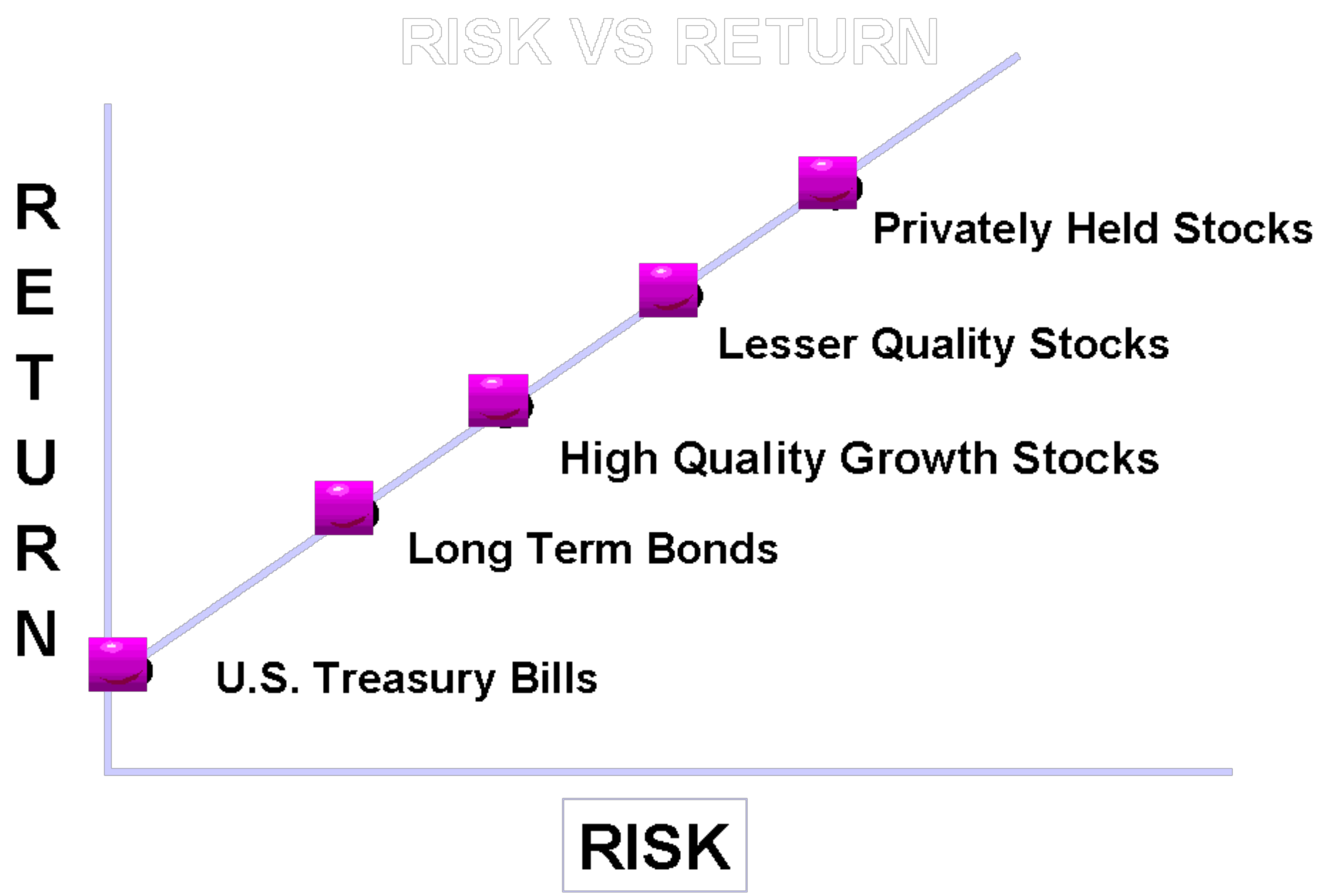
Valuation professionals assess the applicability of each approach, given the facts and circumstances of a specific engagement

Income Approach

- Estimate the Benefit Stream
  - Cash Flow
  - Earnings

- Determine appropriate Rate of Return
  - Multi-Year: Discounted Cash Flow
    - Cash flows may vary from historical performance
  - Single-Period: Capitalized Cash Flow
    - Cash flows are expected to be similar to historical performance

Risk vs. Return



Discount Rate

- Build-up Approach or Capital Asset Pricing Model (CAPM)
- Rate is applicable to net cash flow
- Must match selected earnings/cash flow stream
- If elected stream is different than net cash flow, adjustments need to be made

Determining Equity Discount Rate

Risk Free Rate	3.0%
General Equity Risk Premium	8.0%
Small Stock Size Premium (10th Decile)	6.0%
Specific Risk Premium	5.0%
Cost of Equity Capital for Subject	22.0%

Determining Debt Discount Rate

- Based on current borrowing rate
- Prime rate
- Moody’s rates
- Blend of rates if multiple terms of debt exist
- Minority vs. control matters
- Credit for “unused” debt capacity

Weighted Average Cost of Capital (WACC)

- Determine equity rate and debt rate
- Rates are blended together appropriately
- Blended based on inherent capital structure or market “optimal” structure
- Final WACC is applicable to “debt free” cash flow
- Debt is subtracted from “enterprise” cash flows

Market Approach

- Guideline Public Companies Method
  - Compare subject to publicly-traded companies
    - Works best for larger private companies
    - Industries with public “comparables”
  - Comparisons on size, profitability, growth, risk
  - Apply relevant “multiples” to subject company
    - Price/Earnings (EBITDA)
    - Price/Revenue
    - Price/Book

Market Approach

- Guideline Merged and Acquired Company Method
  - Compare subject to M&A transactions
    - Public company acquisitions
    - Private company acquisitions (data available?)
  - Comparisons on size, profitability, growth, risk
  - Apply relevant “multiple” to subject company
  - Price/Earnings (EBITDA)
  - Price/Revenue
  - Price/Book
- Data is difficult to find and can be unreliable

Asset Approach

- Net Asset Value Method
  - Generally used for holding type entities
- Liquidation Value Method
  - Generally used for companies with poor financial performance
  - Orderly liquidation
  - Forced liquidation
- Not typically applicable in a transaction situation

Levels of Value

Strategic Control Value

- Synergies that can enhance deal price
- Vary by deal, by industry

Control Value

- Influences Strategic Direction
- Can sell the business
- Profits taken distribution vs. salary

Minority Marketable Value

- Shareholder can liquidate interest
- Does not control distributions, strategy
- “As If Publicly Traded” value

Minority Non-Marketable Value

- No secondary market for these interests
- Restrictions on transfer & sale common

Beyond the Basics: Unique Situations in the Valuation Process

Balance Sheet Considerations: Non-Operating Assets and Non-Operating Liabilities

Typical Non-Operating Assets

- Real estate owned in company
- Excess land (untouched for several years)
- Notes receivable
- Airplane
- Other unrelated business assets
- Cash value of life insurance
- Developed technology not currently producing cash flow

Example: Real Estate Owned by Company

- Fair market value rent adjustment
- Discount rate applicable to real estate is different than operating business
- Affects “optimal” capital structure
- Treated different in control vs. minority situation
- May be retained by seller in transaction

Non-Operating Liabilities

Non-Operating Liabilities

- Pension obligations
- Deferred compensation
- Debt fair value adjustments
- Unbooked liabilities
- Lawsuits
- Environmental issues
- Seller-Financing

Capital Structure

Capital Structure

- Preferred stock
  - Dividend required
  - Redeemable
  - Accrued dividends or not
  - Conversion features
  - Fair market interest rate
- Stock options
  - In or out of money
  - Vesting issues on change of control
  - Dilute for shares
  - Exercisable
  - Restricted

Capital Structure

- Subordinated Debt
  - Interest rate terms
  - Conversion features
- Warrants
  - Typically attached to second tiered debt
  - Usually converted on sale
- Profits interest
  - May only participate in sale proceeds once “floor” is reached
  - Can be incentive for non-capital owner
  - LLC’s can have multiple classes of equity interests
  - S-Corps allow for less flexible ownership classes

Income Statement Considerations: Typical Normalization Adjustments

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Normalization Adjustments

- Non-recurring or extraordinary items
- Discontinued operations
- Non-essential asset or liability expenses
- Life insurance expense
- Property taxes (excess land)

Normalization Adjustments

- Personal expenses
  - Golf membership
  - Charitable contributions
  - Airplane expenses
  - Car leases
  - Entertainment expenses
  - Excess compensation
  - Family compensation
  - Excess retirement benefits
  - Benefit expenses related to excess compensation

Working Capital

Working Capital

- Excess cash
- Excess current assets vs. current liabilities
- Industry comparison
- Excess cash can be distributed prior to sale
- AAA account consideration
- Working capital “target” negotiated in purchase agreement
- Escrow account/holdback for working capital, or various other protection issues

Unique Industry Valuation Metrics

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Trucking

- Drivers – employed or independent
- Trucking fleet
- Logistics entity
- Trucking lines may be important to a strategic buyer
- Long haul vs. short haul
- Perishable vs. non-perishable
- Age of fleet (large CAPEX)
- EBIT more meaningful than EBITDA
- Proceeds from sale of used equipment

Service Businesses

- Asset light
- High wage structure
- Industry niche
- Personal vs. corporate goodwill
- Transferability of relationships
- EBITDA and earnings usually not too different
- Non-compete agreements important

Construction/Contractors

- Low margins
- Bonding issues make it difficult to leverage
- Multiple of book value more typical "rule of thumb"
- Backlog of projects important to buyer
- Diversification of project type
- Inconsistent cash flow

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Distributors

- Distribution from various manufacturers
- Tied up with one provider
- Contract with one large customer can make or break company
- Less diversified = lower multiple
- Exclusive territory or low barrier to entry
- Value added distributor

Business Owner Succession Options

Succession Options

- Family Succession
  - Opportunity for next generation
  - Legacy continues
  - Emotional issue
- Sale to Outsiders
  - Owner liquidity
  - Risk / challenges of industry
  - Desire to pursue other interests
- Sale to Insiders
  - Management opportunity
  - Employees (ESOP)

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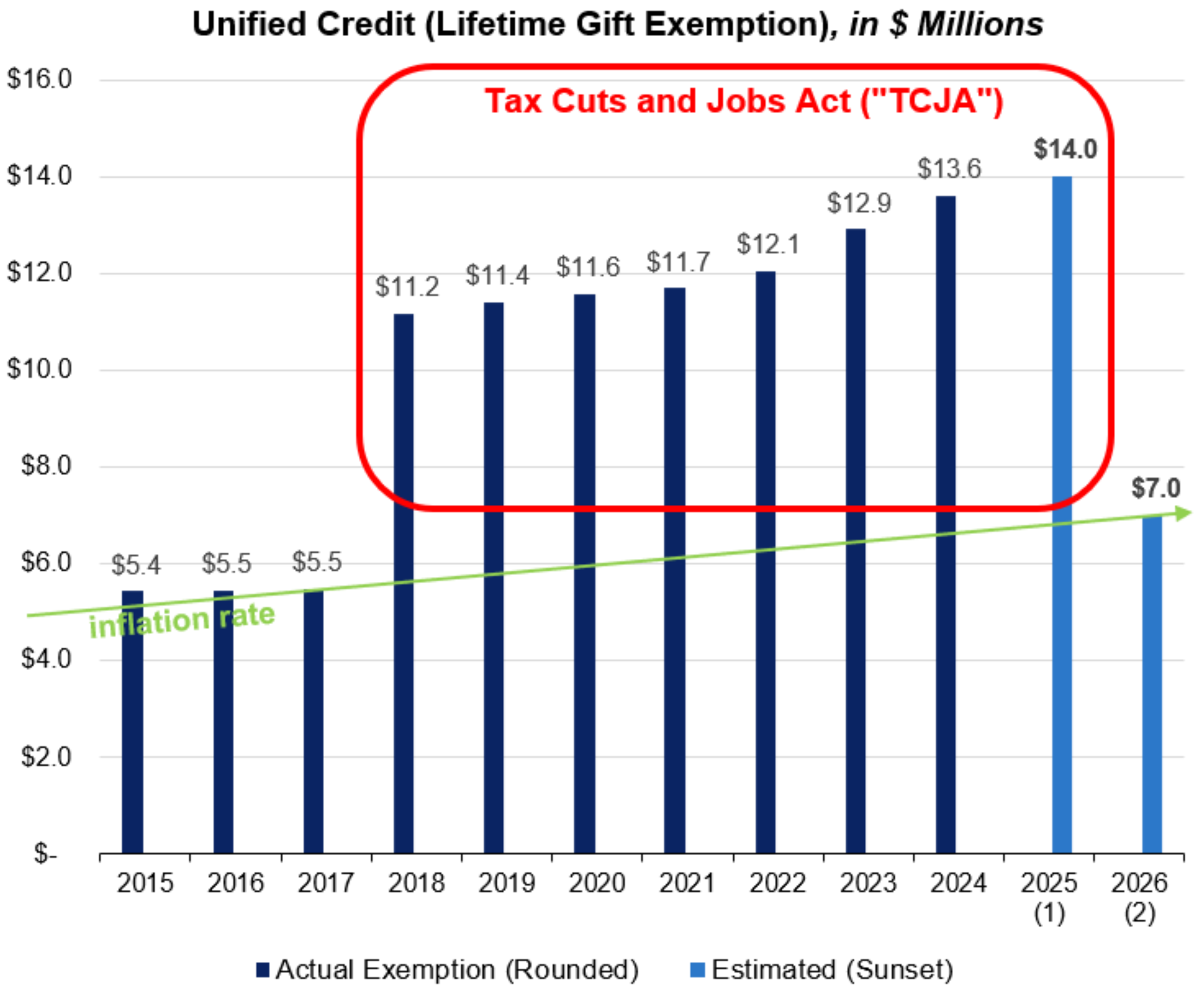
Types of Family Transfers

- Stock sale
- Asset sale
- Installment sale
- Gifting
- Spousal Lifetime Access Trust (SLAT)
- Grantor Retained Annuity Trust (GRAT)
- Intentionally Defective Grantor Trust (IDGT)
- Self Canceling Installment Note (SCIN)
- Family Limited Partnership (FLP)
- Corporate redemption

Tax Cuts and Jobs Act of 2017



1. The 2025 Unified Credit is reflected at a 3% increase (increase TBD ~ November, 2024)
2. The 2026 Unified Credit reflects the reversion ("sunset"), which is "$5,000,000 plus inflation adjustments." An estimate of $7,000,000 is reflected above.

ESOPs: An Estate Planning Option

What is an ESOP?

- An Employee Stock Ownership Plan (ESOP) is an employee benefit plan that is designed to invest primarily in the sponsoring employer's stock.

- United States ESOPs
  - Approximately 7,000 ESOP companies
  - 14 million employee participants
  - $1.6 trillion in total plan assets

- Indiana ESOPs
  - Approximately 170 privately-held ESOP companies
  - Covering 98,000 participants (75,000 current employees)
  - $7.1 billion in total plan assets

Why Consider Forming an ESOP?

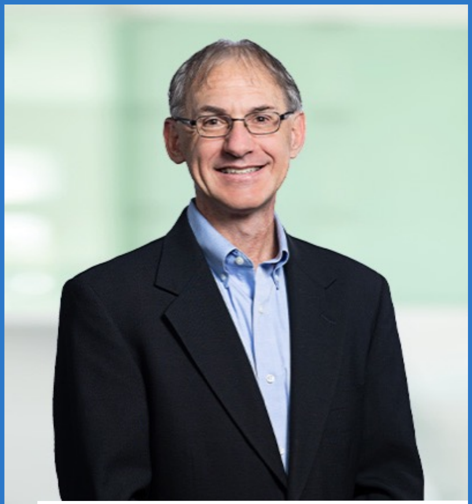
- Tax-advantaged buyer of company stock
  - S corporations with an ESOP do not pay federal income taxes for the portion of their stock owned by the ESOP
  - C corporation shareholders - §1042 Rollover allows for capital gains tax deferral on sale
  - Known buyer/exit strategy
  - Diversify seller's net Worth

- Non-tax reasons to consider an ESOP
  - Employees can participate in the growth of the company's value
  - Recruiting tool to attract talent
  - Long-term benefit to retain talent
  - Continuity of management, staff, and culture
  - Benefit to the community (headquarters can stay local)

ESOP Candidate Profile

- Owner approaching retirement
- Capable management team to succeed owner
- Unused debt capacity
- Profits to support ESOP debt service
- Company size (more cost-effective benefit)
- Motivated by tax advantages
- Motivated by “ownership culture” advantages
- Desire to buy out a minority shareholder
- Limited third party / strategic buyers in market

Presenter



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