

# Business Valuation in the Context of Divorce and Issues of Professional Practices and Goodwill

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# What is business valuation?

- A measure of the worth of a business
- By measuring the cash flow that the business will produce
- And then determining the risk of receiving that cash flow

# How does a business produce cash?

- Continued operations (income approach)
- A liquidation (asset approach), or
- A sale of the entire business (market approach)

## From the non-owner spouse's perspective, it's a given that...

- Last year included some unusual expenses that won't be repeated
- The company is poised to take off and capture the market
- The company is going to do better this year than last year
- The outlook for the future is wonderful

From the owner spouse's perspective, at the same time it's also true that...

- The business owner believes that the business is extremely unique
- The current environment is fraught with risk the extent to which has never been seen before
- They've just lost their biggest customer, or if they haven't they're about to
- The owner will probably have to cut his pay for the foreseeable future.

# How do you know what's true?

- If two opposing experts accept these two dramatically different stories, what do you get?
- Two Dramatically Different Values

# Business Appraiser's Job:

- Hear the WHOLE story, from three sources:
- Owner spouse (and others at Company)
- Non-owner spouse
- Independent sources

# With that background...

- Business Valuation Methods
  - Income
  - Market
  - Asset
- What to look for when you review each method
- Professional Practice valuation
- Personal v. Practice Goodwill

# Let's start at the beginning...

- The relevant standard of value for purposes of divorce in the State of Maine is **Fair Market Value**.

*... the price at which an ownership interest 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, both parties having reasonable knowledge of relevant facts.*

# Hypothetical Investor

- The “hypothetical investor” portion of this definition seeks to place this investment in the context of the marketplace.
- Issue to be addressed is the determination of the amount that a **hypothetical investor** would pay for the stock of Company.
  - Not what it’s worth to the spouse who owns it, which might be a different answer.

# How does hypothetical investor maximize return on investment?

From one of three sources:

1. Cash generated by the on-going operations of the business;
2. Cash generated by a sale of the stock in the Company; or
3. Cash generated by a liquidation of the assets of the business.

*Income Approach; Market Approach; Net Asset Approach*

# Income Approach Generally

*Cash flow divided by rate of return equals value*

- Cash Flow  $\$100,000$
- Divided by Rate of Return  $\frac{\quad}{20\%}$
- Equals Value  $\$500,000$

After **all** expenses of the business are paid, leaving amount available for distribution to investor

- The income approach is about TWO things:
  - **CASH FLOW** and **RATE of RETURN**
  - *So when reviewing, assess these two things*

# Review of Forecasted Cash Flow

- Does it make sense in light of company outlook?
- Can it be backed by industry research?
- Is it grounded in historical cash flow, and where it varies, does it make sense?

# Income Statement – Walker Shoe Co.

	<b>2000</b>	% Sales	<b>2001</b>	% Sales	<b>2002</b>	% Sales	<b>2003</b>	% Sales
Revenue	\$6,500,000	100%	\$5,600,000	100%	\$5,585,000	100%	\$4,900,000	100%
Cost of Sales	-1,600,000	25%	-1,568,000	28%	-1,675,000	30%	-1,960,000	40%
Gross Profit	4,900,000	75%	4,032,000	72%	3,910,000	70%	2,940,000	60%
Operating Profit	565,000	9%	435,000	8%	156,000	3%	126,000	3%
Net Income	\$490,000	8%	\$340,000	6%	\$120,000	2%	-\$75,000	-2%

# What do many valuers do with Walker Shoe?

• 2000	\$490,000	* 1 =	\$490,000
• 2001	\$340,000	* 2 =	\$680,000
• 2002	\$120,000	* 3 =	\$360,000
• 2003	-\$75,000	* <u>4</u> =	<u>-\$300,000</u>
• Total		10	\$1,230,000
• Divided by			<u>10</u>
• Weighted Average			<u>\$123,000</u>

*Does this result make sense??*

# Review of Forecasted Cash Flow

- Does it make sense in light of company outlook?
- Can it be backed by industry research?
- Is it grounded in historical cash flow, and where it varies, does it make sense?

# Review of Forecasted Cash Flow

- Is it grounded in the reality of the Company, or something somebody “made up?”
- What adjustments were made
- The appraiser might have used all sorts of fancy statistics to get his forecasted income BUT: does the result make sense??
- Did the appraiser do both a “Capitalization” and a “Discounting” model?
  - Diametrically opposed growth assumptions

# Income Approach in Professional Practice

- Consider amount of cash flow available for a return on investment *after* all expenses of running the business are paid
- “Reasonable and necessary expenses” include cost of goods sold, wages, and SG&A expenses.
- Often little or no return to an investor after all reasonable and necessary expenses of the business paid.
- This is because the professionals who run the business *are* the business, and once they are paid their wages (upon which the spousal support claim is made), there’s nothing left.

## Income Approach in Professional Practice

- If excess cash flow *is* available after payment of expenses, will an investor pay for it?
- Not without a covenant not to compete
- Covenant is not marital property

# Personal Goodwill v. Practice Goodwill

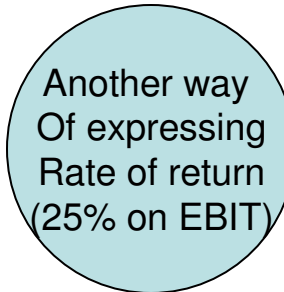
- Personal goodwill if attached to the individual
  - Not saleable
  - Not marital property
  - Usually the case in sole or very small professional practices
- Practice goodwill if attached to the practice
  - A buyer would pay for it, absent a covenant or employment agreement
  - Usually requires substantive infrastructure, multiple professionals in the practice
  - Is marital property, because it is part of the value of the business itself

# Market Approach Generally

- Company variable X market derived multiple = value

- EBIT
- Market Multiple
- Equals value

$\frac{\$125,000}{\$500,000} \times 4 \rightarrow$



Another way  
Of expressing  
Rate of return  
(25% on EBIT)

*Variable, instead of EBITDA, could be revenues, EBIT, operating income, earnings, or any other measure of income upon which a market multiple can be obtained.*

The Market Approach is about two things:

**Income Variable**....and **Multiple** (inverse of rate of return)

*So when reviewing, assess these two things.*

# Areas to focus on in review of expert's report

- Quality of Market Data
- Comparability of Guideline Companies

# Quality of Transactions

- **Duplicate A**
  - Multiple 2.21 versus 2.0
  - I/C Value \$13,260,000 versus \$12,000,000
- **Duplicate B**
  - Multiple 0.82 versus 1.7
  - I/C Value \$4,920,000 versus \$10,200,000
- **Duplicate C**
  - Multiple 0.81 versus 1.0
  - I/C Value \$4,860,000 versus \$6,000,000
- **Duplicate D**
  - Multiple 0.61 versus 1.33
  - I/C Value \$3,660,000 versus \$7,980,000

# Comparability of Companies

- Is an orthodontist like 580 dental practices?
- Is your small natural food retailer really like 280 retail grocery stores?
- Is a small start-up web-based company like Yahoo and Excite?
  
- Most comparisons are reaching, at best
- “Blind application of data” is common: who cares about median P/E ratios of 12 not-very comparable public companies? Looks impressive, if not done right adds nothing.
- Additionally, sometimes the fanciest statistical analyses leads to the most nonsensical results.

# Market data in Professional Practices

- Attempt to find comparable sales with quality data
- Quality market data is very difficult to find
- The “Goodwill Registry” includes many data points that are not transactions
- “Old” medical practice data is likely irrelevant
- Data not directly correlated to a specific practice is also likely irrelevant

# Market Approach in a Professional Practice

- Consider likelihood of cash flow continuing if stock were to be sold, what a buyer would need to do to ensure the continuation of cash flow, and how purchase price would be allocated.
  - *Same issue as income approach*
- Significant portion of acquisition price would need to be allocated to either an employment contract for future services, or to a covenant not to compete

# Net Asset Value

- Adjust Balance sheet to Fair Market Value of assets & liabilities.
  - Cash that could be generated upon liquidation of the assets.
- Often used to value professional practices, coupled with spousal support.
- *When reviewing, assess the reasonableness of the stated asset balances.*

# Adjusted Balance Sheet

	<b>Book Value</b>	<b>Adjustments</b>	<b>FMV</b>
Cash	\$20,000		\$20,000
Accounts Receivable	\$135,000	(\$10,000)	\$125,000
Due from Shareholder	\$150,000	(\$150,000)	\$0
Furniture & Equipment	\$100,000	\$25,000	\$125,000
Real Estate	<u>\$125,000</u>	<u>\$325,000</u>	<u>\$550,000</u>
<b>Total Assets</b>	<b>\$530,000</b>	<b>\$190,000</b>	<b>\$720,000</b>
Accounts Payable	\$65,000		\$65,000
Current Liabilities	\$25,000		\$25,000
Long-term Debt	<u>\$250,000</u>		<u>\$250,000</u>
Total Liabilities	\$340,000		\$340,000
Stockholder's Equity	\$190,000	\$190,000	\$380,000
<b>Total Liabilities &amp; Equity</b>	<b>\$530,000</b>		<b>\$720,000</b>

# Other areas to focus on

- What discounts were taken (LOC and MID)
- How methods were weighted
- Do discounts and weightings double dip?
  - They sometimes do, *if* there's a minority interest and *if* the appraiser weighted methods.

# Areas to focus on in review of expert's report

- The extent to which the appraiser painted a consistently positive or negative picture
- The extent to which the picture was supported by independent evidence

# Prepping for Mediation/Dep./Trial

- The best thing we can do—usually—is help you settle the case
- Use the expert as a teacher
- Assist with deposition questions & attend opposing expert's dep.
- Deposition review of owner/operator
- Prepare our testimony
- Recommend and prepare exhibits

# Income Approach Examples

- The following are examples of the Income approach that demonstrate the impact of variations in cash flow and discount rates by experts.

# Income approach—basic formula

*Cash flow divided by Rate of Return equals value*

- Cash Flow \$100,000
- Divided by Rate of Return 20%
- Equals Value \$500,000

# What to look for-Income Approach: developing the cash flow

	<b><u>Husband</u></b>	<b><u>Wife</u></b>
Sales	985,000	1,000,000
Cost of Goods	650,000	640,000
Gross Margin	335,000	360,000
SG&A Expenses	155,000	145,000
Profit before tax	180,000	215,000
Profit after tax	108,000	129,000
Plus depreciation	125,000	125,000
Less Cap X	(75,000)	(75,000)
Less working Capital	(15,000)	(10,000)
Net Cash Flow	143,000	169,000

# What to look for-Income Approach: developing the rate of return

	<u>Husband</u>	<u>Wife</u>
Safe Rate	4.4%	4.4%
ERP	<b>7.0%</b>	<b>5.8%</b>
Small Stock	<b>9.9%</b>	<b>6.0%</b>
Industry	<b>2.1%</b>	<b>2.0%</b>
Specific Company	5.0%	2.0%
Less Growth	<b>-2.0%</b>	<b>-3.0%</b>
Total Rate of Return (Cap. Rate)	<hr/> 26.3% <hr/>	<hr/> 17.2% <hr/>

# Rate of return

- The items highlighted in the previous slide are areas that either new information has recently been developed, or appraisers commonly mis-apply data.

# What to look for-Income Approach: application of valuation formula

	<u>Husband</u>	<u>Wife</u>
Net Cash Flow	143,000	169,000
Rate of return	<u>26.3%</u>	<u>17.2%</u>
Value	<u>543,726</u>	<u>985,423</u>

# What to look for-Income Approach: impact of alternatively holding cash flow/rate of return constant

	<u>Husband</u>	<u>Wife</u>		<u>Husband</u>	<u>Wife</u>
Net Cash Flow	<b>143,000</b>	<b>143,000</b>	Net Cash Flow	143,000	169,000
Rate of return	<u>26.3%</u>	<u>17.2%</u>	Rate of return	<u><b>26.3%</b></u>	<u><b>26.3%</b></u>
Value	<u>543,726</u>	<u>833,819</u>	Value	<u>543,726</u>	<u>642,586</u>

WACC: Same equity rate, debt rate, net cash flow, and debt, but dramatically different result (see next slide for why)

<b>Equity Rate of return</b>	<b>17.2%</b>		<b>17.2%</b>	
Equity Weight	<b>0.75</b>		0.55	
Debt Rate	4.5%		4.5%	
Debt Weight	<b>0.25</b>		0.45	
WACC Rate	14.0%		11.5%	
	<u><b>Husband</b></u>		<u><b>Wife</b></u>	
<b>Net Cash Flow</b>	<b>169,000</b>		<b>169,000</b>	
<b>Plus interest expense</b>	<b>30,000</b>		<b>30,000</b>	
<b>CF to Invested Capital</b>	<b>199,000</b>		<b>199,000</b>	
<b>Rate of return</b>	<b>14.0%</b>		<b>11.5%</b>	
<b>Value Invested Capital</b>	<b>1,422,699</b>		<b>1,736,854</b>	
<b>Less Debt</b>	<b>(775,000)</b>	<b>54%</b>	<b>(775,000)</b>	<b>45%</b>
<b>Value</b>	<b>647,699</b>	<b>46%</b>	<b>961,854</b>	<b>55%</b>

# WACC example

- The reason it is different is because the first expert used weights other than the actual capital structure of the company for debt and equity, which may be appropriate under *certain limited* circumstances. Such weighting can have a dramatic impact on the value determination.