



A Primer on  
**Business Valuation**

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## Valuation of Closely Held Businesses

It has often been said that valuing a business can be both incredibly simple, and at the same time absurdly complex. On the surface, the analysis that is done to value a business is really nothing more than organized common sense—gathering a bunch of data, putting it through some calculations, and coming up with that magical number.

But obviously, valuing a business is not nearly as simple as that. One of the things that makes it so complex is clearly the amount of details involved--and therein lies the devil--but the other reason they are so “absurdly complex” is the degree of subjectivity involved in the process.

Fortunately, there are more and more tools being made available that lend a degree of objectivity to this process, which is by its nature a very subjective exercise.

One of the first steps that must be taken in any valuation, once the appraiser has a clear understanding of the property being valued, is to establish the appropriate standard of value to use.

### Standards of Value

The standard of value used in a business appraisal can have profound impact on the valuation outcome. It is critical to be certain that all parties are operating under the same assumptions as to the definition of value that is being appraised.

What follows are the definitions of the most commonly used standards of value.

#### **Fair Market Value:**

“The price that a hypothetical willing buyer will pay a hypothetical willing seller, neither being under any compulsion to act and both being knowledgeable of all relevant facts.”

Some definitions add that the buyer not only be willing, but also able to consummate the transaction.

**Investment Value:**

“Investment value” is the specific value of an investment to a particular investor based upon individual investment requirements; distinguished from market value, which is impersonal and detached.

The derivation of fair market value involves creating assumptions based upon the “hypothetical willing buyer.” However, the investment value conclusion comes from analyzing the business from the perspective of a particular specified buyer. Therefore, assumptions must be made from his or her point of view.

**Value to the Marital Community (or “divorce value”):**

“Value to the marital community” is as the investment value to the marital community given their particular investment requirements.

So, the “particular buyer” in this case is the marital community.

**Fair Value:**

“Fair value” is the value of equity immediately before the effectuation of the corporate action to which a dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable.

**Intrinsic Value:**

Sometimes referred to as “fundamental value”, “intrinsic value” is the “true” value based not upon market forces, but discounted earning potential.

Intrinsic Value is different from fair market value. Although both are from the perspective of the “hypothetical willing buyer”, intrinsic value is derived in isolation from market forces

for the company as a whole. Therefore, it is the inherent earning value of the company that is considered “intrinsic value”, and high premiums that the market is willing to pay for speculative or strategic reasons are not considered.

**Strategic Value:**

The price that a specific willing buyer will pay a specific willing seller, based on an expectation of benefits that will inure to the buyer beyond that which an average hypothetical buyer would enjoy.

A financial buyer will pay no more for a company than that which can be supported by the cash flow. A strategic buyer purchases in order to benefit from financial, operational, or market synergies to be derived from the combination of the purchase with currently owned assets.

What factors are considered in a business valuation?

Many of the issues that need to be addressed in a valuation for any purpose are spelled out in Internal Revenue Ruling 59-60. Although this ruling is meant to provide guidance for valuation for estate and gift taxes, it is relevant to this discussion because these same factors are generally relevant for valuations for almost any purpose, including mergers and acquisitions, divorce, shareholder disputes, or any other reason a business may need to be valued.

Revenue Ruling 59-60 enumerates eight factors to be taken into consideration in the valuation process, as follows:

1. Nature and history of the business: simply, tell the business’s story: What does it do; what is its capital structure, form of entity; has it been growing; how diverse is its product base?
2. Economic condition generally and outlook for the industry specifically: This is an absolutely crucial step in the valuation, because it provides the key to predicting where a

company will go in the future—and it is critical to understand that value is based on the anticipation of future cash benefits, as opposed to its past history.

3. Book value of the stock and financial condition of the company: The Ruling directs you to look at the past five years of financial history of the company. Part of the reason the financial history is important is to be able to compare the company to others in its industry. For example, if the company is more sound financially than its competitors, that would tend to indicate it is perhaps less risky than its competitors, and would therefore command a higher relative value. The other reason to consider the financial history of the company is as an indicator of the future. So, although the appraiser gathers a great deal of information about the financial history of the company, what they are really trying to do is predict the financial future of that company.
4. The earnings capacity of the company, for the reasons just described;
5. The dividend paying capacity of the company--and note it says capacity, not dividends actually paid.
6. It directs you to consider intangibles, and specifically goodwill. This portion is expanded on significantly in a separate revenue ruling, which lays out a way to calculate goodwill as a separate component of value.
7. Prior sales of stock of the company, as they likely have relevance to the value; and finally
8. Sales prices of stocks of comparable companies that are traded in the active market.

### Are There Commonly Used Valuation Approaches?

There are three general approaches used to value a business, and each general approach has within it numerous “methods.” These approaches include the Asset Approach; the Market Data Approach; and the Income Approach.

## 1. **Asset Approach—**

This approach includes methods such as book value, adjusted book value, and liquidation value.

This approach is best suited for non-operating businesses and for asset/capital intense businesses, such as real estate operators and holding companies, and also for manufacturing companies. It is also suitable for a company that is about to be liquidated or any company that generates losses.

Asset based methods rely on the fair market value of the individual assets of the company. There are many variations on this theme, for example, a going concern asset value as opposed to a liquidation value. Usually, the circumstances of the valuation dictate which type of asset based method would be used.

## 2. **Income Approach—**

Income based methods, sometimes referred to as capitalization methods, tend to be the methods that are most widely used and accepted for business appraisals, because they are the methods that makes the most sense to an investor.

The basic premise of the Capitalization theory is that value of the business depends on its probable future earnings. This method is often used to value profitable companies of any type. Essentially, it answers the hypothetical question, “What rate of return would an investor require to invest in this particular business?”

Mechanically, value is determined by applying a capitalization rate to the earnings of the business. The value of all operating assets are excluded from separate consideration as they are deemed to be included in the value under this method. Non-operating assets, however, are added to the indicated value.

There are two primary factors to take into consideration when using this method:

1. What level of income is to be capitalized; and
2. What capitalization rate (rate of return) is to be used?

We will first address the level of income to be capitalized.

**Income to be capitalized:**

There are many different “levels” of income that could be determined appropriate for capitalization, including:

- Operating Profit;
- Earnings before interest and taxes;
- Earnings before interest, taxes, and owners compensation;
- Net profitability;
- Net Free Cash Flow to Owners;

and others. There is no “right” or “wrong” level of income to capitalize; rather, the important issue is to make sure that the capitalization rate correlates to whatever income level the appraiser has selected.

We start by determining what is usually called either “normalized income,” or “economic income.” This income is that level of income that is most likely to be reflected in the annual operating results of the company for some period of time into the future. Certain items are adjusted out of (or into, as the case may be) the company’s actual financial results, to arrive at what would be a level of income that would be obtained if certain “non-arm’s-length” items, such as owner perquisites, were removed from the statements.

For example, in many cases, the owner will have taken salaries in excess of what industry averages for his job type would indicate. The normalized statements would adjust annual salary to a comparable executive level. There are many other items on a closely held

company's financial statements that might be considered other than arm's-length, that might require adjustment.

### **Selection of Appropriate Capitalization Rate:**

There are several different ways you can go about arriving at an appropriate capitalization rate. In effect, that is what is done in the Market Data analysis, by use of a multiplier (rate of return) obtained from comparable sales data.

The capitalization rate for a particular business needs to take into consideration the risks associated with the business, and be based on facts relating to that business. A typical rate of return analysis begins with the minimum rate of return an investor would expect on an investment that is considered a "safe" investment, usually measured by the current market rate on long-term U.S. Government bonds.

To that safe rate, further points are added to compensate the investor for the added risk of investing in something other than a safe investment. Such additional risk factors include:

- The risk associated with investing in public markets;
- The risk associated with the size of the investment;
- Risk associated with the particular industry; and
- Risk associated with the particular business under examination, such as financial risk, business risk, and management risk.

There is a great body of empirical data available to assist in the rate of return analysis, but ultimately it is the subjective interpretation of that data, and of the company, that determines the appropriate rate of return.

Once the normalized earnings and the capitalization rate have both been determined, it is simply a matter of applying the capitalization rate to the income to come up with the value.

Again, there is no “right or wrong” level of income to use, and there is no hard and fast rule for determining the appropriate capitalization rate. It is, however, extremely important to make sure that the capitalization rate is applied to a corresponding level of income; for example, one of the most common errors in business appraisals is to apply a capitalization rate appropriate for post-tax earnings, to a level of income that is pre-tax.

### **3. Market Data Approach—**

This approach can be suitable for any type of business, if sufficient data is available to compare your company to. This data comes from two sources--publicly traded securities and data on closely held transactions. Such data, if you think you have gotten a close enough match between the company being valued and the comparable company, can then be applied against your company’s data to arrive at an estimate of value.

In many acquisitions, the consideration paid is all or partly something other than cash. Since it is usually difficult, if not impossible, to find out the terms of a prior deal, one typically needs to develop a value measure based on a cash or cash equivalent price.

You also need to have a complete understanding of exactly what was sold in the prior transactions, and what classes of assets were sold and what liabilities were assumed, because such issues can have a profound impact on value.

Some industries are characterized by lots of acquisition activity, while others have little information available. Ideally, there should be at least a few transactions that are believed to be reasonably comparable to the subject company.

#### **How do you know which method to use?**

In the end, what determines which methodology to base the valuation conclusion on? It depends; for each valuation, there will typically be one method that makes the most sense for that particular company, and for the particular purpose of the valuation.

- Acquisitions of closely held companies by an individual who intends to own and operate the business tend to be based on an income method, because an individual owner is looking to pay only that which the cash flow as a stand-alone entity can support.
  
- Acquisitions of closely held companies by a strategic (often synergistic) buyer tend to be based on a market data method.
  
- Acquisitions of capital intensive businesses or businesses with low or no profitability tend to be based upon an asset method.

However, these are far from hard and fast rules, but rather merely guidelines. Again, the individual circumstances of the valuation at hand determine the methodology selected.

Once you have established the value of the entire company, the final issue to consider is whether any valuation discounts or premiums apply.

## Valuation Discounts

The two primary discounts are marketability discounts and minority interest discounts. The former reflects the difficulties inherent in the sale of a closely held business. The latter accounts for the lower value of a minority interest in a business as compared to a controlling interest of the same business.

### Minority Interest Discount

A minority owner of a company does not have some of the key elements of control required for maximization of cash flow. As such, the value of the investment to a minority owner is lower. Some of the elements of control include the following:

- Ability to appoint management
- Ability to control management
- Ability to acquire or liquidate assets
- Ability to liquidate, sell or recapitalize the company
- Ability to authorize distributions

The discount is calculated using control premium studies as a source of data. The control premiums are measured by comparing control acquisition prices with pre-acquisition minority interest transaction prices. The difference in the two prices can be expressed either as a control premium or as a minority discount.

The studies present a range of data. It is the appraiser's job to figure out where on that data spread the subject company falls. This determination is made by analyzing two things. The first is the elements of control as listed above, taken in the context of the levels of control inherent in that ownership interest. Examples of such levels of control include:

- 100% ownership interest
- Controlling interest with liquidating control
- 51% interest – operating control (without liquidating control in a supermajority state)

- Two shareholders with 50% interests
- Plurality interest, but not majority interest
- Nonmajority, nonminority interest with “swing vote” characteristics
- Pure minority interest

The second consideration relates to how much the level of control would be reflected in a discrepancy between the cash flow to a control owner versus the cash flow to a non-control shareholder. These items are dependent upon how well the company is performing if cash flow distributions are made to shareholders, and how risky the outlook is for future cash distributions. As the risk inherent in these factors increase, the discount should rise.

### Lack of Marketability Discounts

Certainly, smaller or more remote companies will not be worth as much as larger, more accessible ones, all other things held equal. The related discount is due to a decrease in the liquidity of the investment, which increases risk and lowers value, and an increase in the time and transaction costs that would have to be incurred in order to sell the company.

The derivation of a marketability discount is dependent on a similar analysis. A wide array of studies have compared the prices of restricted stock with the prices of the same stock after such restrictions were removed. The difference is thought to indicate how a restriction on the marketability of the stock would affect its trading price.

The factors to consider have been laid out by Mandelbaum v. Commissioner, 91 F.3d 124, 78 A.F.T.R.2d 96-5159, 96-2 USTC P 60. They include the following general considerations:

- Financial Statement Analysis
- Distribution Policy
- Corporate History
- Industry Position
- Economic Position

- Management Performance
- Restrictions on Transferability
- Redemption Policies

Analysis of these factors allows the appraiser to realistically place the subject company onto a background spread of marketability discount data. An approximate discount can then be supported by qualitative analysis.

## **Typical Valuation Mistakes**

The valuation process is full of pitfalls. The number of angles and details to be considered can be overwhelming. As such, there are some commonly made oversights and misapplications that you can look out for when reviewing an appraisal report.

### **Subject, Premise, and Standard of Value**

It is helpful to question some of the underlying assumptions about the value given:

- Is the subject of the valuation the correct subject? Is it a business, or the underlying assets of the business?
- Is the premise of value correct? Should the appraisal be done on a going concern basis or on a liquidation basis?
- Is the standard correct? Does the appraiser use assumptions that lend themselves to a fair market value conclusion, but then call the value conclusion “investment value”?

### **Application of Income Approach**

The nuances and complexities of the method lend themselves to numerous places where inconsistencies can occur.

- Does the income method use a reasonable expectation of *future* earnings based upon the qualitative, factual aspects of the business? Or does it rely too heavily on past financial performance?

- Do the income level and the capitalization rate match? For example, if the capitalization rate is one appropriate for cash flow, is the earnings based upon actual expected cash flows?
- Is the overall capitalization rate reasonable based upon the qualitative state of affairs of the business?

### **Application of Market Data Approach**

The Market Data Approach is a relatively simple method, but it can be over-simplified. The following are some things to watch out for using this method:

- Are the transactions in the multiple database employed comparable to the subject company?
- Is the data used applied in a manner which is consistent with that which it represents. For example, if the multiple is one that is based upon sales price to Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA), did the appraiser apply the multiple to the appropriate level of earnings?
- Is the data abused? Did the appraiser just take the average multiple? Or did he/she attempt to reasonably place the subject company on the backdrop of the data based upon qualitative research, analysis, and conclusion?

### **Application of Discounts**

Application of discounts presents another trouble spot to review:

- Double application of discounts. Minority based assumptions are often used when executing valuation methods. If this is the case, the minority interest discount has already been applied through the assumptions. Reapplication would double count the effect of minority interest control.

- Abuse of the data. Again, this is an area for which there is empirical evidence, which should be subject to a thorough analysis relative to the subject company, as opposed to applying a straight average.

### **Valuation Conclusion**

The different methods will all yield different results. The results can vary quite widely. An appropriate reconciliation of the various indications of value should consider the strengths and weaknesses of each method in relation to the subject company and the data on which the methods are based. As with discounts, here, too, simple averages are inappropriate.