Introduction to Business Valuation

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The term "appraisal" is used synonymously with the term "valuation". Therefore, a business valuation is the same as a business appraisal. A business appraisal is a "supportable opinion about the worth of something"[1]. By definition, an opinion is never 100% objective and that is one of several reasons why different appraisers looking at the same business often end up with different appraisal values.

The term "value" can have several different meanings in the context of a business appraisal and that is why it is essential to define the standard of value that's being used. Examples of values include:

- Fair market value
- Fair value
- Investment Value
- Intrinsic Value

There are a number of widely accepted valuation rules but there are exceptions to each of these rules. However, the valuation process is by no means completely arbitrary. IRS Revenue Ruling 59-60 states: "It is advisable to emphasize that in the valuation of the stock of closely held corporations or the stock of corporations where market quotations are either lacking or too scarce to be recognized, all available financial data, as well as all relevant factors affecting the fair market value, should be considered. The following factors although not all-inclusive are fundamental and require careful analysis in each case:

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[1] "Understanding Business Valuation", Second Edition, p. 57, by Gary R. Trugman

(a) The nature of the business and the history of the enterprise from its inception.

(b) The economic outlook in general and the condition and outlook of the specific industry in particular.

(c) The book value of the stock and the financial condition of the business.

(d) The earning capacity of the company.

(e) The dividend-paying capacity.

(f) Whether or not the enterprise has goodwill or other intangible value.

(g) Sales of the stock and the size of the block of stock to be valued.

(h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter. "

Revenue Ruling 59-60 also states: "Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance."

Factors, such as the "Right of First Refusal" in a buy-sell agreement, can have an impact on the valuation of a company which is why it is important that a business appraiser undertakes a very thorough analysis of the subject company and its contractual obligations.

Choosing the right valuation method is an important factor in the appraisal process of the business. Three different approaches are commonly used: the income approach, the asset-based approach, and the market approach. Within each of these approaches, there are various methods for determining the fair market value of a business.

- Methods under the income approach determine value by calculating the net present value of the benefit stream generated by the business. Underlying question: What is the present value of the estimated future returns from the business? Discounting cash flows or capitalizing earnings are two methods.

- Methods under the asset-based approach determine value by adding the sum of the parts of the business. Underlying question: How much was paid, or would be paid, for the assets of the business? Adjusted book value and liquidation value are examples. This method is usually not suitable for companies that have a significant amount of intangible assets (most services companies fall into this category).
- Methods under the market approach determine value by comparing the subject company to other companies in the same or a similar industry. Underlying question: What do others pay for similar assets or returns? This approach is fundamental to valuation, as fair market value is determined by the market. Also, Revenue Ruling 59-60 obliges the appraiser to consider market data. Guideline Public Company method and Transaction Data method are the two most common examples.

Each method has advantages and drawbacks, which must be considered when applying them to a particular subject company. Appraisal standards suggest that an appraiser applies as many methods as may be suitable based on the facts and circumstances of the appraisal assignment. It is then up to the appraiser's informed judgment to decide how these values will be reconciled in deriving a final estimate of value. Applying multiple valuation methods is also a great sanity check on the assumptions used. It is commonly accepted in the appraisal community that a business valued as a going concern will generally be appraised based on the earnings or cash flow capacity of the business. Only in limited circumstances would primary weight be afforded to an asset-based approach.

It is also important to remember that the value of a business fluctuates over time. External and internal factors can change the value within days or weeks. A business appraisal therefore determines the value at a specific moment in time.

Financial Statements Adjustments

The seller's Financial Statements are the base for all valuations. Public companies always require audited Financials in a M&A transaction. Smaller, privately held businesses are often content with "CPA approved" Financials. Most business appraisers will take the Financials of the last 5 years into account, when calculating the company's value. However, before starting with any valuation assignment certain adjustments of the Financial Statements might be appropriate:

- **Comparability Adjustments**. The appraiser may adjust the subject company's financial statements to facilitate a comparison between the subject company and other businesses in the same industry or geographic location. These adjustments are intended to eliminate differences between the way that published industry data is presented and the way that the subject company's data is presented in its financial statements.
- **Non-operating Adjustments.** It is reasonable to assume that if a business were sold in a hypothetical sales transaction (which is the underlying premise of the fair market value standard), the seller would retain any assets which were not related to the production of earnings or price those non-operating assets separately. For this reason, non-operating assets (such as excess cash) are usually eliminated from the balance sheet.
- **Non-recurring Adjustments.** The subject company's financial statements may be affected by events that are not expected to recur, such as the purchase or sale of assets, a lawsuit, or an unusually large revenue or expense. These non-recurring items are adjusted so that the financial statements will better reflect the management's expectations of future performance.
- **Discretionary Adjustments.** The owners of private companies may be paid at variance from the market level of compensation that similar executives in the industry might command. In order to determine fair market value, the owner's compensation, benefits, perks and distributions must be adjusted to industry standards. Similarly, the rent paid by the subject business for the use of property owned by the company's owners individually may be scrutinized and adjusted.

Definitions of Value

It is important that a business appraiser is aware of the purpose of a valuation since laws and regulations may dictate which standard of value has to be applied. For example, an appraisal that was conducted for the purpose of determining gift and estate taxes should not be used for a stockholder dispute situation.

- Fair market value

  "The amount 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, both parties having reasonable knowledge of relevant facts"[1]. This definition implies that the property was placed on the open market for a reasonable amount of time and usually assumes the existence of a non-compete agreement between the seller and the buyer. It assumes a hypothetical buyer, not a specific one. Finally, fair market value assumes payment in cash or cash equivalents.
- Fair value

  Fair value is a legally created standard of value. Its definition varies from jurisdiction to jurisdiction and is often dependent on circumstances. One of the fundamental differences between fair value and fair market value is that in the former situation there is rarely a "willing" seller (e.g. divorce or stockholder disputes). Fair value is usually higher than fair market value. The definition of fair value in many jurisdictions prohibits the appraiser from applying certain discounts such as the "Discount for lack of control".
- Investment Value

  The investment value of a business will be different for every buyer since it is the value of a company to a particular person who may have specific investment criteria or opportunities for synergies. It answers the question of a buyer "How much is this company worth to **ME**?"

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[1] Revenue Ruling 59-60

Valuation Purposes and their applicable Standards of Value[1]

Valuation Purpose	Applicable Standard of Value
Estate and gift taxes	Fair market value
Inheritance taxes	Fair market value
Ad valorem taxes	Fair market value
ESOP's	Fair market value
Financial Acquisitions	Fair market value
Stockholder Disputes	Fair value (in most states)
Corporate or partnership dissolutions	Fair value (in most states)
Going private	Fair value (in most states)
Strategic acquisitions	Investment Value
Buy-sell agreements	Whatever the parties agree to
Marital Dissolution (divorce)	No standard is specific in most states; look to case law

Discounts and Premiums

It is customary during a business appraisal that the appraiser applies certain premiums and discounts to the subject company to arrive at an opinion of value. The type and size of the discount(s) and premium(s) applied will vary depending on the data starting point and valuation method applied. The most common discounts and premiums concern risk, marketability and control.

The market price of a publicly traded stock reflects a marketable, minority interest since public companies generally have many owners, all of whom are deemed to be minority owners due to the lack of control that they can exercise over the corporate entity.

[1] Understanding Business Valuation, Second Edition, p. 64, by Gary R. Trugman

A marketable, controlling interest in a company is the most valuable. Non-marketable, minority level is the least valuable, representing the level at which non-controlling equity interests in private companies are generally valued or traded.

Marketability and control over business decision have a profound impact on the value of an ownership interest. There are four basic levels of marketability and control:

- marketable controlling interest (a controlling share in a public company)
- non-marketable controlling interest (a controlling share in a private company)
- marketable minority interest (minority share in a public company)
- non-marketable minority interest (a minority share in a private company)

Discount for lack of marketability (DLOM)

Marketability is defined as the ability to convert the business interest into cash quickly, with minimum transaction and administrative costs, and with a high degree of certainty as to the amount of net proceeds. All other factors being equal, an interest in a publicly traded company is worth more because it is readily marketable (an owner can sell his/her shares on the stock market). Conversely, an interest in a privately held company is worth less because no established market exists.

A discount for lack of marketability (DLOM) may also be appropriate when the interests that are being valued have either legal or contractual restrictions placed upon them (e.g. restricted stock, buy-sell agreements). The DLOM is usually larger for minority interests than controlling interests since minority interests are more difficult to sell. The most commonly used source of data for determining an appropriate level of DLOM are studies involving restricted stock purchases or initial public offerings. With Revenue Ruling 77-287, the IRS recognized the effectiveness of using such data. A summary of some of the best know studies conducted between 1966 and 1995 on this subject show average DLOMs ranging from 23% to 45% with most being in the 31-36% range.[1]

[1] Understanding Business Valuation, Second edition, by Gary Trugman, Pages 269 and 270

Discount for lack of control / Control Premium

Controlling interest level is the value that an investor would be willing to pay to acquire more than 50% of a company's stock, thereby gaining the attendant prerogatives of control. Some of the prerogatives of control include: electing directors, hiring and firing the company's management and determining their compensation; declaring dividends and distributions, determining the company's strategy and line of business, and acquiring, selling or liquidating the business. This level of value generally contains a control premium over the minority level of value, which typically ranges from 20% to 50%. A 51% controlling ownership in a company is therefore typically significantly more valuable than a 49% non-controlling share in that same company.

The size of the minority discount will depend on factors such as the size of the interest being valued, the amount of control, the stockholder's ability to liquidate the company, etc. A significant, but less than 50%, interest in a public company could represent a controlling interest since it would be relatively easy to get the necessary additional votes at the annual stockholder's meeting to pass any initiative pursued by the stockholder especially considering that the likelihood of all other stockholders attending the meeting is very low.

The case law in many US states sets "Fair Value" as the standard of value for business appraisals in a divorce situation. The same case law often defines that no "discount for lack of control" may be applied to determine the fair value of the ownership interest. However, applying a discount for lack of control is an accepted and necessary step in most other appraisal situations. The ability to apply minority discounts can have a tremendous tax savings effects in situations where e.g. a minority interest is being put into a trust or valued for gift tax purposes. Appraisers regularly involved in valuing ownership interests for gift tax purposes have seen settlements between individuals and the IRS that set the total discount at 50-70% even though most documented court decisions are in the 30-40% range. It should be noted that the IRS tends to prefer settling out of court and most settlement details are therefore not available to uninvolved parties. The formula to calculate a minority discount in cases where the control premium is known is:

$$1 - \frac{1}{1+Control premium}$$

If the control premium equals 20%, the resulting calculation is as follows:

$$1 - \frac{1}{1+0.2}$$ = 16.67% minority discount

Discounts/premiums and their attribution to valuation methods1

Method	**Control/Minority**	**Marketable/Nonmarketable**
Market Approach		
Guideline public company	Minority	Marketable
Acquisition method-public company	Control	Marketable
Acquisition method-private company	Control	Nonmarketable
Asset-Based Approach		
Adjusted book value	Control	Marketable
Liquidation	Control	Marketable
Cost to create	Control	Marketable
Excess earnings	Control	Marketable or non-marketable
Income Approach		
Capitalization of benefits	Control or minority	Marketable or non-marketable
Discounted future cash flow	Control or minority	Marketable or non-marketable

To be interpreted as following: The guideline public company method will produce the value of a minority, marketable interest in a company. A control premium and marketability discount need to be applied to arrive at the value of a control, non-marketable ownership interest.

[1] Understanding Business Valuation, Second Edition, by Gary Trugman, page 358

Risk Premiums

An investment into a closely held business is always associated with a substantial amount of risk. The level of risk associated with an investment generally has great impact on the required rate of return for an investment. That is why a Certificate of Deposit (no risk) may pay 3.5%, a long term treasury bond 5%, corporate bonds (medium risk) 9% and very risky junk bonds 15% or higher. An investment into a closely held business requires a high rate of return compared to an investment into e.g. mutual funds, to compensate the investor for the associated higher risk.

A business appraiser will apply a risk discount during the valuation process to account for the risk associated with the specific appraisal subject (compared to guideline company data under the Market Approach or the risk-free rate under the Income Approach). A non-marketable minority interest in a business is more risky than a marketable controlling interest in a company. However many additional factors are being considered when calculating the appropriate risk discount. They include but are not limited to:

- Size
- Quality of Management
- Dependability on key person
- Financial performance volatility
- Nature and outlook of industry
- Nature and diversification of products/services offered
- Customer and supplier diversification
- Geographical diversification