

SOFT POINTS IN BUSINESS VALUATIONS*

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I. THE MOST DAUNTING BUSINESS VALUATIONS ARE THOSE USING INCOME AND MARKET APPROACHES.

A. The concept of the whole being worth more than the sum of its parts.

1. What does an investor expect?
2. Compensation for an owners labor distinguished from income of the business.

B. When presented with a 35 page Valuation Report, what is really important to understand and prepare for its understandable presentation or cross examination?

II. INCOME APPROACH TO VALUATIONS.

A. Discounting Cash Flow (DCF) or Future Earnings (DFE) Method.

1. Discount Rate (true value of money and risk).

* Presented at American Bar Association Family Law Program October 22, 2004 at Milwaukee, Wisconsin.

2. Project cash flow or earnings over a number of specific years and then for perpetual period (implicitly also considers risk).
3. Normalize cash flow or earnings being projected.
4. Discount each year's projected cash flow/earnings and a "terminal value" back to a present value at the discount rate. Terminal value is the capitalized value of those projected cash flows following the individual projections computed using a long term sustainable growth rate into perpetuity.

B. Capitalizing Earnings Method.

1. Normalize a single year's earnings (make adjustments, consider recent earnings history).
2. Divide by a CAP rate (discount rate – projected rate of growth of earnings).
3. The discount rate divided into 1 would equal the implicit P.E. ratio commonly considered in market approach.

C. Excess Earnings Method.

1. Revenue Ruling 68-609 states that this "formula" approach "should not be used if there is a better guidance available from which the value of intangibles can be determined . . . Accordingly, the 'formula' approach

may be used for determining the fair market value of intangible assets only if there is no better basis therefore available”.

2. A net tangible asset value must be determined. A required rate of return must be determined by what one would expect from those tangible assets.
3. Determine the dollar amount of the required rate of return with the tangible assets by multiplying the rate of return by the net tangible asset value.
4. Subtract the computed rate of return for the tangible assets from the company’s own normalized net cash flow or earnings which may result in a dollar amount of “excess earnings”.
5. Divide the “excess earnings” by a capitalization rate that would be applicable to excess earnings (usually higher than the rate of return for tangible assets).
6. The value of the entity is a total of the net tangible asset value and intangible asset value.
7. Enterprise good will vs. personal good will.

III. MARKET APPROACH.

- A. Find comparable companies – “guideline companies”.
- B. Are your comparables based on sales of control or trading minority interests
(Is there a need for premiums or discounts)?

- C. Determine P/E ratios of comparables (normalize earnings and adjust for accounting differences and inconsistent timing. Has the guideline company's earnings been normalized?)
- D. Are the variables used to determine comparability reasonable? (Industry, size, products, price/earnings, price/sales, price/book, etc.)
- E. P.E. ratio is price of a stock divided by earnings.
- F. Multiply the earnings of subject company by chosen P.E. ratio.

IV. THE BIG TWO FACTORS COMMON TO THE INCOME AND MARKET APPROACHES TO VALUE.

- A. Returns from an investment.
 - 1. Earnings and its definitions:
 - a. Net income (in accounting sense: income after depreciation, interest and taxes) is the most often used in Income Approach.
 - b. Earnings before tax – EBT.
 - c. Earnings before interest, taxes, depreciation and amortization – EBITDA.
 - d. Net sales.
 - e. b-d are more commonly used in the Market Approach.

2. Net Cash Flow.
 - a. Accounting definition: net income with depreciation and amortization added back and capital expenditures subtracted.
 - b. Used usually in the Income Approach.

3. Soft Spots related to earnings and cash flow.
 - a. How good are the historic books and records?
 - (i) Reliability and issues of mischief.
 - (ii) Reasonable adjustments.
 - (a) Write down excessive wages of owner and family members.
 - (b) Write down or off obsolete inventory.
 - (c) Remove non-reoccurring items of expense or income.
 - (d) Adjust for adequate reserves.
 - b. In Market Approach are comparable companies using the same:
 - (i) Basis of inventory i.e. LIFO and FIFO.

- (ii) Using the same methods of depreciation.
- (iii) Measure of return on investment.
- (iv) Time period for comparison.

B. Determining a Discount Rate.

1. Discount rates must be determined in order to use the following valuation methods:
 - a. Discounting cash flow.
 - b. Capitalizing earnings (cap rate is derived by adjusting a discount rate).
 - c. Excess Earnings Method (cap rate used here is derived by adjusting a discount rate).

2. Arriving at a discount or capitalization rate has a number of soft spots because they are built up and reduced by many factors.
 - a. Building a discount rate:
 - (i) Start with the rate of return for safest investment – long term US Treasury Bonds.

- (ii) Increase the US Treasury Bond rates for:
 - (a) Systemic risk – the capital asset pricing model uses Betas to represent the difference between a subject industries percentage rise and fall in changing markets to the entire markets rise or fall.
 - (b) Unsystematic risk – particular risks of the subject company i.e. thin management, high leverage, falling sales.
 - (c) Small stock premium – smaller companies are inherently riskier.

C. Making a Capitalization Rate From a Discount Rate.

- 1. Using a discount rate to discount cash flow in that valuation method requires no adjustment to the rate due to expected growth rate of earnings. The growth of earnings is already reflected in the individual years of earnings that are projected and then discounted.

2. Using a capitalization of earnings method for valuation requires the discount rate to be adjusted for a projected growth rate of earnings since only a single year's earnings are being capitalized. The discount rate minus the projected growth rate of earnings equals the capitalization rate.
3. Price Earnings ratios (P/E) used in the Market Approach when comparing companies are implicitly an inverted capitalization rate.
 $1/P.E. = \text{Cap Rate.}$

V. MINORITY AND MARKETABILITY DISCOUNTS OR CONTROL PREMIUMS

A. Discounts For Lack Of Marketability (Liquidity)

1. Although publicly traded is the trading market thin?
2. Are the shares subject to "put" rights? Is it stock in a private company with an imminent public offering?
3. Is it stock in a private company with frequent private transactions?
4. Is it a private company with few or no transactions?
5. Is it a private company with interest subject to restrictive transfer provisions?
6. Are the shares absolutely prohibited from transfer due to voting trusts, etc.

B. Minority Discounts

1. A minority interest holder may have enough stock to block super majority requirements ($2/3$ votes) to effect certain corporate actions.
2. 50 percent interest has blocking power.
3. A minority block may have swing power. It depends on the distribution of the other stock and if it exists it enhances the value of the minority shares.
4. Although a minority interest it may have enough to elect a director under cumulative voting.
5. The minority interest may be large enough to have a right to bring a minority oppression dissolution action under state law.