

WHITE PAPER

BUSINESS VALUATION: A PRIMER FOR BUSINESS OWNERS

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WHY DOES A BUSINESS OWNER NEED A BUSINESS VALUATION?

Often, the largest asset in a business owner's portfolio is the business. Yet many business owners do not know the value of their businesses.

A business valuation is important for a number of reasons, but principally it answers the owner's question, "how much is my business worth?"

A business valuation helps the owner gain an understanding of the business's worth, and can be used for business succession planning, grooming the business for sale, and even for increasing the value of the business.

There are a number of other equally important reasons a business owner might need a business valuation. From a transactional standpoint, we see most activity in the areas of:

- Estate & Gift Taxes
- Divorce
- Buy-Sell Agreements
- Succession Planning
- Shareholder Disputes & Buy-Outs
- Charitable Contributions
- Litigation
- Bankruptcy
- Financing
- Mergers & Acquisitions
- Company Sales

WHAT IS “VALUE”?

Value is largely defined by the “standard of value,” although the premise of value and level of value are two additional concepts that help to refine what is meant by “value.” Collectively, value can be defined by these three separate concepts.

“Standard of value” defines the context and meaning of “value” for the particular engagement. In other words, it defines the hypothetical conditions under which the business will be valued — all of which are predicated upon the purpose.

Standard of Value

Two of the most commonly used standards of value are “fair market value” and “fair value.”

Fair market value has widespread usage – it is used for federal tax purposes, such as estate and gift, charitable gifting, and other tax-related matters. It is also used in divorce and financial acquisitions. Hence, it is the standard frequently used by the IRS, tax courts, family court, and valuers.

Fair market value is not the layman’s definition of fair market value. It is not synergistic buying, and there are no compulsions to buy or sell. Instead, because of its tax-based origins (e.g. estate and gift), it is defined by Revenue Ruling 59-60. This ruling assumes a hypothetical arm’s length sale, without regard to a specific buyer or seller, in that both parties are willing, with no compulsion to buy or sell.

Alternatively, “fair value” is more ambiguous and is seldom defined in state statutes. It is court-determined, based on case law, ever-evolving, and varies by state. In most states, it is typically employed when a minority shareholder believes they will not get adequate consideration for his or her ownership percentage. Most states dictate the use of “fair value” when the valuation purpose is shareholder disputes, corporate or partnership dissolutions, or going private.

The American Law Institute defines the concept as:

- The value of the eligible holder's proportionate interest in the corporation, without any discount for minority status, or lack of marketability.
- In many states, the difference between "fair market value" and "fair value" is just that: fair value employs no lack of control or lack of marketability discount.
- However, not all jurisdictions follow it, so we seek the definition of value from legal counsel.

The remaining two standards of value used by valuers are:

Investment value is the value to a specific or prospective owner, rather than the hypothetical buyer. It reflects synergistic buying and includes a synergistic, or acquisition, premium that reflects the additional value to that particular buyer. This method is used in mergers and acquisitions.

Intrinsic value is generally used by financial and security analysts and is based on analytical judgment. In stock analysis, it is referred to as the "appropriate price," "true worth," or "real worth" as opposed to the market price. The term is vague and, even in court cases, it is often not clearly defined.

Premise of Value

Once the standard of value is determined, the premise of value is derived.

"Premise of value" is defined in *The International Glossary of Business Valuation Terms*¹ as: "an assumption regarding the most likely set of transactional circumstances that may be applicable for the subject valuation; for example, going concern, liquidation." Going concern value² and liquidation value³ are considered the two primary premises of business valuation.

Thus, the premise of value is decided based upon whether the business is worth more as a going concern or as an orderly liquidation. This is consistent with the "highest and best use" concept in real estate appraisal that states the appraiser must consider "the reasonably probable use that produces the highest property value," of which, the ultimate selection thereof, "may or may not be the current use of the property."

¹ *The International Glossary of Business Valuation Terms* is a glossary jointly approved by the American Institute of Certified Public Accountants, the American Society of Accountants, the Canadian Institute of Chartered Business Valuators, the Institute of Business Appraisers, and the National Association of Certified Valuation Analysts.

² *The International Glossary of Business Valuation Terms* defines "Going Concern" as "an ongoing operating business enterprise," and "Going Concern Value" as "the value of a business enterprise that is expected to continue to operate into the future. The intangible elements of going concern value result from factors such as having a trained work force, an operational plant, and the necessary licenses, systems, and procedures in place."

³ *The International Glossary of Business Valuation Terms* defines "Liquidation Value" as "the net amount that would be realized if the business is terminated and the assets are sold piecemeal. Liquidation can be either 'orderly' or 'forced'."

COMPREHENSIVE DUE DILIGENCE IS A NECESSITY

Before we value, we do our homework. First, we analyze the industry, the economy, the future outlook, as well as the company itself. **A strong analysis of external and internal value drivers is critical to valuing the company.**

External Value Drivers

Industry plays a critical role in the valuation of the company. Life cycle stage is pertinent — is the industry in the growth phase, mature stage, or declining stage of its life cycle? Are there special industry risk factors or growth opportunities? What is the competitive landscape of the industry? Are new major competitors or disruptors entering the industry? Do population demographics play a role? Are there specific value drivers and demand determinants present in the industry?

The economy also plays a crucial role in the value of the business. Depending upon the size of the company, we will examine the status of the local, regional, national, and international economy. Is the business cyclical, or is it resistant to economic conditions? Is the business susceptible to personal and household disposable income, consumer spending, gross domestic product, housing market, interest rates, population growth, or economic cycles? Does consumer confidence impact the demand for its products or services? A business that is resistant to economic conditions tends to be more valuable than one that is held hostage by the economy.

Not only do we analyze the current conditions of the industry and economy, but it is equally important to consider the future outlook of each.

Next, we analyze the subject company's strengths and risk factors.

Internal Value Drivers

Primary considerations in the value of an entity are the company's strengths and its risk factors.

In considering the business's history and its reputation, an older established business with a good reputation is much more valuable than a newer business or a business with a lackluster reputation. A company with a solid organizational structure and management team, good processes in place (i.e., turnkey operation), and/or great customer service is much more valuable than one that lacks these characteristics.

We analyze the company's operations, core competencies, growth drivers, and product and service selection. We ascertain whether a company has customer or supplier concentrations, and whether it is dependent upon a specific industry. We also look at its competitive conditions, the impact of industry and economic conditions, market trends, information technology, and many other factors that would impact its growth and profitability. We consider how it manages its risk factors, takes advantage of growth opportunities, and addresses growth impediments.

Lastly, but equally important to this analysis, is to consider management's viewpoint on the degree to which these external factors, internal characteristics, and competitive advantages and disadvantages have impacted the business.

- Does the industry life cycle stage impact market conditions? For example, is the company growing, shrinking, or stagnant?
- Who are the Company's direct and indirect competitors?
- Do they have a differentiated product or service from the competition?
- Do they have technology related value?
- Do they have dominant market share or cost advantages?

With these external and internal value drivers analyzed, we are now ready to perform our in-depth financial analysis of the subject company.

Our Industry-Comparative Financial Analysis

- **Analyze five years of financials**
- **Review growth: past and future expectations**
- **Perform an industry comparative ratio analysis and rate the subject company's performance**

We start by analyzing the past five years of financial statements, horizontally and vertically, to isolate trends and growth patterns.

We then calculate the company's liquidity, coverage, leverage, and operating ratios over the past five years.

Next, we prepare a comprehensive, industry-comparative financial analysis in order to identify the company's financial strengths and weaknesses. This step is critical to assessing the company's health and performance in an objective manner. It offers deep insight into its historical growth, profitability, debt capacity, and overall liquidity. To readily gauge performance, we rate its performance for each of these measures against its industry. We then rank each indicator into performance quartiles.

This in-depth analysis serves as an indispensable benchmarking tool to isolate and understand its trends, growth patterns, and overall financial condition. Important value drivers include recurring revenues, high profit margins, and growth.

We find that this extensive operational analysis offers a sense of objectivity and can greatly aid the CFO in managing the company's financial planning, financial risk, capital structure, financing, forecasting, and in developing appropriate strategies to ensure the company's success in the future.

Only now, after having completed our due diligence, are we ready to select the appropriate valuation method(s) to value the subject company.

BUSINESS VALUATION METHODS

Valuation Approaches

The final selection of approach and methodology used to value a company is predicated on a number of factors. Among these factors are the company's growth potential, profitability, and financial strength.

Only after having completed a full analysis of the company's internal and external environment, including but not limited to an examination of its strengths and weaknesses, its industry, the economy, and its historical financial performance, is it appropriate to select a valuation approach. There are three primary approaches: an asset-based approach, an income approach, and a market approach.

Asset-Based Approach

The asset approach is generally applicable to asset-intensive companies such as real estate holding companies or companies holding significant amounts of assets or inventories. This method is appropriate when the ultimate value of the business is derived from the company's underlying assets more so than its income stream. It is also suitable for troubled companies or instances where a company's earnings or cash flow is negative or nominal and is worth less than its assets.

For service businesses, the asset approach may provide the "floor benefit," or minimum value.

The asset approach is generally not the most relevant indicator of value for a minority interest since minority shareholders typically cannot force the sale of the company assets. It is sometimes used as a test of reasonableness when compared to the income and market approaches.

The two asset-based methods include:

Net Asset Value Method: Under this method, the cost-based balance sheet is converted to market value. Appraisers are hired to value the real estate and, depending upon the size of the company, machinery, equipment, and inventory as well. During this process, the balance sheet is adjusted for missing assets or liabilities, and, if appropriate, income tax adjustments are made as well. The amount of total equity, after making these adjustments, is the entity's value.

Liquidation Method: If it is unlikely that the company is to continue operating, the liquidation method may be more appropriate. This method is used for troubled companies or when companies are "better off dead than alive." In other words, the going concern value produces a value less than the liquidation value. In such cases, assets are valued assuming either an orderly or forced liquidation.

Income-Based Approach

The income approach arrives at an entity value based on the company's benefit stream — whether it be earnings or cash flow. There are two commonly used methods:

Capitalized Returns Method: This method is used when the company's future operations are expected to be consistent with the past. Basically, this method utilizes historical earnings, allowing the valuator to convert that income stream to a lump sum value by applying an expected rate of return.

Discounted Future Returns Method: This method is used when a company's future is expected to be materially different from its past. It, too, employs the same concept as the Capitalized Returns Method (capitalization of an income stream), but instead of historical financial statements, the valuator uses forecasted earnings.

Market-Based Approach

The market valuation approach also has two commonly used methods:

Transactional (Merger & Acquisition) Method: Under this method, we examine recent sale transactions of similarly-sized companies in the marketplace using transactional databases. If a statistically relevant sample can be secured, we apply common multipliers such as sale price to revenue, sale price to earnings, and sale price to EBITDA. If there is limited data, we may use broker data to supplement our results.

Guideline Public Company Method: This method is required to be considered under Revenue Ruling 59-60. Under this method, we look for publicly traded companies that are comparable to the subject companies. We then use pricing multiples of these “guideline companies” as indicators of value. In practice, this method is typically not used because a closely-held company is usually too dissimilar from a publicly-traded company to make a meaningful comparison.

Under both the income and market methods, the benefit streams utilized may need to be normalized for a variety of reasons, including, but not limited to, eliminating nonrecurring or nonoperational items, adjusting for related party items, and, if appropriate, adjusting for income taxes.

LEVELS OF VALUE

Types of Ownership Interest & Discounts

There are many types of discounts and premiums involved in the valuation of a business, but the most often cited are tied to the level of ownership interest.

The valuation methods we discussed in our other white paper, titled *Business Valuation: Business Valuation Methods*, yield **the value of the company as a whole**. The final component of value is the “level of value.” Level of value reflects the characteristics of ownership, essentially surrounding the type of ownership interest (control or noncontrol) and its relative liquidity.

Common levels of value are:

- Controlling, marketable ownership interest
- Controlling, nonmarketable ownership interest
- Noncontrolling, marketable ownership interest
- Noncontrolling, nonmarketable ownership interest

Valuation methods are critical.

It is very important to consider the methods employed to value a company, as each method may produce a differing level of value.

For instance, the Transactional Method utilizes sale transactions of entire companies, both public and private. Because of this, the method yields the value of the company on a control basis. If the transactions of private companies are used, the result is a controlling, nonmarketable value. If public companies are used, the result is a controlling, marketable value.

The Guideline Public Company Method yields the value of the company on a noncontrolling (minority), marketable basis since the underlying multiples are derived from publicly-traded stock.

A controlling interest might have no discounts associated with it and might even include a premium. When valuing a minority (noncontrolling) interest in a business, however, the applicability of a lack of control discount is considered. Additionally, when valuing a closely-held company, a discount for lack of marketability is considered.

Discount for Lack of Control

Clearly, a controlling shareholder enjoys more benefits of controls than the minority shareholder. The following is a list of some of the more common benefits of control associated with a controlling shareholder.

Common Attributes of Control

- Appointing management or members of a board of directors
- Setting operational or strategic policy and changing the course of business
- Acquiring, leasing, or liquidating assets
- Selecting suppliers, vendors, or subcontractors
- Negotiating mergers and acquisitions
- Liquidating, dissolving, selling, or recapitalizing the company
- Selling or acquiring treasury stock and registering D/E securities for public offering
- Declaring or paying dividends
- Changing the articles of incorporation or bylaws
- Setting compensation or perks for management, related-party employee, or one's self
- Selecting joint ventures and entering into joint venture and partnership agreements
- Deciding products, services, pricing, markets, locations, and customer categories
- Entering inbound/outbound license and sharing agreements (intellectual property)
- Blocking any or all of the above actions

Source: Valuing a Business, 4th Ed., Dr. Shannon Pratt

Because a controlling shareholder enjoys these benefits of control, it stands to reason that the minority interest is worth considerably less as a result of his or her lack of control, and, thus, we employ a discount for this lack of control. Tax courts have recognized substantial discounts for minority interests. For instance, with a minority interest, a minority (lack of control) discount is applied; however, with a majority interest, no such discount is applied.

In order to quantify the lack of control, or minority discount, we first begin with empirical data and use these results as a benchmark for our discount. Specifically, we use a database that compiles annual statistics on publicly announced mergers and acquisitions.

If the subject company holds substantial real estate, we also look at real estate programs, such as limited partnerships and investment trusts, traded in the secondary market.

From this benchmark, we must also consider company-specific and ownership-specific factors that would tend to increase or decrease the discount. We also consider fragmentation of the remaining ownership interest, overall voting rights, the power to influence action, as well as discounts on an industry-specific basis. Once we gather all related information, we may then arrive at an appropriate level of discount.

Discount for Lack of Marketability

All closely held companies lack a readily available market. Thus, there is an inherent lack of marketability. The discount for lack of marketability recognizes that one cannot simply call up a broker and ask them to sell shares in the subject company, and receive cash within days.

To calculate an appropriate discount, we form a preliminary benchmark based on empirical data derived from restricted stock and IPO studies, option pricing models, and court cases. Next, we apply company-specific and ownership interest-specific factors that may warrant an upward or downward adjustment from our benchmark. We also consider factors identified by the IRS as well as the profession that would impact the level of marketability. Finally, we consider additional factors used by the court in the 1995 landmark case, *Bernard Mandelbaum et al. v. Comm.*, to determine the level of discount.

As can be seen, it is not until we have fully considered the empirical studies, theoretical models, court cases, and refined the analysis utilizing a variety of models designed to account for company-specific and interest-specific factors, that we arrive at our overall conclusion for a lack of marketability discount.

Discount for Lack of Voting Rights

The discount for lack of voting rights is considered when the company has non-voting shares.

When valuing very small minority interests where there are large amounts of both voting and non-voting stock outstanding, there may be little or no difference in values. Thus, no discount would be warranted.

Whether a discount is applied depends on the size of the block and distribution of ownership. Our research indicates that in most cases, the discount, if warranted, is negligible in comparison to the discount for lack of control and for lack of marketability.

FINDING THE RIGHT BUSINESS VALUATOR

It is best to hire an unbiased professional — a business valuation expert with recognized credentials from a reputable business organization who is replete with the appropriate training, education, and experience.

The major professional organizations currently awarding designations in the business valuation field all require experience, written exams, report submissions, and may require continuing education on a prospective basis. The following qualifications for the credentials are written to be general in nature. For an accurate recital of the qualifications necessary for the designation, the actual entity awarding the designation must be referenced.

- **American Institute of Certified Public Accountants:** The AICPA awards the **ABV** designation. The individual must be a CPA, pass rigorous testing, and be experienced in business valuation.
- **The National Association of Certified Valuation Analysts:** The NACVA awards the **CVA** designation to CPAs who have completed training and passed an exam. The **AVA** designation is awarded to non-CPAs holding a business degree and who have substantial experience in business valuation from current or former employment.
- **American Society of Appraisers:** Originally founded as a real estate appraisal organization, the **ASA** credential is awarded to an individual with a 4-year college degree (or equivalent) and extensive professional business experience.

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