BUSINESS VALUATIONS: EFFECTIVE PRESENTATION OF COMPLEX ISSUES

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DIFFERENT MEASURES OF VALUE

- Fair market value
- Investment value
- Intrinsic value
- Liquidation value
- Going concern value
- Book value
- Sentimental value

"VALUE" UNDER REV. RULE 59-60

The Revenue Ruling 59-60 definition of "fair market value" is:

> the price 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.

Rev. Rul. 59-60, § 2.02.

PJC INSTRUCTION ON VALUE

PJC 203.1 Value

The value of an asset is its fair market value unless it has no fair market value.

"Fair market value" means the amount that would be paid in cash by a willing buyer who desires to buy, but is not required to buy, to a willing seller who desires to sell, but is under no necessity of selling.

If an asset has no fair market value, its value is the value of its current ownership as determined from the evidence.

TRADITIONAL VALUATION APPROACHES

Cost

Market

Income

BUSINESS VALUATION APPROACHES

Cost	Market	Income
Asset-based • Book value • Adjusted book value • Asset appraisals	**Multipliers** • Multiple of revenue • Multiple of EBITDA • Multiple of other parameters	**Present value** • Capitalized earnings • Dividend discount models • Free cash flow models

ASSET APPROACH

Assets
<u>- Liabilities </u>
= Value

ASSETS OF A BUSINESS

- The assets of a business consists of –
  - (i) cash and A/R, and
  - (ii) tangible assets, and
  - (iii) intangible assets that are "identifiable", and
  - (iv) the enterprise goodwill of the business, and
  - (v) the personal goodwill of the owner & key employees.

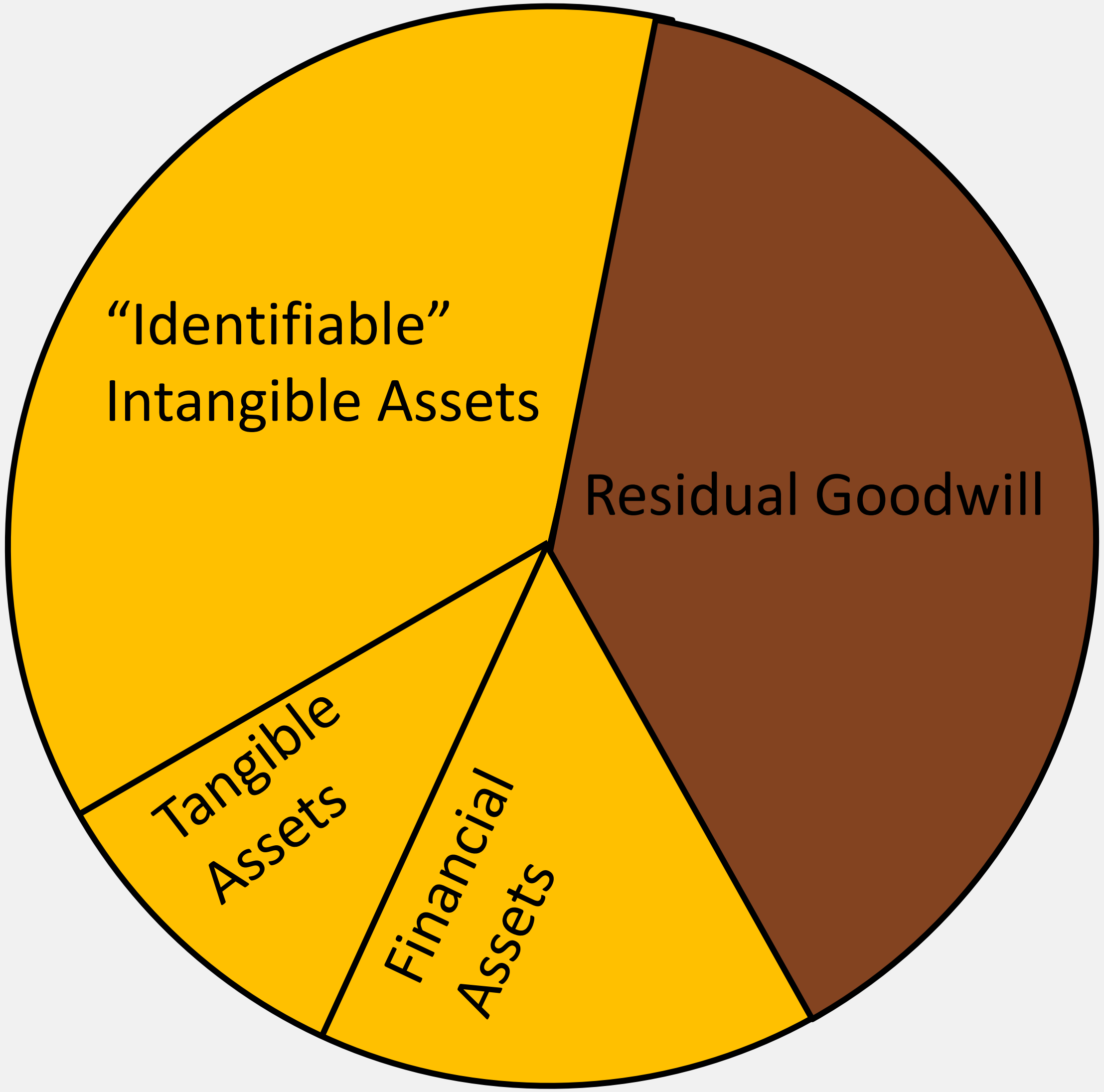
(iv) and (v) together constitute "residual" goodwill.

(iv) and (v) are not reflected on the business's Balance Sheet.

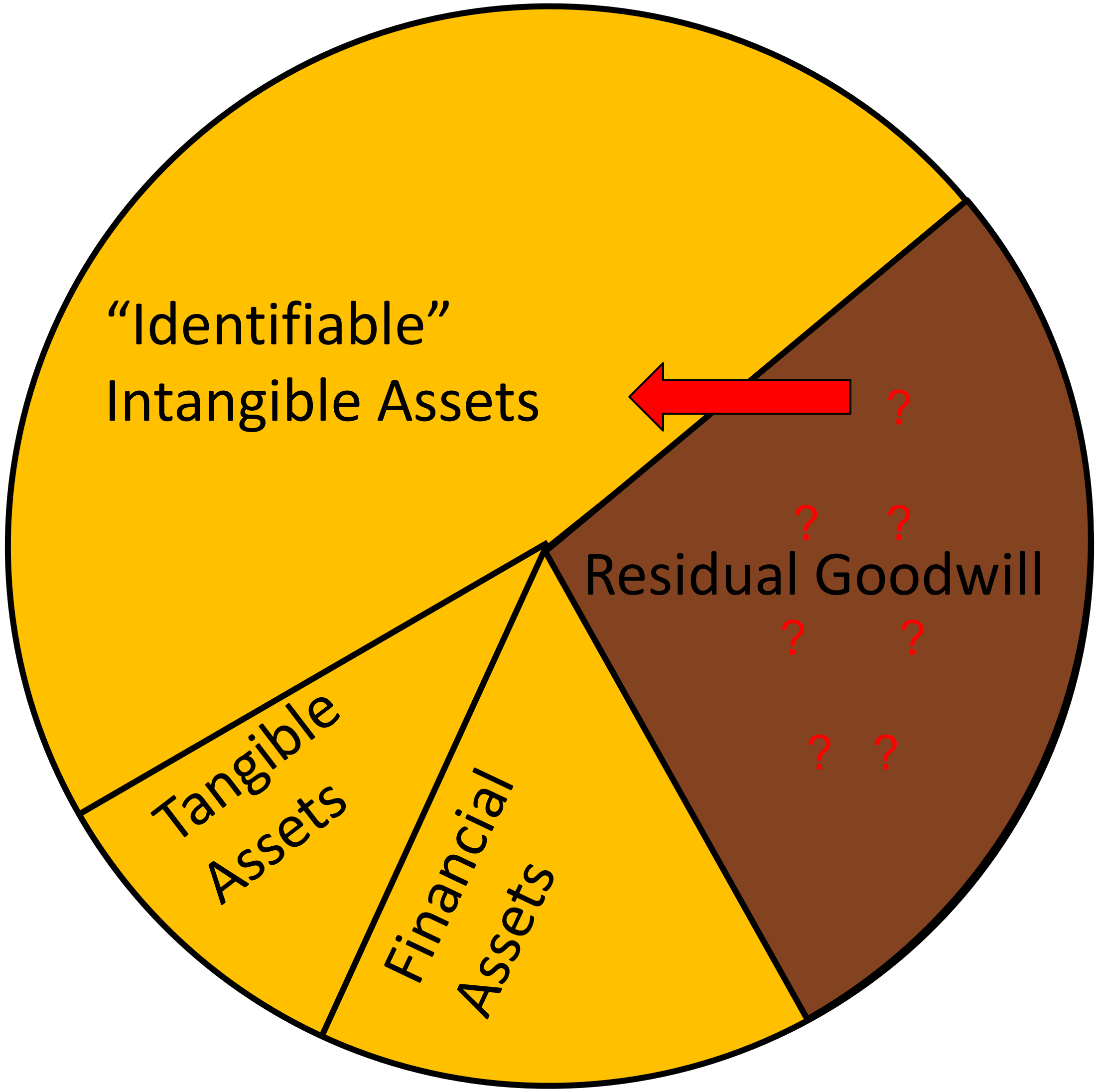
GOODWILL IS EXCESS VALUE

Goodwill is the value of a business beyond cash, A/R, tangible assets, and indentifiable intangible assets.

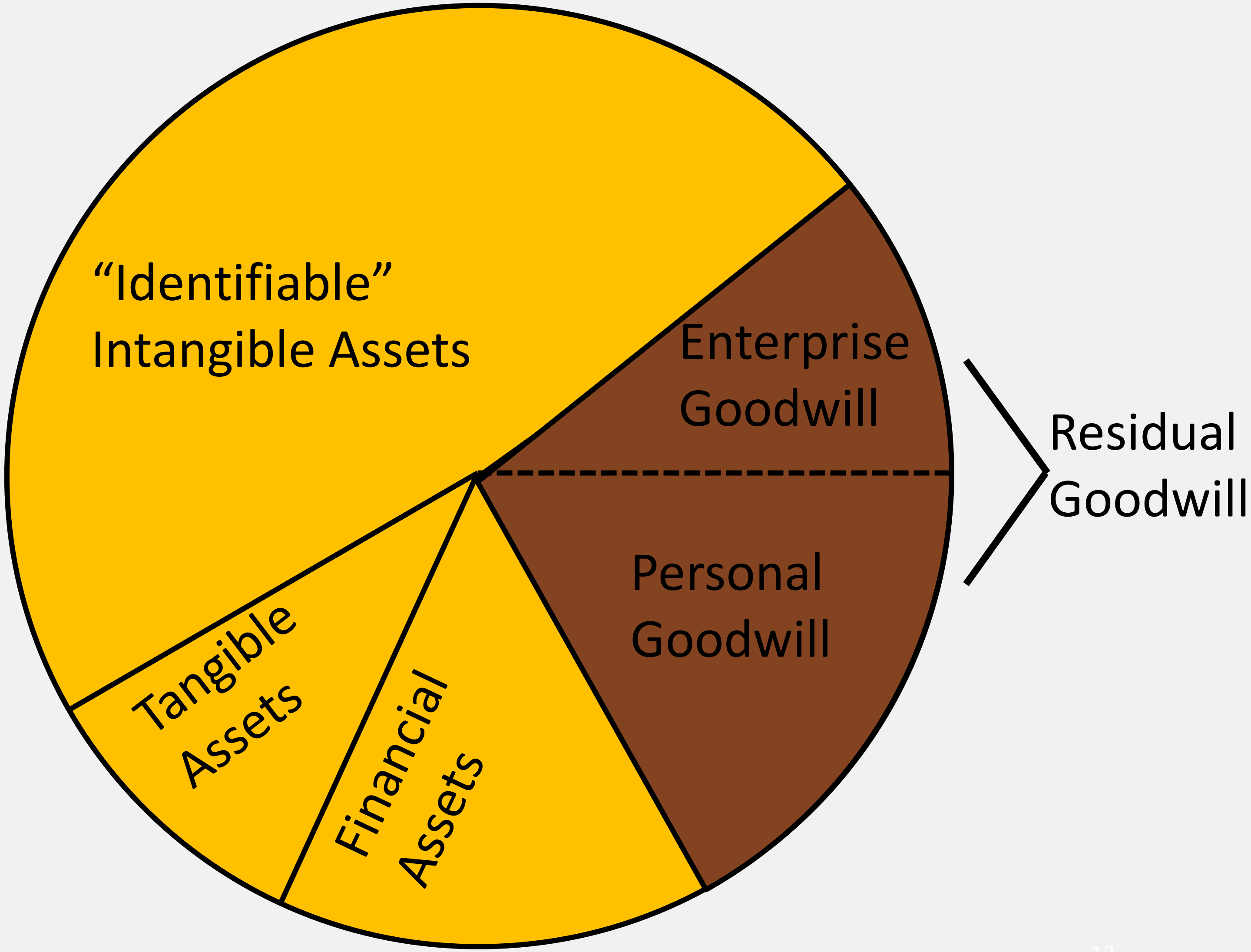
ASSET-BASED BUSINESS VALUATION



REDUCING RESIDUAL GOODWILL



ENTERPRISE VS. PERSONAL GOODWILL



GOODWILL FROM A BUYER'S PERSPECTIVE

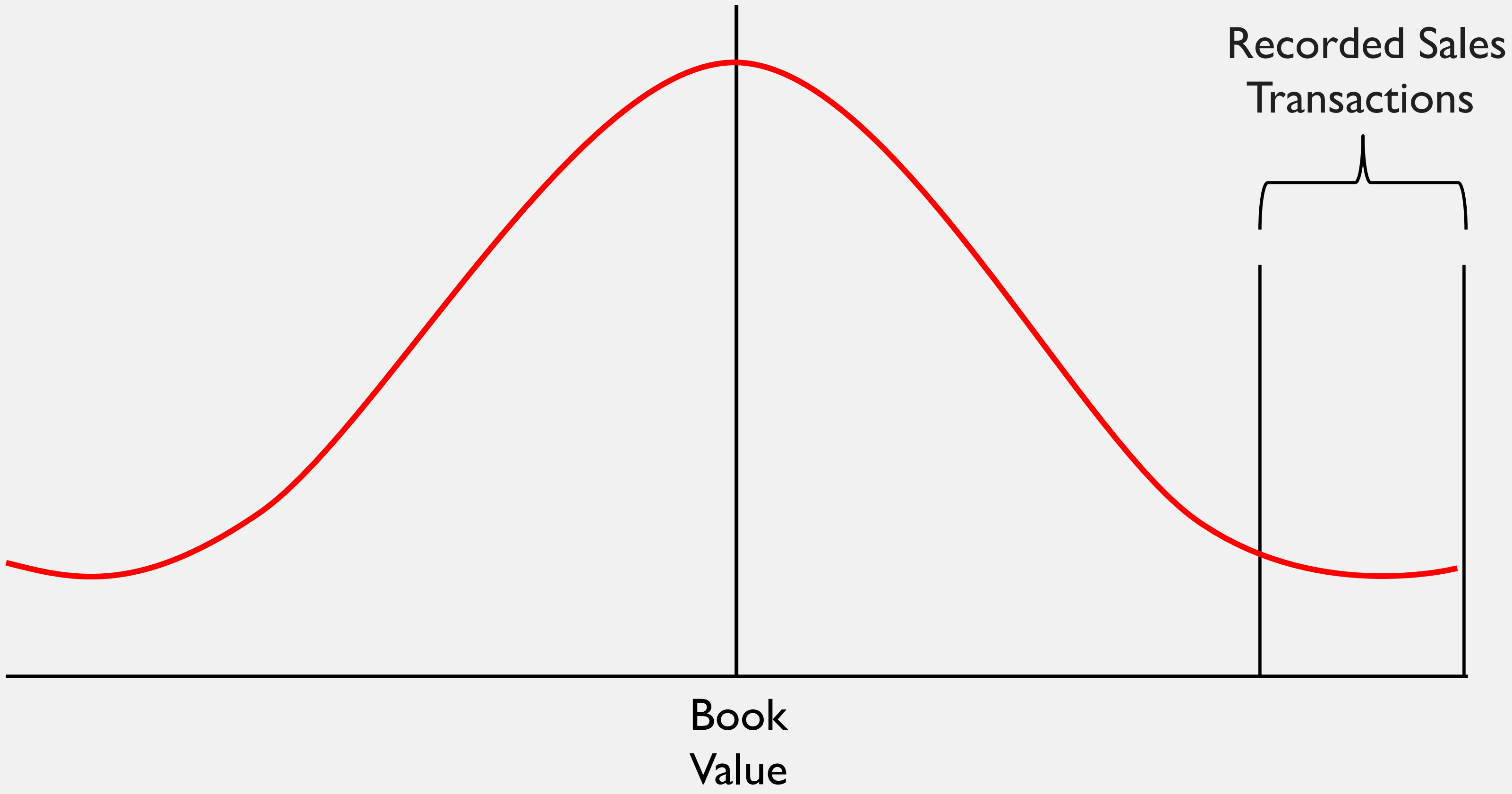
"Companies often choose to acquire versus develop internally because it may not be feasible within a reasonable time frame and can be more cost effective. Therefore, we believe goodwill represents a portion of the cost that a company would have incurred internally to achieve the same business objective."

Ford Motor Company

TAKE AWAYS ON ENTERPRISE GOODWILL

- Goodwill is no longer the continued patronage of existing customers.
- Self-created goodwill of a business is ignored in accounting, financial reporting, and the asset approach to business valuation, and yet it constitutes much of the value of a business.
- Ignoring self-created intangibles is no longer viable.
- Residual goodwill under accounting standards is overbroad. Many "unidentifiable" intangible assets can in fact be identified and valued and ascribed to the business.
- Enterprise goodwill should include intangible assets that are not recognized by the accounting purposes profession, such as:
  - "Intellectual capital" of a business;
  - Assembled workforce.

VALUE OF ALL BUSINESSES



VALUATION BASED ON FUTURE EARNINGS OR CASH FLOWS

- Future dividends, revenues, or cash flows
- Divide by Capitalization Rate
- Discount to P.V. using Discount Rate
- Result: Present Value

“RULE OF THUMB” MULTIPLIERS

REVENUE

- Same as Gross Income
- Total income from sale of goods and services
- Top line on the Profit & Loss Statement
- Distinguish Gross Income (Revenue) from Net Income
  - Gross Income

    <u>- Expenses</u>

    = Net income

“TIMES REVENUE” RULE OF THUMB

30 to 40% x Gross Revenue = Value

EBITDA

- EBITDA is Earnings Before Interest, Taxes, Depreciation, & Amortization
- EBITDA estimates cash flow without regard to capital structure (i.e., debt vs. investment), taxes, and non-cash deductions (depreciation & amortization)
- To calculate EBITDA:

  Net Income

  + Interest Expense

  + Taxes

  + Depreciation

  <u>+ Amortization</u>

  = EBITDA

“TIMES EBITDA” RULE OF THUMB

3 to 3.5 x EBITDA = Value

THE MARKET APPROACH USING MULTIPLIERS

MARKET APPROACH

- Guideline Public Companies
- Data from the sale of privately-held companies
- Sales of interests in the company being valued

GUIDELINE PUBLIC COMPANY METHOD

1. Identify comparable companies traded on a major stock exchange
2. Determine multiples such as price-to-earnings ratio, or price-to-cash-flow ratio, or total-invested-capital-to-EBITDA ratio; etc.
3. Apply multiples (with adjustments) to target company's parameters
4. Glaring problem: lack of comparability due to different size, depth, and liquidity of guideline companies

INCOME APPROACH USING CAPITALIZATION OF EARNINGS

CAPITALIZATION OF EARNINGS METHOD

- Next year's adjusted free cash flow

÷ Divide by Cap Rate

= Current Value

- Free cashflow (FCF) is net income, minus capital expenditures, less working capital, plus depreciation, minus taxes.
- Future year's FCF may deviate from the projected figure.
- For some businesses, the Cap Rate is subjectively determined.

THE INCOME APPROACH USING PRESENT VALUE OF FUTURE CASH FLOWS

DISCOUNTED CASH FLOW METHOD

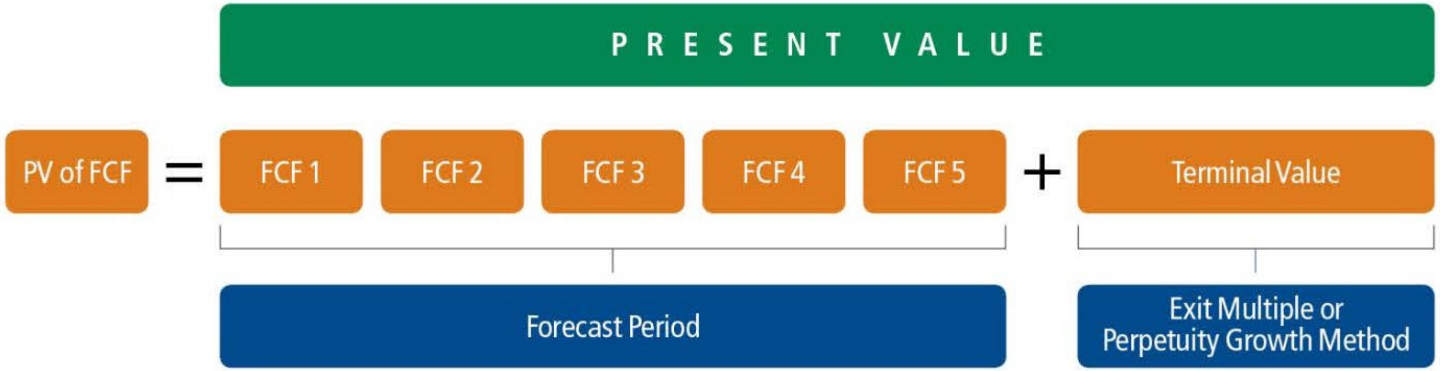
1. Estimate free cash flow for each separate future year (5 to 10 yrs)
2. Discount to present value using Discount Rate
3. Add Terminal Value (P.V. at the end of 5 to 10 yrs)
4. Gives you Enterprise Value

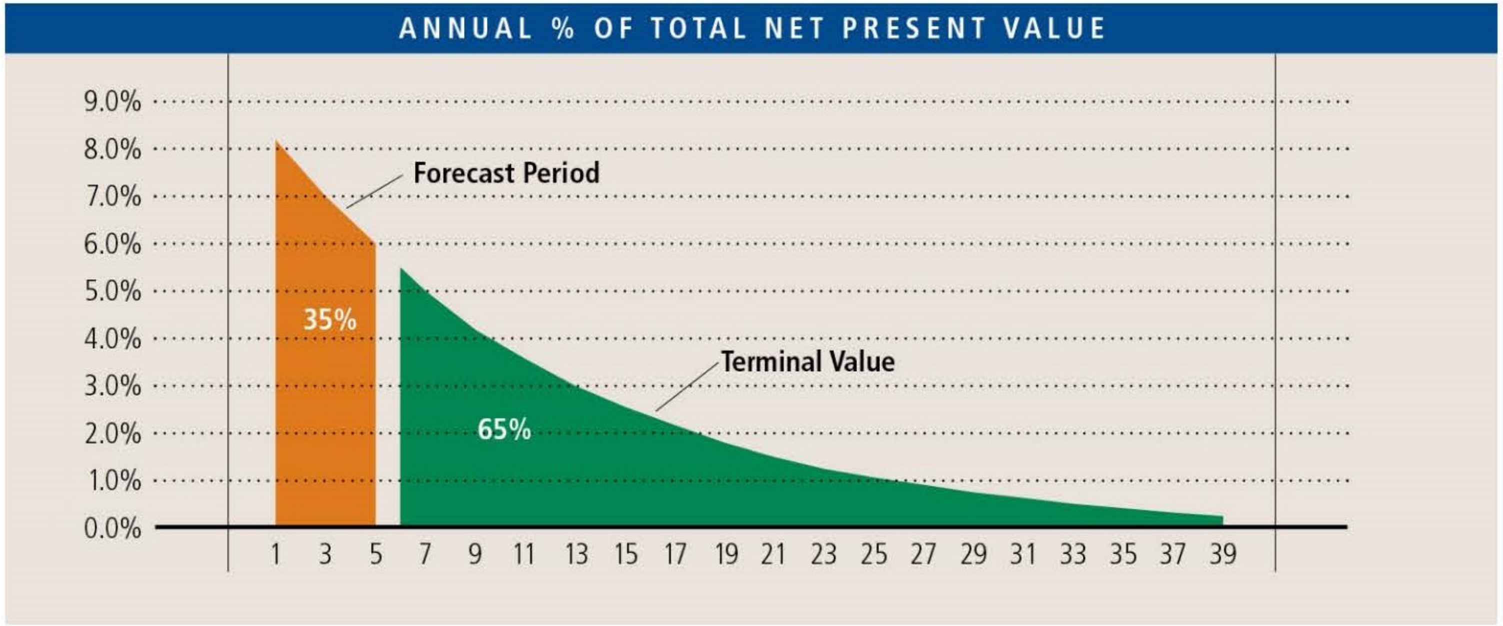
#1 Projecting Future cash flows is subject to uncertainty

#2 Discount Rate is subjectively determined

#3 Terminal Value is the P.V. of far future earnings, assuming stable growth; you need a very good crystal ball.

DISCOUNTING FUTURE CASH FLOWS





https://www.zacharyscott.com/blog/blog/capital-finance/beyond-the-forecast-period

CONSTRUCTING THE DISCOUNT RATE USING THE BUILD-UP METHOD

Total	___________%
Specific Company Risk Premium	___________%
Size Premium	___________%
Industry Risk Premium	___________%
Equity Risk Premium	___________%
Risk Free Rate	___________%

PUBLICLY-TRADED MINORITY VALUE VS. PRIVATE SALE ENTERPRISE VALUE

Publicly-Traded No Cash No Debt Price/EBITDA	9.00
Private Sale No Cash No Debt Price/EBITDA ($15,000,000 Sales Company)	3.00
Implied Discount from Minority Public to Enterprise Private	-66.67%
Discount for Size	?
Discount for Specific Risk	?
Discount for Marketability	?
Premium for Control	?
	-66.67%

Punchline: The Data Regarding Pubicly-Traded Companies is Irrelevant.

VALUE LINE MATH

Expected Return 3-5 years	=	25%
So, 4 year annual compound growth	=	5.737%
Add Dividends		1.8 %
		7.537%

Query: Is this not a better estimate of cost of equity (i.e., Cap Rate or Discount Rate)?

PJC INSTRUCTION ON PERSONAL GOODWILL

PJC 203.2 Factors to be Excluded for Valuation of Business

"Personal goodwill" is the goodwill that is attributable to an individual's skills, abilities, and reputation.

In determining the value of SPOUSE A's medical practice, you are not to include the value of personal goodwill or the value of time, and labor to be expended after the divorce. However, you may consider the commercial goodwill, if any, of the practice that is separate and apart from personal goodwill.

MARK O. DIETRICH'S ARTICLE (2005)

IDENTIFYING AND MEASURING PERSONAL GOODWILL IN A PROFESSIONAL PRACTICE

By Mark O. Dietrich, CPA/ABV

Author's Note: This article builds upon the concepts originally laid out in my article "Valuing Covenants Not to Compete in a Professional Practice," which appeared in the Summer 2000 issue of CPA Expert. *That article contained a detailed quantitative model for such a valuation.*

In many situations, most notably valuation for marital dissolution and allocation of purchase price for tax or financial reporting purposes, distinguishing personal goodwill from enterprise goodwill is a critical undertaking.

In the marital arena, personal goodwill is not a divisible asset in some jurisdictions, and the status is uncertain in many, and therefore cannot be awarded by the Court. Given this norm, it is curious that many valuation analysts fail to provide evidence as to the separate values of personal and enterprise goodwill.

In tax planning, particularly for C Corporations, allocating the proceeds of a sale of a business to personal goodwill and/or a noncompete agreement can reduce or eliminate the amount recognized as corporate gain and the related corporate level tax. In valuation for purposes of a sale of a business, properly attributing value to different intangible assets may be critical to both buyer and seller obtaining the proper measure of the bargain.

There are two fundamental issues in differentiating personal from enterprise goodwill:

1. Identifying which portions of cash flow are attributable *directly* to the individual's characteristics.
2. Identifying which cash flows attributable to otherwise enterprise-level tangibles and intangibles would be lost if the individual competed.

ILLUSTRATIVE EXAMPLES

1. Personal goodwill flowing from individual characteristics
   - A physician at a renowned medical center is well known for his skill in diagnosing complex diseases. His ability to do so is due to his intellectual skills, knowledge base, and experience in similar cases.
   - An attorney has won several high profile cases because of her ability to relate to the jury and make complex issues understandable. In her current firm, she is also the principal "rainmaker."
2. Enterprise goodwill flowing from individual characteristics
   - The same physician is part of a group practice. Subsequent to the diagnosis, other group physicians, some of whom are employed, may treat the patient. The employed physicians generate a profit in excess of their compensation that the practice owners share.
   - The same attorney has attracted dozens of new cases and is unable to handle most of them, which are assigned to other partners or members of the growing staff. The "points system" in the law firm allocates profits based in large part upon who generated the underlying business.

Observation:

*The second set of examples is perhaps subject to some dispute in jurisdictions that treat personal goodwill as a non-divisible asset in marital dissolution. Some judges may treat any profit resulting from the personal goodwill of a marital litigant as non-divisible. For example, in a Florida appellate case (*Weinstock v. Weinstock *634 So. 2d at 777), the Court ruled that a dental practice had no divisible goodwill because the expert testified that a noncompete agreement would be required in any sale of the practice as well as the dentist's continued presence for a six-month patient transition period. Valuation analysts need to obtain a clear understanding from legal counsel as to the proper interpretation of state law or precedent.*

Personal goodwill, then, is the asset that generates cash profits of the enterprise that are attributed to the business generating characteristics of the individual, and may include any profits that would be lost if the individual were not present.[1] The value of a Noncompete[2] with that individual is the value of those cash profits, adjusted for the probability of the individual competing in each future year where the potential of competition exists. Thus, the noncompete is a portion of the value of personal goodwill and cannot exceed that value. Unless the probability of competition is 100%, the personal goodwill will always exceed the value of the noncompete.

ENFORCEABILITY OF NONCOMPETES

How much is an unenforceable promise to pay worth? Or, better yet, how much will the hypothetical buyer pay for an unenforceable contract with a hypothetical seller? "Not much" would seem to be the answer. To illustrate the concepts involved in

1 Subject to jurisdictional precedents.

2 A lawyer once told me to capitalize key terms to call attention to them.

"WITH AND WITHOUT" APPROACH TO DETERMINING PERSONAL GOODWILL

- Under the "with and without" approach, the valuator determines the reduction in profits resulting from the seller leaving the business, or competing with it, as the case may be. This reduction in value is attributed to the seller's personal goodwill.
- The first step in determining personal goodwill is to remove the owner's knowledge, skill and experience from consideration by normalizing his/her compensation.
- The second step is to determine lost future profits if the owner leaves but does not compete.
- The third step is to determine lost profits if the owner leaves <u>and</u> <u>competes</u>.

THE MULTI-ATTRIBUTE UTILITY MODEL FOR ASSESSING PERSONAL GOODWILL

- The MUM was unveiled by CPA David N. Wood in a 2004 article in the American Journal of Family Law.
- The steps of the MUM are:

  (1) Assign attributes to enterprise and personal goodwill.

  (2) Assign a number for the "utility of importance" of each attribute.

  (3) Assign a number for the "utility of existence" of each attribute.

  (4) Multiply (2) x (3).

  (5) Total the product of step (4) for all attributes of enterprise goodwill; same for personal goodwill.

  (6) Allocate residual goodwill based on the relative % of total utility determined in step (5).

COMPARING THE MUM TO THE "WITH AND WITHOUT" APPROACH

Rating

- = MUM is inherently subjective, while "with and without" is based on difficult projections that cannot be verified.
- \+ The MUM is easy to implement and easy to understand.
- \+ MUM forces the valuator to identify & weigh relevant factors.
- \+ The MUM assessment is in writing and can be reviewed by others.
- \- The averaging step of the MUM creates an "aura" of mathematical certainty that it does not have.
- \- Experts who use MUM won't criticize it, even when they should.
- \- The fact finder might think MUM is more reliable than it is.
- \- In *Gaskill v. Robbins*, (Ky. Supreme Ct. 2009), the averaging of values was rejected as being no evidence of anything.
- \- The MUM merely allocates Residual Goodwill. If Residual Goodwill is too small or too large, Personal Goodwill will be too small or too large.
- \+ "With and without" values Personal Goodwill independently from Residual Goodwill.

VALUE OF PARTIAL OWNERSHIP INTEREST

Enterprise value

x Ownership %

= Fractional value of ownership interest

+ Control Premium

- Lack-of-Control Discount

- Marketability Discount

= Value of partial ownership interest

MARKETABILITY DISCOUNT

- Enterprise value

  - Marketability discount

  = Value realized through sale

- How is this different from a Lack of Liquidity Discount?

TAX CONSIDERATIONS

- C-Corp vs. S-Corp.; effect of tax rate on value
- Built-in unrealized taxable gains (*Davis v. CIR*; *Dunn v. CIR*)
- Partnerships: Inside & Outside Basis
- Depreciation recapture
- Capital gains tax on sales proceeds
- When will the tax be incurred? P.V. discount to today.
- What will the tax rate be?

PARTING SHOTS

- Survivor Bias (the dead don't rise until Judgment Day)
- The quest for an "exit price" (finding the flea on the elephant)
- B.V. assumes business will continue in its present form (the merger problem)
- The size problem (one size doesn't fit all)
- Lack of directly relevant data (you fish where the fish are biting)
- Comparables are inherently not comparable (apples to oranges)
- Projecting future revenues (how clear is your crystal ball?)
- Each component of the Build-Up Discount Rate is subject to question (a totem pole of odd creatures)
- Business people tend to use rules of thumb (the real world beckons)
- No extensive literature on how to segregate personal goodwill (good luck with *Daubert*)

THE END