An Introduction to Business Valuation

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Introduction to Business Valuation

If you own stock in a public corporation, you can readily determine its value by going to The Wall Street Journal and finding the price at which the stock is trading.

However, if you own stock in a closely held corporation, you have no market reference to determine the stock's value.

How can you determine the value of your closely held stock?

The process Capital Valuation Group follows in valuing the stock of a closely held business applies many of the same procedures used by the securities analyst and sophisticated investor in establishing the trading range for a publicly owned security…but, in most instances, there is no actual market transaction to test the value determined for the closely held security.

What are these procedures for establishing the value of a closely held security, and how can you be sure if the value determined is reasonable if there is no actual transaction gains which to test value?

The successful valuation of a closely held security requires:

- determining the proposed use of the valuation option
- defining the meaning of the term "value" which is appropriate for the proposed use of the opinion
- analyzing and pricing the business enterprise underlying the closely held security being valued
- analyzing and pricing the specific block of securities being valued.

This publication is meant to be an introduction to the valuation of closely held businesses and their securities, not a comprehensive course in “how to value a business”. The professional discipline of business valuation is a dynamic one. The theory of valuation is constantly being analyzed and modified. This publication will be updated as new theories emerge and old ideas are modified.

Determining the Use of the Valuation

Capital Valuation Group values closely held securities for many different reasons. For example,

- Someone is interested in buying all the outstanding stock of a closely held corporation. How much should the buyer pay for the stock?

- The owner of all the stock of the same corporation is getting divorced. The stockholder is also the president and key employee of the corporation. What is the value of this stock for purposes of the corporation? What is the value of this stock for purposes of dividing the marital estate if the stockholder is going to continue owning and operating the business after divorce?

- An individual dies owning all the stock of the same corporation. What value should be placed on this stock interest for purposes of filing an estate tax return?

Since all of these situations deal with stock of the same corporation, isn't the value of the stock the same in all three instances? No!

More Than One Correct Value

A "real world" buyer of a closely held business must value both the Correct Value benefits of ownership under its own plan of operation and the benefits of continued ownership to the seller in order to form a fundamental pricing strategy to begin purchase negotiations.

The "legal world" of hypothetical transactions and values attempts to simulate real world events under the guidance of special definitions of the term "value" developed from statutes and case law history. These special definitions develop as judges and juries seek fairness and equity for the parties at odds over estate taxes, divorce, shareholders squeeze-outs, and condemnations.

Defining the Term “Value”

The value of a closely held security is commonly considered its fair market value. "Fair market value" has been defined as the cash (or cash-equivalent) price at which the security would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

The purpose for the valuation affects the value conclusions by its characterization of the willing buyer and seller in this common definition. The characterization of the willing buyer and seller is important because different buyers and sellers assign different values to a business and its securities. A "real world" buyer would assign a higher value to a business or its securities if that business were a good fit with the buyer's current business. In this way, the "best fit" buyer both increases the benefits and reduces the risk of the business investment opportunity.

On the other hand, a buyer who had no similar business, did not want to manage the business purchased, and was concerned about the lack of liquidity in owning a closely held security would pay far less for the same business or its securities. This buyer would pay less because the risks are so much greater than they are to the "best fit" buyer.

The chart on the next page is one Capital Valuation Group uses to illustrate the different relative values that would be assigned to a business enterprise by different types of buyers.

Prospect Ranking Chart
Buyers of a Business Enterprise
(A Generalization About Relative Value)

Highest Enterprise Value

9	**Strategically Positioned Business** in the same industry or market which would employ their own business plan to: 1. realize the added economic benefits of vertical or horizontal integration (synergy) or 2. realize the economic benefit of eliminating competition.
8	**Diversifying Businesses** that have their own business plan to aggressively enter competition in the seller's industry and which desire the seller's business and management as the nucleus of this planned growth.
7	**Competing Business** within the same industry, concerned that sale of the business to a more aggressive competitor would adversely affect their own market position and business plan.
6	**ESOPs** that will be organized to utilize the income tax and borrowing benefits of an Employee Stock Ownership Plan to enhance their proposed purchase offer.
5	**Outside Investors/Managers** who will be owners/managers and who possess deep management skill, knowledge, and experience within the seller's industry and markets.
4	**Insider Management Group** who has intimate knowledge of the seller's business, which greatly reduces the investment risk but also may give the group potentially intimidating leverage if the seller lacks management alternatives.
3	**Diversified Passive Investors** who have no interest in a job, who will take on the seller's management team and business plan, and who have a diversified investment portfolio.
2	**Investor/Job Seeker** who desires both the investment opportunity and an executive position within the seller's business.
1	**Undiversified Passive Investors** who have no interest in a job, who lack a diversified investment portfolio, and who will take on the seller's management team and business plan.

Lowest Enterprise Value

Bargaining Position

The terms "value" and "price" are not synonymous. Bargaining position is a function of economic strength, knowledge, skill, and timing. As the diagram below illustrates, the price actually paid for a business enterprise has as much to do with successful positioning as it does with the value delivered. Successful negotiation of price and terms under a sound strategic plan are as important as intrinsic value in the economic outcome of a business sale transaction.

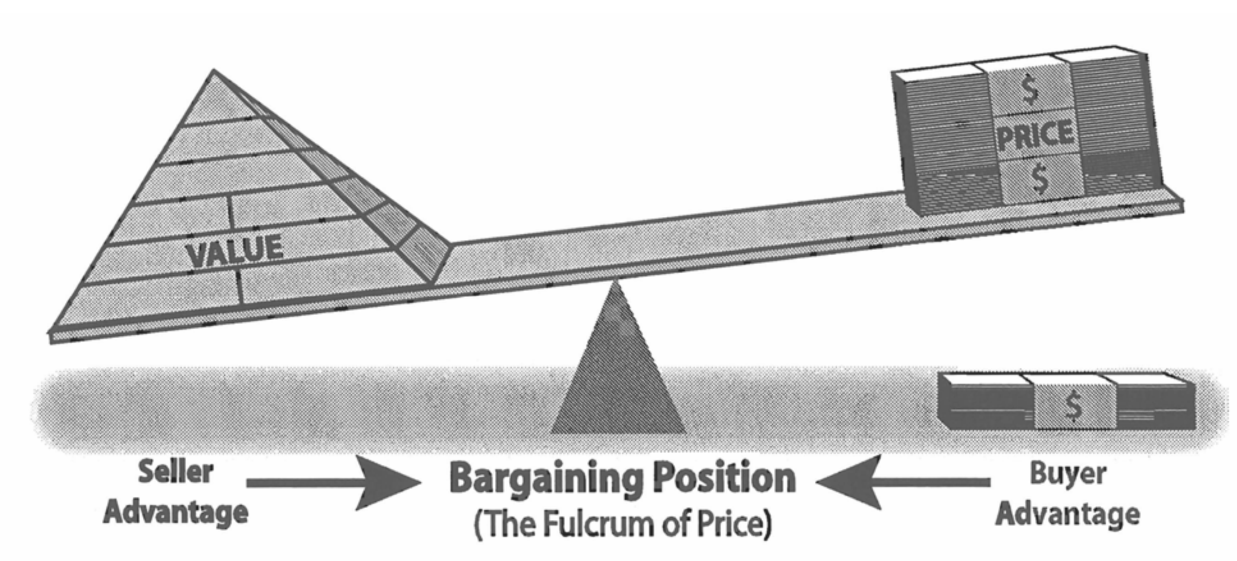
Characterization of Buyer and Seller

In actual business sales, the buyer and seller seldom have equal bargaining positions. The seller is often at a disadvantage because the business enterprise must be sold - an owner and key employee has died, the business is no longer competitive, the owner wishes to retire but has not developed successor managers or owners. In these instances, the buyer may acquire the business at a price well below its value since the seller does not have a strong bargaining position.

If the valuation is prepared to assist in negotiations in an actual sale and purchase of business or its securities, the characterization of the buyer and seller is not difficult. But the characterization of the willing buyer and seller is more difficult - but very important - in a transaction in which an actual "sale" will not take place, such as a valuation for purposes of determining an estate tax.

Who is to be considered the seller and buyer for purposes of an estate tax valuation or a divorce valuation? They are different in each circumstance and may differ from state to state - depending on the law.

Laws, regulations, and interpretive cases continue to modify these definitions to fit our ever-changing economy, tax laws, and individual property rights.



Analyzing the Business Enterprise

Is This a Business or a Career?

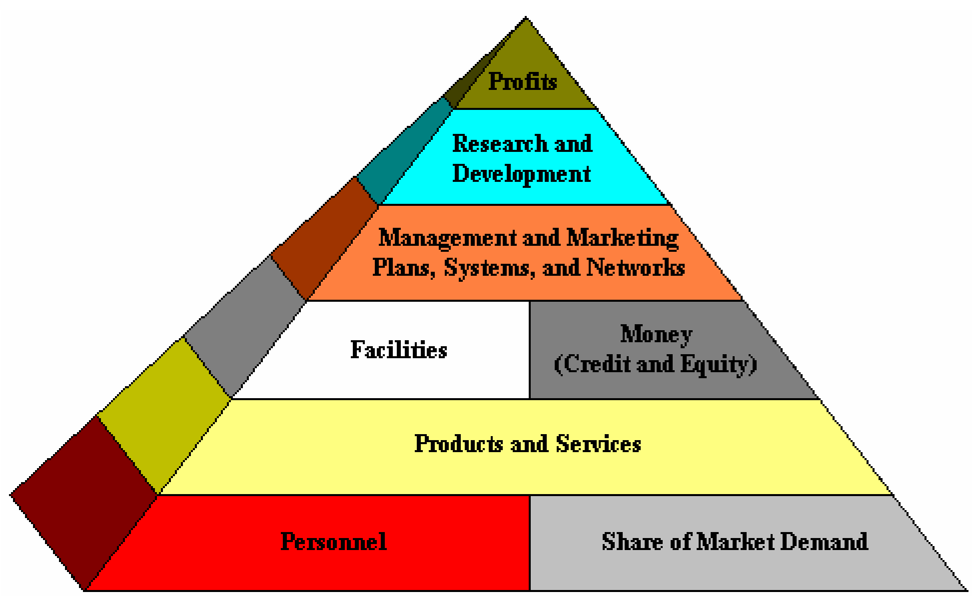
The business enterprise being valued must be clearly defined and fully analyzed. Capital Valuation Group must first determine whether a business exists. In some instances, the business enterprise may really be an individual's career, and there may be no business enterprise of transferable value beyond the individual's "tools of trade." The appraiser must also ask whether the business would continue under new ownership and whether the business generates earnings above and beyond a fair salary paid for the owner's services to the business.

If it is determined that a business exists apart from the owner's career, the appraiser must then determine what contributes value to the business.

Any business enterprise is only partially described by its financial statements. Accounting conventions employed in preparing standard business financial statements are based upon "cost" (not market value) and focus on "tangible" properties (not intangible properties). Intellectual properties like software, patents or databases may be the most valuable property rights owned by a business but may not appear as an asset on its balance sheet. Appreciated real estate worth millions may appear at its depreciated asset cost of a few thousand dollars.

Building Blocks of Value

Every transferable business enterprise is built of well-defined structural components. In the chart below, Capital Valuation Group illustrates these value components. These building blocks of value will be different for every business enterprise. The capacity of each block is as important as the seller's history of utilization of that capacity.



Capacity and Utilization

The structure of a business enterprise and its capacity to produce profits may yield significant value that cannot be seen in the financial statements if current owners and managers have not fully exploited this capacity. Financial statements are prepared according to certain generally accepted accounting principles that are not intended to indicate the value of a business enterprise. Financial statements reflect only the historical utilization of this capacity.

In addition, the growing importance of services and the declining emphasis on manufacturing in our economy are accompanied by a declining importance of tangible assets and increasing importance of intangible assets. In many business enterprises, the most significant building blocks of value are such intangible assets as:

- marketing and distribution systems
- personnel having appropriate education, talent and experience
- computer programs and databases
- management systems

These value components are not readily identified from financial statements and are only evident from a thorough understanding of the operations of the business enterprise.

Consider Your Business Enterprise

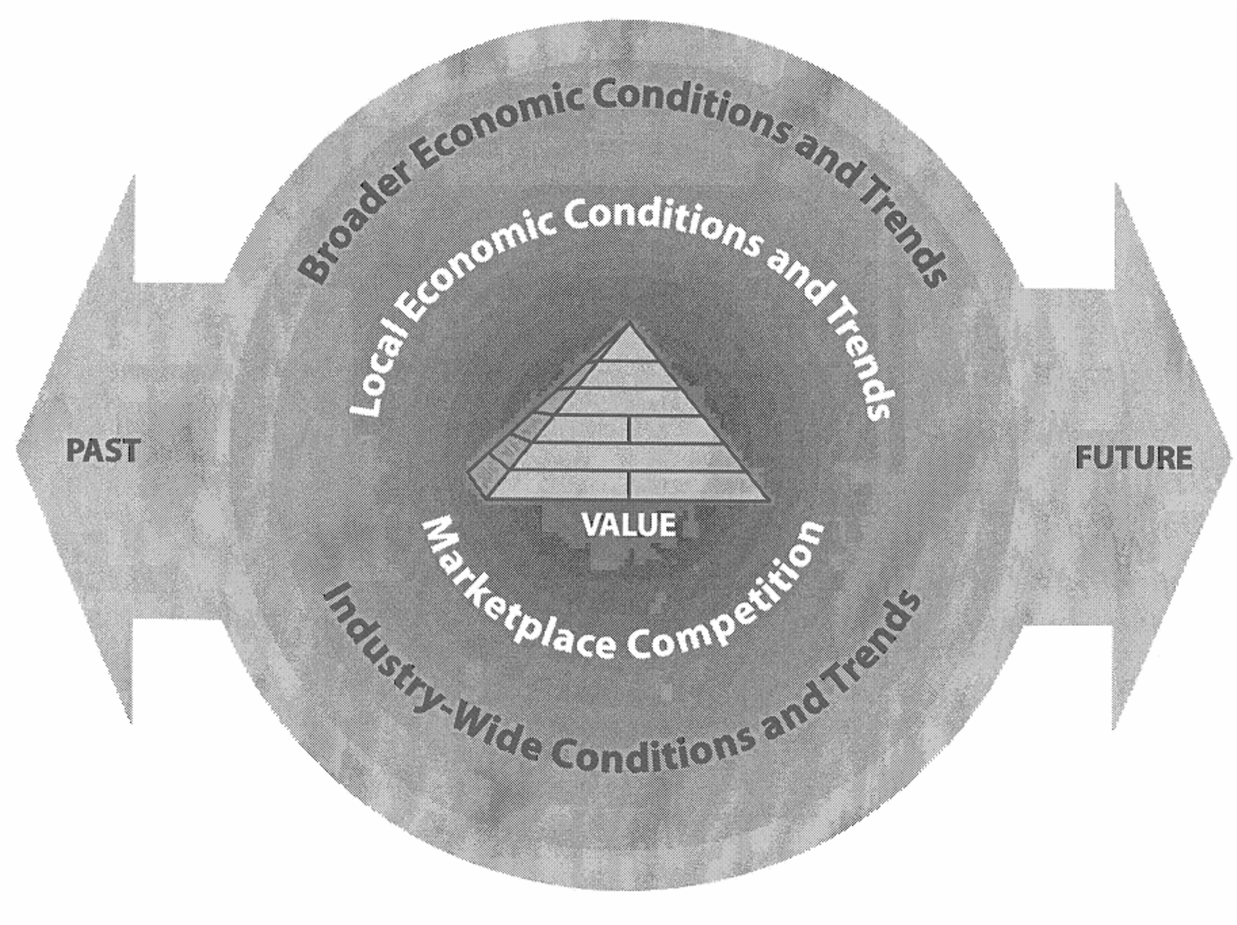
Consider your business enterprise for a moment:

- Do you have a business enterprise that is transferable to a buyer, or do you have a career? (A career usually has few of the value components of a fully developed business enterprise.)
- What makes your business "tick"?
- What are the valuable building blocks of your business?
- What do the financial statements for your business tell you about the historical utilization of these components of value?
- What is the earning capacity of these valuable business components?
- What is the plan for your business's future?

Dynamic External Conditions Can Change Value Quickly

A business enterprise does not operate in a vacuum. It is affected by the economic conditions of its industry and market and by the economy in general. The diagram below illustrates the ever-widening environment in which a business enterprise operates and which affects the value of the business enterprise.

A business enterprise is dynamic and changes over time along with changes in its environment. Similarly, the value of a business enterprise changes over time.



Pricing the Business Enterprise

A thorough analysis of a business enterprise provides information for pricing the business enterprise. Common pricing methods under the three approaches to value include:

Income Approach to Value

Capitalization of earnings - The price obtained by applying to a business enterprise's established annual earnings base a factor that reflects:

- the risk-free rate of return available to investors in United States Treasury obligations
- the additional rate of return required by the particular risks associated with the business enterprise being priced
- the growth rate that can be expected in the business enterprise's annual earnings in future years

Discounted cash flow - The price obtained by projecting the expected cash flows produced by the business enterprise during the investment period and determining its present value using a discount rate that reflects:

- the risk-free rate of return available to investors in United States Treasury obligations
- the additional rate of return required by the particular risks associated with the business enterprise being priced.

The discount rate differs from the factor applied in the capitalization of earnings pricing method because the projected cash flows directly reflect expected growth in annual earnings.

Market Approach to Value

Guideline company - The price indicated by applying pricing ratios derived from publicly traded companies that are similar to the closely held business being priced. Pricing ratios for the guideline companies are derived from stock price information related to appropriate financial data. These pricing ratios are then applied to similar financial data of the closely held business to arrive at an indicated price of the business as if it were traded as a series of publicly traded minority shares of stock. Common pricing multiples include:

- Price/earnings
- Price/sales
- Price/cash flow
- Price/book value

The prices indicated using this method must be adjusted to reflect the fact that the stock of the closely held business is not publicly traded and that the ownership interest in the business being valued may be a controlling position and not a minority one.

Formula - The price obtained by applying a "rule of thumb" specific to a particular industry.

Acquisition - The price indicated by applying pricing information obtained from sales of similar closely held business enterprises.

Previous transactions – The price indicated by previous arm's length transactions in the subject company's stock.

Asset Approach to Value

Orderly liquidation - The dollar amount realized from sale of the business enterprise's assets in an orderly manner (not an auction) followed by payment of all debt. This pricing method usually assumes that the business will not continue as an on-going business, which may mean that any intangible value associated with the business will be lost.

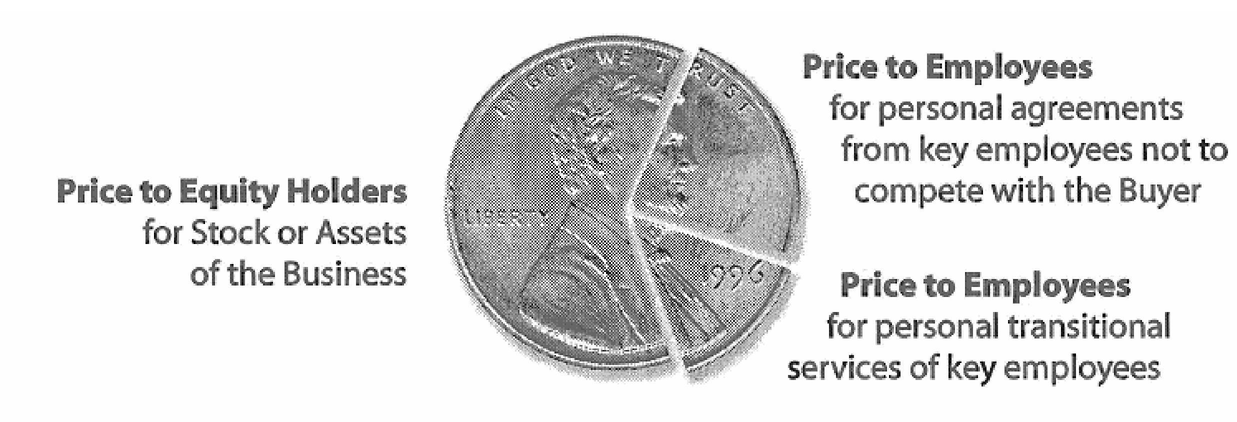
Replacement cost - The dollar amount necessary to reproduce the business enterprise's tangible and intangible assets and liabilities as part of an on-going business.

Assignment of Buyer's Total Price

These pricing methods determine the price of an entire business enterprise, which is made up of such "building blocks" as key people, facilities, customer and supplier relationships, product and service lines, and credit relationships. In order to own and enjoy the full benefit of such an enterprise, a buyer needs reasonable assurance that all of these components will be delivered by the seller. It is not unusual for a major portion of the buyer's purchase price for the business enterprise to go directly to key people for their assurance of continued services and non-compete covenants.

In an actual sale of a business enterprise, a buyer will only be willing to pay the established business enterprise price to the equity holders if the buyer can obtain full enjoyment of the business enterprise's value. A buyer would not pay this price if a key employee will not continue with the business or the sellers are free to compete with the buyer after the sale.

As the diagram below illustrates, portions of the total enterprise price may have to be assigned to certain individuals to assure their continued cooperation or non-competition with the buyer. The balance of the total business enterprise price is assigned to the equity in the business enterprise.



Slices of the Business Enterprise Buyer's Total Price

Analyzing the Security

If an individual owns one hundred percent of the securities of a business enterprise, each share is usually assigned a pro rata portion of the total equity value of the business enterprise.

If the enterprise is owned by a number of shareholders, each shareholder's block of stock may carry a very different value per share. The key to the value of a particular block of stock relates to the degree of "control" that block may have over key business decisions. As the diagram on the following page illustrates, the value of a block of securities in a business enterprise depends on the influence that block of securities has in the operations of the total business enterprise.

The particular securities being valued must be thoroughly analyzed, since the value of a specific ownership interest in a business enterprise reflects the rights of, and restrictions on, the securities.

The analysis of the security must consider such factors as:

- the voting rights of the security relating to such matters as:
    - declaring cash dividends
    - electing directors and officers
    - selling or reorganizing the business enterprise or its assets
    - hiring, firing, and setting salaries
    - setting general business policies

- preference rights over other classes of securities relating to:
    - distribution of cash dividends from earnings
    - distribution of liquidation proceeds
    - voting rights

- transfer rights or restrictions reflected in:
    - "buy-sell" agreements with the business enterprise or other stockholders which restrict the free transfer of the securities or establish a set price for the securities if certain events occur
    - "options" held by the corporation or other stockholders to buy the owner's stock at a set price if certain events occur
    - "puts" held by the owner which protect the value of the stock by allowing the stockholder to sell the stock at a set price if certain events occur
    - "income tax election" availability for special corporate return consolidation or avoidance of double taxation at corporate level ("S" election).

Block Ranking Chart
for Blocks of Stock in a Closely Held Corporation
(A Generalization)

Relative value attributed to various size ownership interests in a closely held business enterprise, assuming only one equity ownership class outstanding and no restrictive or protective agreements governing ownership of these equity interests.

Highest Share Value

A	**Pivotal small block** critical to buyer wanting control of business enterprise.
B	**80% to 100% block** possessing total authority over the business enterprise, including the power to elect income tax consolidation and assert other legal rights associated with squeeze-outs, liquidations, etc., and to dictate Board of Directors composition and management policy.
C	**51% to 80% block** possessing substantial control yet lacking only a few of the income tax and legal rights; able to elect the Board of Directors, officers, set salaries, hire, fire, expand or contract business activities, declare dividends, redeem or issue ownership interests.
D	**50% block with only one equity holder owning other 50%** possessing at least negative control, able to block but not to initiate action; potentially able to join with one or more other equity holders to assert substantial control.
E	**50% block with only one other equity holder** possessing negative control with high risk of a deadlock.
F	**49% or smaller block but relatively large compared to other block(s) and no one block over 50%** possessing potential leadership power through assembly of other equity holders with sufficient vote to gain group control or to dominate business affairs because of wide dispersal of other interests among satisfied or disinterested equity holders, thus gaining effective control with this block.
G	**Small block among many small blocks** not a dominant block but yet not dominated by other blocks; management may hold significant control over such disorganized equity holders.
H	**Small block dominated by large block(s) with clear control** a dominated block; at the mercy of those in control

Lowest Share Value

Pricing the Securities of the Business Enterprise

Once the value of the business enterprise has been determined, and any necessary allocations of value have been made to key employees for their non-compete and transitional service agreements, the final step is to price the securities of the closely held business enterprise.

A thorough analysis of the securities of a business enterprise provides information for pricing its securities. Common pricing methods include:

Discounted pro rata value - The value determined for one hundred percent of the equity of the business enterprise is allocated pro rata among the securities outstanding.

If the particular block of stock being valued cannot control the business enterprise, a discount for lack of control is applied to the pro rata value to reflect the lack of control.

If the value of the entire business enterprise was determined by reference to publicly traded comparable companies' stock, a discount for lack of marketability is applied to the pro rata value to reflect the illiquidity of the closely held security.

Contractual value - Apply pricing methods contained in contractual agreements with the business enterprise or other equity holders. These agreements should be analyzed to determine if their purpose is comparable to the purpose for this valuation, since valuations for different purposes will produce different values.

Prior transfers - Apply prices identified from prior transfers of similar blocks of securities in the business enterprise. Again, the purpose for these earlier transfers must be examined to determine whether the price is applicable to the valuation at hand.

Dividend discount model - This method allows the analyst to value the securities of the business enterprise directly, without first valuing the business enterprise. However, it is still necessary to analyze thoroughly the business enterprise before proceeding to his step. This method determines the value of a share of stock by projecting the expected dividends to be paid to common stockholders produced by the business enterprise and determining their present value using a discount rate that reflects:

- the risk-free rate of return available to investors in United States Treasury obligations
- the additional rate of return required by the particular risks associated with the business enterprise and the stock being valued

In Conclusion

Each step in the valuation process requires the insight and input of owners and managers to assure a meaningful valuation conclusion. The process itself can be as worthwhile as the value conclusion to all who participate in the gathering of information and its analysis.

Most important, however, all appraisals must reflect judgment and common sense. An appraisal of a closely held business enterprise is not merely an academic exercise. Real businesses and individuals are involved, and the appraiser must be careful to reflect the judgments that real business owners and investors would apply in determining the fair market value for a business enterprise or its securities.

Glossary

Adjusted Book Value The book value that results after one or more asset or liability amounts are added, deleted, or changed from the respective book amounts.

Annuity Investment that produces a level stream of cash flows for a number of periods.

Appraisal The act or process of determining value. It is synonymous with valuation.

Appraisal Approach A general way of determining value using one or more specific appraisal methods. (See Asset Approach, Market Approach, and Income Approach definitions.)

Appraisal Date The date as of which the appraiser's opinion of value applies.

Appraisal Method Within approaches, a specific way to determine value.

Appraisal Procedure The act, manner and technique of performing the steps of an appraisal method.

Appraised Value The appraiser's opinion or determination of value.

Asset Approach A general way of determining a value indication of a business's assets and/or equity interest using one or more methods based directly on the value of the assets of the business less liabilities.

Book Value

1. With respect to assets, the capitalized cost of an asset less accumulated depreciation, depletion or amortization as it appears on the books of account of the enterprise.
2. With respect to a business enterprise, the difference between total assets (net of depreciation, depletion and amortization) and total liabilities of an enterprise as they appear on the balance sheet. It is synonymous with net book value, net worth and shareholders' equity.

Business Appraiser A person who by education, training and experience is qualified to make an appraisal of a business enterprise and/or its intangible assets.

Business Enterprise A commercial, industrial or service organization pursuing an economic activity.

Business Valuation The act or process of arriving at an opinion or determination of the value of a business enterprise or an interest therein.

Capitalization

1. The conversion of income into value.
2. The capital structure of a business enterprise.
3. The recognition of an expenditure as a capital asset rather than a period expense.

Capitalization Factor Any multiple or divisor used to convert income into value.

Capitalization Rate Any divisor (usually expressed as a percentage) that is used to convert income into value.

Capital Structure The composition of the invested capital (debt plus equity).

Cash Flow Net income plus depreciation and other non-cash charges.

Control The power to direct the management and policies of an enterprise.

Control Premium The additional value inherent in the control interest, as contrasted to a minority interest, which reflects its power of control.

Corporation A legal entity with a perpetual existence where ownership is represented by stock certificates. Shareholders have limited personal liability for the debt and obligations of the business.

Covenant Not to Compete A contractual agreement whereby an individual or a corporation agrees not to enter into competition against another for a specified period of time.

Discount Factor Present value of one dollar received at a stated future date.

Discount Rate A rate of return used to convert a monetary sum, payable or receivable in the future into present value.

Economic Life The period over which property may be profitably used.

Employee Stock Ownership Plan (ESOP) An employee benefit plan whose primary investment goal is to purchase and own the equity of the sponsoring company.

Enterprise See Business enterprise.

Equity The owners' interest in property after deduction of all liabilities.

Fair Market Value The amount at which property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts.

Going Concern An operating business enterprise.

Going Concern Value

1. The value of an enterprise, or an interest therein, as a going concern.
2. Intangible elements of value in a business enterprise resulting from factors such as having
3. A trained workforce, an operational plant, and the necessary licenses, systems and procedures in place.

Goodwill That intangible asset which arises as a result of name, reputation, customer patronage, location, products and similar factors that have not been separately identified and/or valued but which generate economic benefits.

Income Approach A general way of determining a value indication of a business or equity interest using one or more methods wherein a value is determined by converting anticipated benefits.

Invested Capital The sum of the debt and equity in an enterprise on a long-term basis.

Limited Liability Company (LLC) The LLC is a hybrid between a partnership and a corporation, combining the limited liability advantage of a corporation with the flow-through tax status of an S corporation or sole proprietorship but without having to conform to the S corporation restrictions.

Limited Liability Partnership (LLP) A type of company that provides liability protection for all general partners as well as management rights in the business. Most commonly used in professional practices, an LLP offers, in most cases, the same limited liability enjoyed by a corporation, with the flow-through tax status of a partnership.

Majority Ownership position greater than 50% of the voting interest in an enterprise.

Market Approach A general way of determining a value indication of a business or equity interest using one or more methods that compares the subject to similar investments that have been sold.

Marketability Discount An amount or percentage deducted from an equity interest to reflect lack of marketability.

Minority Discount The reduction, from the pro rata share of the value of the entire business, which reflects the absence of the power of control.

Net Assets Total assets less total liabilities.

Net Income Revenues less expenses, including taxes.

Opportunity cost of capital (hurdle rate, cost of capital) Expected return that is forgone by investing in one investment opportunity or project rather than in comparable alternative investment opportunities.

Partnership

1. Made up of two or more individuals, where each partner has the authority to act on behalf of the business, and each partner has unlimited personal liability for all obligations of the business. Partnerships have an uncertain life and can be terminated by any partner (*partnership at will*).
2. Limited Partnership – Type of partnership comprised of one or more general partners who manage the business and who are personally liable for partnership debts, and one or more limited partners who contribute capital and share in profits but who take no part in running the business and incur no liability with respect to partnership obligations beyond contributions

Perpetuity Investment offering a level stream of cash flows in perpetuity.

Present Value Discounted value of future cash flows.

Rate of Return An amount of income realized or expected on an investment, expressed as a percentage of that investment.

Replacement Cost New The current cost of a similar new item having the nearest equivalent utility as the item being appraised.

Report Date The date of the report. May be the same as or different from the appraisal date.

Reproduction Cost New The current cost of an identical new item.

S Corporations A corporation that has elected to be taxed under Subchapter S of the Internal Revenue Code. S corporations are not taxed at the corporate level. Corporate income or losses are passed through on a pro rata basis to the individual shareholders who then are individually responsible for the tax liability.

Sole Proprietorship Usually a “one-person business" in which the same individual is the owner and worker. The owner is subject to unlimited personal liability for all obligations of the business. The business will cease to exist upon the death or incapacity of the owner.

Terminal Value The value of an asset or investment at the end of some specified time period.

Transitional Services Services of former key owner/managers that are provided to the new owners of a business to assist in the transition between ownership.

Valuation See Appraisal.

Working Capital The amount by which current assets exceed current liabilities.