
Business Valuation Primer for Attorneys

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The numbers don't lie
...we tell their story.

Agenda

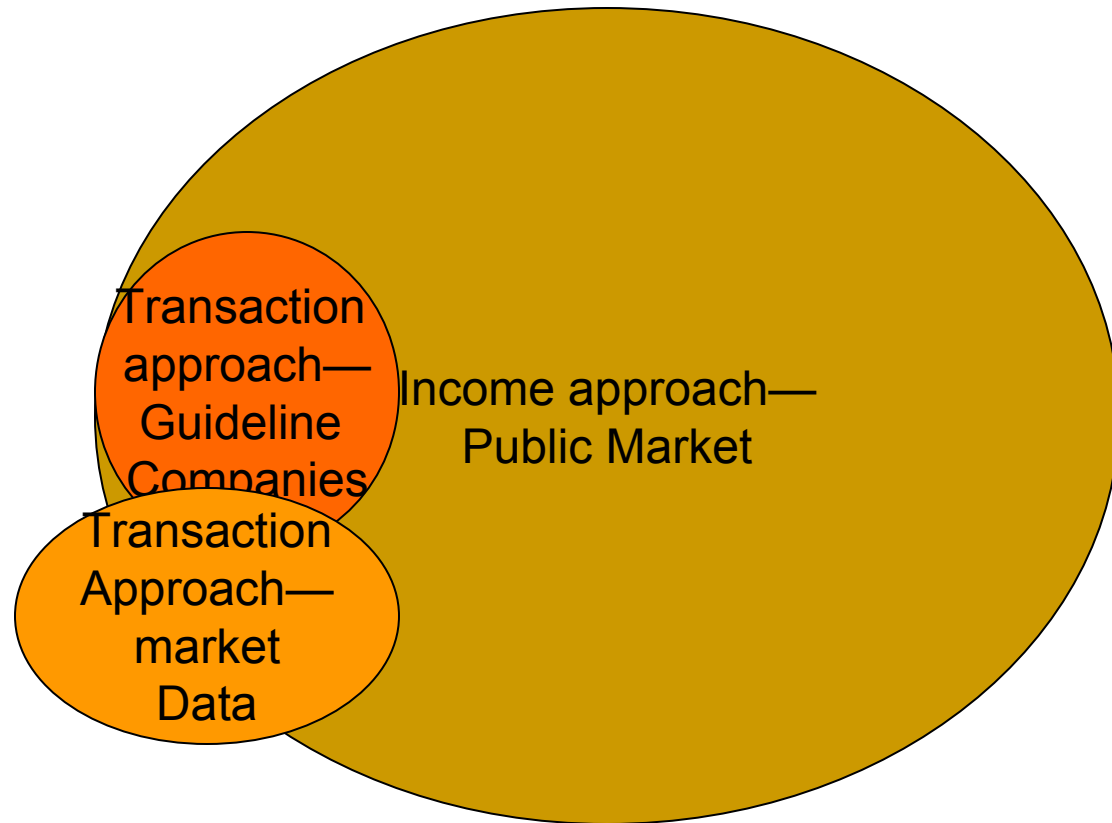
- A (very) brief primer on valuation
- Information and the reliance on it
- Standards of value and conundrums therein
- Designation & valuation standards overload

A (very) brief primer on valuation

- Three Approaches
 - Income Approach
 - Market Approach
 - Asset Approach

Its all about cash flow and the risk of getting it.

Valuation Methods



Income approach: a prophecy of (someone's view of) the future

- **The Company (doing the buying out):**
 - Business is off 20% from last quarter, and it looks like its going to get worse.
 - Costs are going up dramatically.
 - We have a significant new competitor who is putting us out of business.
 - We have severe regulatory risks and a key person who is threatening to leave and compete
 - We need to conserve all cash so that we're prepared to deal with these dire circumstances
- **The minority shareholder (being bought out):**
 - They just designed a new product that they are projecting 20% revenue increases
 - They are installing new high-speed machines that will dramatically cut costs
 - A key competitor just went out of business
 - No agency monitors the regulations and they've already hired a replacement.
 - They are paying their exec's excess compensation instead of the dividend they should be paying me, and they have the cash to do it.

Income approach

Our task: to reconcile these opposing views through:

- Documents and information from company
- Independent research and analysis

	Buyer says		Seller says	
Sales	\$ 900,000	Business is off, new competition	\$ 1,200,000	Revenues are increasing, competitor just went out of biz.
Cost of sales	38%		34%	installed new machine that will improve efficiency
	\$ (342,000)		\$ (408,000)	
Gross profit	\$ 558,000		\$ 792,000	
G&A expense	13%	Costs are going up	11%	
	\$ (117,000)		\$ (132,000)	
Operating profit	\$ 441,000		\$ 660,000	
Capitalization rate	22%	Regulatory risk and key person	17%	No more risk now than any other time related to regulation; key person already replaced.
	\$ 2,004,545		\$ 3,882,353	
Add: benefit to pass-through entity	10%		20%	
Indicated value, income approach	\$ 2,205,000		\$ 4,658,824	
Add: excess cash	0		\$ 500,000	
Indicated value, income approach	\$ 2,205,000		\$ 5,158,824	

The court's frustrations with this...

“It is not unusual for the opinions of the experts to differ by a factor of ten. It is, therefore, not surprising that courts have evidenced frustration with this process.”

The Shareholders' Appraisal Remedy and How Courts Determine Fair Value, 47 Duke L.J. 613, 629 (1998)

“Accordingly, perhaps I should consider myself fortunate, since the experts in this case vary by a factor of only about five (\$9 million at bottom; \$48 million at top).”

Kaplan v. First Hartford Corp. --- F.Supp.2d ----, 2007 WL 973941 (D.Me. Apr 02, 2007)

For all those reasons experts are so far apart...

The courts are exercising their gate-keeping role

- In 2007, 41% of all challenges to financial experts were successful at excluding the expert's testimony in whole or in part.
- 70% of exclusions target plaintiff's experts
 - *2000-2007 Financial expert witness Daubert study* by PricewaterhouseCooper (PwC), http://www.pwc.com/en_US/us/forensicservices/assets/2000_2007_daubert_study.pdf

Requirement for the expert to reconcile these views:

Federal Rule of Evidence 702: Testimony by Experts

- If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training or education, may testify thereto in the form of an opinion or otherwise if (1) the testimony is based upon **sufficient facts or data**, (2) the testimony is the product of **reliable principles and methods**, and (3) the witness has applied the principles and methods **reliably to the facts of the case**.

- **Financial experts are *evidence gatherers*; collectors of proof for the claim**

Something else to consider in the application of the income (and market) approach....

Private C corporation v. Pass-through entity				
	C corp		Pass-through	
Revenue Level	Operating profit	Compensation	Operating profit	Compensation
\$0-<\$1M	1.9%	10.5%	10.0%	8.1%
\$1-<\$10M	1.4%	5.2%	7.2%	3.3%
\$10-<\$30M	3.4%	1.9%	7.7%	1.1%
\$30-<\$50M	4.4%	1.3%	8.0%	1.3%
>\$50M	5.2%	nm	4.9%	0.1%

Pratt's Stats™

C Corp v. S Corp Operating Profit Margin By Revenue Range
Through Feb. 2009

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Market (transaction) approach

- Probably least understood and most mis-applied method, leading to most material mis-statements of value.
- Difficulties in knowing what comparable transactions included
 - Difficult, but not necessarily impossible.
- Difficulties in finding true “comparables”.
- Nevertheless, strong method that can provide good evidence of value, *if properly applied and if data exists.*

Acquisition of Machine Products Company

- For assets of the Company, the owner was paid:
 - ✓ \$7.2 million cash at closing
 - ✓ 250,000 shares of buyer's stock—restricted, could be put at \$4, 8K noted \$2 value and 15% discount
 - ✓ Performance based earn-out
 - ✓ 3-year CNTC @ \$300,000
 - ✓ Employment contract
 - ✓ 5 year lease with 5 year renewal
 - ✓ 3-year, performance-based earn-out

Single deal, as reported by three databases

	<u>Pratt's Stats</u>		
Seller	3541		
SIC Sales	\$9,439,346		
Sales as of	12/31/97		
Price (EV)	\$8,037,500		
Note:	✓ Notes in terms that buyer's stock is valued @ \$500,000, value includes CNTC, and mentions earn-out.		
P/R Multiple	0.85		

Single deal, as reported by three databases

		<u>Done Deals</u>	
Seller		3569	
SIC Sales		\$8,200,000	
Sales as of		Annualized – 3 months	
Price (EV)		\$13,600,000	
Note:		✓ Adds earn-out and stock valued at \$425,000; no debt.	
P/R Multiple		1.66	

Single deal, as reported by three databases

			<u>Mergerstat</u>
Seller			3566
SIC Sales			\$8,620,000
Sales as of			LTM
Price (EV)			\$15,520,000
Note:			✓ Provides revenues for ea. Of 10Q latest, 10K latest, and 10K prior; EV calculated off LTM revenue.
P/R Multiple			1.82

Single deal, as reported by three databases

	<u>Pratt's Stats</u>	<u>Done Deals</u>	<u>Mergerstat</u>
Seller	3541	3569	3566
SIC Sales	\$9,439,346	\$8,200,000	\$8,620,000
Sales as of	12/31/97	Annualized – 3 months	LTM
Price (EV)	\$8,037,500	\$13,600,000	\$15,520,000
Note:	✓ Notes in terms that buyer's stock is valued @ \$500,000, value includes CNTC, and mentions earn-out.	✓ Adds earn-out and stock valued at \$425,000; no debt.	✓ Provides revenues for ea. Of 10Q latest, 10K latest, and 10K prior; EV calculated off LTM revenue.
P/R Multiple	0.85	1.66	1.82

Adjusting multiples reported by database

MVIC Price 19,838,000

EBITDA 996,679

MVIC/EBITDA 19.9

•“Consideration paid as follows: \$17,138,000 cash, \$2.7 million promissory note for real estate...”

- ...note the footnote to MVIC price says deal did not include real estate (as noted on every deal.)

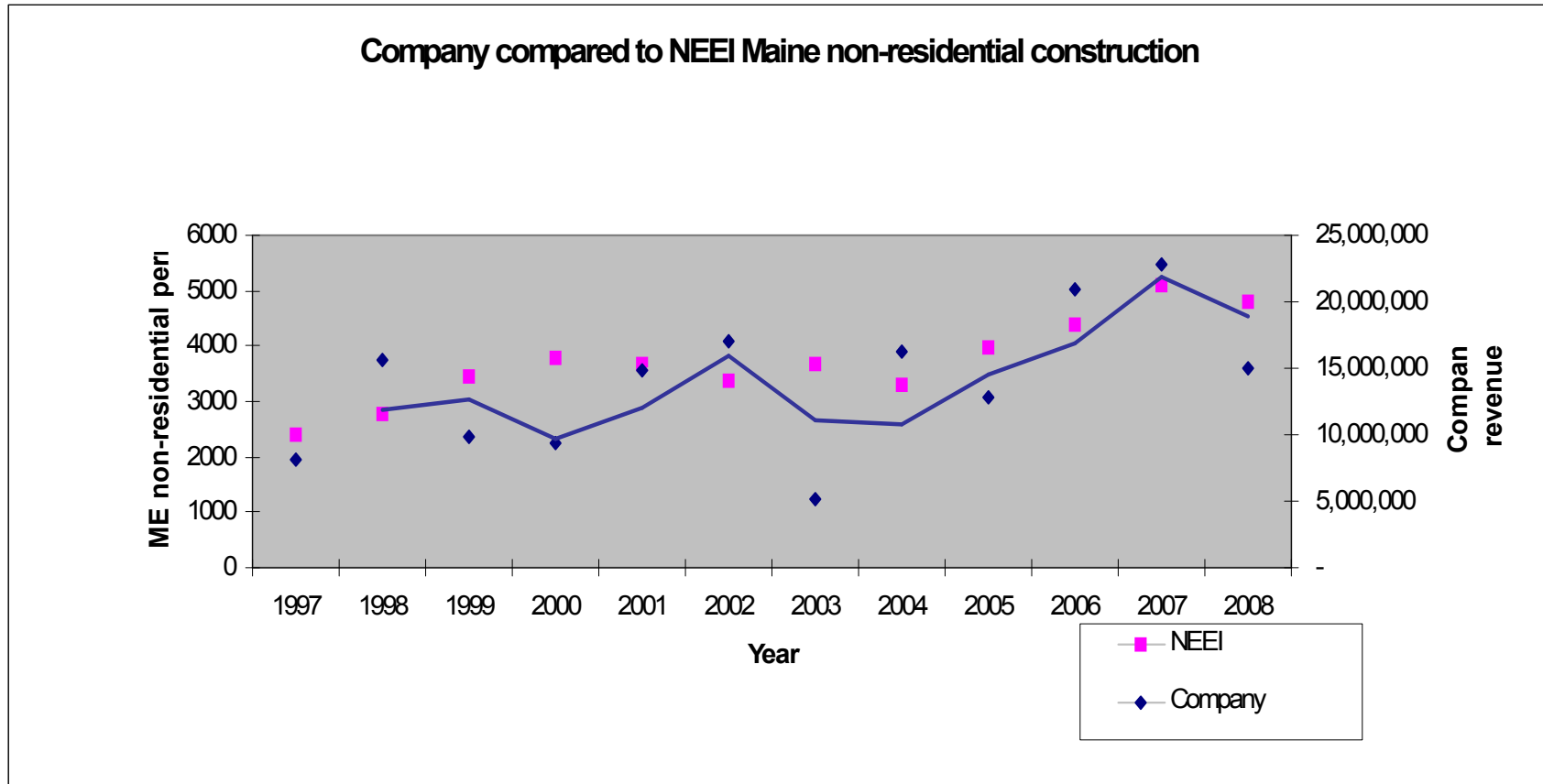
•Additional notes:

- “EBT includes stockholder bonuses expense of \$3,449,000 and other income of \$101,824.”

Every industry has special issues associated with it the analyst has to consider, such as....

- Medical Practices
 - CPT coding
- Restaurants
 - Identifying actual v. recorded revenues & income
- Construction
 - Longer historical analysis to determine cycle

Long-term trends especially important now



Conclusion of value

- Reconciliation of methods

FMV is *Cash Equivalent deal*

- Real-world deals are often not. Implications?
- Consider that in a market where there are public buyers, public buyers will often pay double what private buyers will pay.

Pratt's Stats Database, all transactions, > \$1M to < or = \$10M

Pratt's Stats Market Transactions, 1996-2008	Public buyer, Asset Sale	Private Buyer, Asset Sale
	For Companies with Revenues > \$1 million and < or = \$10 million	
Pratt's Stats C Corp Med MVIC/Sales	1.17	0.43
Pratt's Stats Pass Through Med MVIC/Sales	1.10	0.42

Public buyer v. private buyer price

- Private buyer pricing typically more reflective of “cash flow value” of the company.
- Public buyer pricing typically more reflective of “strategic value” of the company.
- Where the transaction market is all or mostly public buyers, this *is* the market for fair market value.

And so....you end up with value indications looking like this:

Value indication, income approach	\$	6,500,000
Value indication, transaction approach	\$	11,250,000

In the “real world”, these differences are typically reconciled through the terms of the deal—usually tails on the sale for a given number of years, i.e.:

Closing at proportionate share of	\$ 6,500,000
Participation of seller in proceeds of subsequent acquisition:	
Year	Percent
1	80%
2	60%
3	40%
4	20%
5	10%
6	0%

FMV conundrum.

- We do not have the luxury of agreeing upon terms
 - We are forced to determine the end-result of an all-cash transaction.
 - This involves the appraiser weighing the likelihood of a sale event in with the cash flow methodology, using the best information available.
 - In other words, the appraiser should “do” the negotiation in order to reach a conclusion.

Consideration of discounts for minority interests

- Discounts for lack of liquidity, control, and marketability
 - Highly evolving area right now

Categories of information for the appraisal

- **Financial**
 - Half internal
 - Half external

- **Operational**
 - Half internal
 - Half external

Document & Information Request

- Attempt to make sure that both sides understand the role of appraisers and why we are requesting this specific information
 - A lofty goal, seldom realized; we often have to fight for information.
- Document discovery
 - Establish at the outset of engagement
- Electronic documents
 - For better or worse?

Are costs of discovery overtaking outcome?

- ACTL study:
 - 87% cited electronic discovery as too expensive
- Fullbright & Jawarski Litigation Trends Study:
 - Cost management cited as the area of greatest concern
 - Followed by electronic discovery

Owners & Management

- *Invaluable sources of information*
- Eliciting answers from a sit-down interview v. through interrogatories
- That said, over-reliance on management is common area of expert exclusion.

Exclusion of expert based on lack of independent analysis by expert

- The court found the opinion “wholly unreliable [because] ‘the entrepreneur’s “cheerful prognostications” are not enough.’”
 - Improperly assumed the truth of the plaintiff’s own revenue projections and/or placed undue weight on the alleged decrease in plaintiff’s estimate of merger synergies

Celebrity Cruises, Id. (quoting *Schonfeld v. Hilliard*, 218 F.3d 164, 173 (2d Cir. 2000)).

Exclusions based on lack of independent analysis by expert

- Calculations were based solely upon projections in an agreement between the parties. The expert did not perform any independent market analysis to verify the reasonableness or accuracy of the projections or compare the projections with actual results achieved by other, similar enterprises

Otis v. Doctor's Associates, Inc., 1998 U.S. Dist. LEXIS 15414, *3 (N.D. Ill. 1998).

- the court cites a lengthy list of problems that permeate the expert's work

Weight v. Exclusion—Distinction between...

- Misapplication, missed, or mis-used factual data
 - Tends to go to **weight** of testimony
- Pulling out of thin air (speculation, conjecture, unsupported conclusions)
 - Greater tendency toward **exclusion**

Many cases demonstrating court's impatience with expert's over-reliance on management with lack of evidentiary support.

Standards of Value: The definition of “Value” is....



Value is either...

- Negotiated price, or
- A legal construct.

If you're hiring me, it's the latter, which is not necessarily the former.

Definitions of Value--# 1: Fair Market Value

Fair Market Value (“FMV”)—the one people always “think” you mean:

The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm’s length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of relevant facts.

Definition from the International Glossary of Business Valuation Terms, as adopted by the American Institute of Certified Public Accountants, the American Society of Appraisers, the Canadian Institute of Chartered Business Valuators, the National Association of Certified Valuation Analysts, and The Institute of Business Appraisers; February 2000.

FMV often used to buy out minority shareholder or spouse in divorce

- As well as being used and abused in many other types of cases as well
- Which has many implications for both sides of the table that affect the calculation and resulting value.

Think about the key words in “FMV”:

Cash equivalents,

Hypothetical,

Willing buyer,

Willing seller,

Arm’s length,

Open and unrestricted market,

Neither is under compulsion,

Reasonable knowledge of relevant facts.

FMV is *Cash Equivalent deal*

- Recall the conundrum of public v. private buyers....

In addition, the “Willing Buyer” is usually not so willing...

- The “willing buyer” in the fair market value construct is often represented by parties such as a company buying out a minority shareholder or a propertied spouse
 - Each of whom the legal definition for the standard of value we operate under requires us to put the “willing” mantle on, whether in reality they are willing or not.
 - A buyer, in real life, often negotiates for as low a price as possible, emphasizing the downside risk.

Neither is the willing seller “willing”...

- At the same time, the “willing seller”, often represented by the minority shareholder being bought out or the non-propertied spouse, seeks to emphasize the positive.
- Both sides, coming to the table, weigh in to the fair market value conclusion.

2: Acquisition

- Value is in the eyes of the beholder.

- But...most analysts go straight to “fair market value.”
 - Why would you do this? A seller is not hypothetical, a deal usually comes with terms, they’re usually looking for the best price they can get....

- How does one divine what’s in the eyes of the beholder?
 - With a lot of protective language, and....
 - *Extremely Careful* analysis transactions
 - *...transaction analysis book*

Acquisition value = “Investment value”

- When determining the value for an acquisition, this is sometimes defined as “investment value:
 - The specific value of an investment to a particular investor based upon individual investment requirements; distinguished from market value, which is impersonal and detached.

Post-acquisition disputes

- “Benefit of the bargain”
 - Not based on what hypothetically might have happened, but the deal that actually transpired.
 - Usually expressed as a multiple (of EBITDA, for example.)
 - And based on seller representations, deviations from past practices.

3: Value for lost profits damages

- “Lost profits” are calculated as either a lost income stream or a loss of value.
- Lost profits:
 - Losses of limited duration
- Lost value:
 - Permanent losses
- *As an aside...the corporation (technically) cannot lose value in itself*
 - *Notwithstanding this economic reality, some courts have found the corporation to be proper claimant for loss of value.*
 - *If you find lost value to the corporation, as opposed to the shareholders, it can have real, and sometimes substantial, economic consequences.*

Is “fair market value” the correct measure for lost profits damages?

- *Most analysts* automatically calculate FMV when the damages are permanent.
- Does this definition place the injured party in the same position as it would have been in had there been no injury?

Courts have defined lost value as this:

- ❑ The purpose of compensatory damages for lost *business value* is to place an injured party in the same position as it would have been in had there been no injury; that is, to compensate for the injury actually sustained (*Action Marine, Inc. v. Continental Carbon*, 481 F.3d 1302 (11th Cir. 2007))
- ❑ This is no different than the purpose of compensatory damages for lost profits: the amount necessary to “make the defendant whole” and “place it in the same position it would have been but for [the defendant’s breach]. (*Sierra Wine and Liquor Co. Heublein, Inc.*, 626 F.2d 129, 132 (9th cir. 1980))

Value in lost profits

- The “injured party”—the defendant—is neither hypothetical nor willing.
- So?
 - “hypothetical” involves making market-based assumptions that may differ from the actual business plan and direction of the plaintiff (the company), and these differences can be substantial.

The most significant difference between fair market value and lost profits--

- Fair market value requires valuation with facts known as of the date of the valuation, with subsequent events generally not considered.
- Lost profits damages consider hindsight—clearly for calculations of losses of profit, somewhat less clearly for calculations of value.
 - This single point is the point upon which more financial experts are excluded than any other issue.

Such exclusions generally related to causation:

- “...expert testimony may be excluded where the expert failed to consider other causes for the lost profits such as market saturation and reduced prices of alternate products.

See Isaksen v. Vt. Castings, Inc. 825 F.2d 1158, 1165 (7th Cir. 1987).

...lost profits book

4: Fair Value

3: Fair Value

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, unless exclusion would be inequitable.

Definition varies by jurisdiction and case law

Fair Value as “going concern”

- Discounted-cash-flow method is the most frequently used method (consistent with the notion of a going-concern valuation).
- However, courts continue to use all methods available, depending on the facts and circumstances
 - Weighing them appropriately.
 - Typically without regard to valuation discounts (a whole other can of worms....)
- Excellent resource:[1] Barry M. Wertheimer, “The Shareholders’ Appraisal Remedy and How Courts Determine Fair Value,” *Duke Law Journal*, 47 Duke L. J.

So...does the “Standard of Value” (the definition of value) matter?

- Definitely.
- And even once you get the standard, courts and jurisdictions define it differently.
- Case law precedent is extremely important—not only what they say, what they mean.
 - Because often, the conclusion reached demonstrates that they didn't mean what their words said.

A simple example of mixed messages...

- For example...
- Some states say value for divorce can't be premised on future earnings (because future earnings are not marital), so they don't allow discounted cash flow.
 - This makes no sense, as every valuation method is based on future cash flow—even a capitalization model that averages the last five years
 - Because: the average of the last five years is only a proxy for future earnings.

Sources of Authority for Definition of Value

1. Statutory law
2. Legally binding rules and regulations (Stark, for example)
3. Contractual definitions of value (such as shareholder agreements)
4. Precedential court decisions
5. Direction from the court
7. Use of IRS authority in tax situations

Professional Accreditation overload

AIBA	Accredited by IBA (Institute of Business Appraisers)
AM	Accredited Member (American Society of Appraisers)
ASA	Accredited Senior Appraiser (American Society of Appraisers)
AVA	Accredited Valuation Analyst (National Association of Certified Valuation Analysts)
BVAL	Business Valuator Accredited for Litigation (Institute of Business Appraisers)
CBA	Certified Business Appraiser (Institute of Business Appraisers)
CBI	Certified Business Intermediary (International Business Brokers Association)
CBV	Chartered Business Valuator (The Canadian Institute of Chartered Business Valuators)
CFA	Chartered Financial Analyst (CFA Institute)
CFFA	Certified Financial Forensic Analyst (National Association of Certified Valuation Analysts)
CPA/ABV	Certified Public Accountant Accredited in Business Valuations (American Institute of Certified Public Accountants)
CVA	Certified Valuation Analyst (National Association of Certified Valuation Analysts)
FASA	Fellow of the American Society of Appraisers (American Society of Appraisers)
FCBI	Fellow Certified Business Intermediary (International Business Brokers Association)
FCBV	Fellow of the Canadian Institute of Chartered Business Valuators
FIBA	Fellow of the Institute of Business Appraisers (Institute of Business Appraisers)
MCBA	Master Certified Business Appraiser (Institute of Business Appraisers)

Adapted from *The Lawyers Business Valuation Handbook*.

Accompanied by Standards overload...

- American Institute of Certified Public Accountants (AICPA)
- National Association of Certified Valuation Analysts (NACVA)
- Institute of Business Appraisers (IBA)
- Uniform Standards of Professional Appraisal Practice (USPAP)
- American Society of Appraisers (ASA)
- The Appraisal Foundation
- Canadian Institute of Chartered Business Valuators (CICBV)
- Internal Revenue Service (IRS)