

Business Valuation – More Art Than Science



One of the more difficult aspects of business planning is business valuation. It is also one of the more important aspects. While owners of closely held businesses may have some idea of what their companies are worth, few owners can accurately assess the “fair market value” that their businesses could be sold for if put on the market in an “arm’s-length” transaction. Fair market value is a relatively simple concept to understand, but in reality it is difficult to determine because a company’s actual fair market value depends on many variables, including the state of the economy, if the owner feels pressured to sell, and how quickly a qualified buyer can be identified. Also, legal and tax rules can make the valuation process more complex.

It is conceivable for a buyer and the owner to decide between themselves in a matter of minutes (on the back of a napkin even) a sale price that meets both of their needs. However, the rights of a business owner’s spouse may come into play and the presence of a minority owner may impact the purchase price. Also, the Internal Revenue Service (IRS) has an interest in business valuations because they impact gift taxes, estate taxes, and income taxes.

For these reasons, owners of closely held businesses who are planning a sale, engaging in the succession planning process, implementing a buy-sell agreement, or putting an estate plan together should hire a qualified business appraiser. The appraiser will use various techniques to determine the ultimate value assigned to the business. Your advisors can assist you in locating a qualified business appraiser, facilitate communications between you and the appraiser, and integrate the value determined by the appraiser into your succession, buy-sell, and estate plans.

What Is Fair Market Value?

Treasury Regulation § 20.2031-1(b) states that “the fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.” Although this regulation provides a definition, applying it to the actual valuation of a closely held business is easier said than done. To provide additional guidance, the IRS issued Revenue Ruling 59-60, setting forth eight factors that should be considered in the determination of a closely held company’s fair market value. They are:

1. The nature of the business and its history
2. The economic outlook in general and for the specific industry in particular
3. Book value of the business and its general financial condition
4. Earnings capacity
5. Dividend paying capacity
6. Goodwill
7. Recent sales of an interest in the business and the size of the interest to be valued
8. Market prices of similar businesses that are publicly traded

Let’s take a look at some specific valuation methods that take these eight factors into account. These methods are the appraiser’s “tool box” when valuing a business. The methods include:

- Book Value and Adjusted Book Value
- Capitalization of Earnings
- Discounted Cash Flow
- Comparables
- Accepted discounts, including lack of marketability and minority ownership



Book Value

The book value of a business is determined by reviewing its balance sheet. On the simplest level, value is determined by the bottom line of the balance sheet – assets less liabilities. However, just as few public companies' stocks are valued at book value per share, few successful closely held companies change hands at book value.

The most common reason why book value may be artificially low is that accounting methods often require assets to be valued at their historical cost. Typically, assets such as plant, equipment, and real estate may not be adequately valued by this method when considering depreciation. More importantly, the historical cost would not reflect current fair market value of certain assets, such as real estate.

If a buyer and seller who are not related agree to a sale of a business at book value in an arm's-length negotiation, the IRS may accept the valuation for estate tax purposes. However, problems may arise if the buyer and seller are related, since the IRS can claim that the transaction is not at arm's-length. The IRS has had some success arguing that book value based valuations represent attempts to pass businesses to children or other family members as disguised gifts or bequests. This, in turn, can cause gift or estate taxes to be owed by the seller.

Adjusted Book Value

Adjusted book value, which is sometimes referred to as liquidation value, begins with book value and then makes adjustments, usually upward, to accurately reflect the current value of the assets. For example, specific assets of the business (e.g., land and buildings) can be appraised and this value can be substituted for depreciated historic cost.

Generally, the adjusted book value is more indicative of fair market value than basic book value, but even this may not be the most accurate appraisal method. For instance, it may not reflect all of the goodwill of a successful ongoing business, including valuable customer relationships, and it also may not account for the future value and growth of the business.

Capitalization of Earnings

Capitalization of earnings is a valuation method that is similar to the P/E ratio commonly used to evaluate public companies. With public companies in a given industry, the share price and earnings are known and the relationship between them creates a Price / Earnings ratio. The inverse of the P/E ratio is the capitalization rate ($1 \div \text{P/E} = \text{Capitalization Rate}$). For example, a business with a P/E ratio of 20 has a Capitalization Rate of 5%. This ratio can be used to value closely held companies with similar characteristics, using this formula:

$$\text{Earnings} \div \text{Capitalization Rate} = \text{Estimated Business Value}$$

For example: \$100,000 of Earnings \div 5% Capitalization Rate
= \$2 Million Business Value

The challenge in using this method is to select the most appropriate inputs for earnings and capitalization rates. A good starting point may be the pre-tax net earnings of the business for the year prior to the valuation date. However, an average of earnings over the past three to five years can sometimes provide a more accurate input, especially in fast-growing or cyclical businesses.

Some appraisers may also use a weighted average of up to five years of earnings, with the most recent years weighted more heavily. In determining earnings for each year, adjustments should be made for unusual non-recurring events that impact earnings. For an appraiser, determining the earnings input is part art and part science, and two appraisers using the same raw data may arrive at different results. Determining the capitalization rate input begins with the current return on a “risk-free” investment, such as a United States Treasury bond. A percentage is then added to account for the risks associated with an investment in a closely held business and this risk factor can vary widely depending on a multitude of factors. Typically an appraiser will review current capitalization rates of other businesses in the same industry with an emphasis on public companies and any recent sales of similar companies. The table below shows how even a fairly small change in the capitalization rate can multiply into very different values for a closely held business.

Capitalization Rate	Multiplier (P/E)	Earnings	Estimated Value
5%	20	\$100,000	\$2,000,000
8%	12.5	\$100,000	\$1,250,000
10%	10	\$100,000	\$1,000,000
12%	8.33	\$100,000	\$833,000
15%	6.67	\$100,000	\$667,000
20%	5	\$100,000	\$500,000



Discounted Cash Flow (DCF)

DCF has acceptance among many appraisers because they believe it provides the most accurate measure of a company's value based on current and future potential to generate profits. Also, unlike the methods described above, DCF can include a projection of a company's ability to sustain its growth after a sale is completed. The major inputs used in the valuation include:

- A forecast of future cash flows over a forecast period (often 5-10 years)
- A residual value estimate at the end of the forecast period
- A weighted average cost of capital (WACC), which is used as a discount rate

The table below shows the methodology in a simplified form over a five-year forecast period.

Forecast Year	Forecasted Cash Flow	Present Value Factor @ 12% WACC	Discounted Cash Flow
1	\$200,000	0.89	\$178,571
2	\$225,000	0.80	\$179,369
3	\$290,000	0.71	\$206,416
4	\$245,000	0.64	\$155,702
5	\$289,000	0.57	\$163,986
Residual	\$750,000	0.57	\$427,500
Estimated business value			\$1,311,544

For example, the first-year cash flow is \$200,000 and this is discounted by a 12% WACC (0.89 factor) to value the first-year cash flow at \$178,571. The residual value after five years is \$750,000, which has a present value of \$427,500 in today's dollars. The estimated business value is the sum of all the discounted cash flows plus the discounted residual value.

Professional appraisers follow a variety of different methods for forecasting cash flows. For example, a common method begins with earnings before interest (EBIT) and then subtracts estimated income taxes. It adds back any depreciation and amortization and subtracts capital expenditures and changes in working capital. The WACC is determined through methods similar to the capitalization rate, which was discussed under the capitalization of earnings method.

DCF is a relatively sophisticated and difficult appraisal method because it requires the appraiser to build and support a detailed earnings forecast. Also, it may be easier for critics (e.g., the IRS) to challenge unproven future-year forecasts than black-and-white income statements or balance sheets.

Comparables

Appraisers may also factor into their valuations an analysis of “comparables,” which can include recent sales of similar privately held companies and public companies in the same industry. Comparables are often used to determine the capitalization rate used in the capitalization of earnings method or the WACC used in the DCF method.

Discounts

Under any of the methods described above, appraisers may reduce their initial estimate based on commonly accepted discounts. Two types of discounts that are often used for closely held companies are a minority discount and a lack of marketability discount.

Minority Discount

The IRS and the courts have recognized that minority ownership of a closely held business does not have the same value as majority ownership, primarily due to a minority owner’s lack of control of the business. To fairly value minority interests, appraisers assign a discount to the value established under any method described above. The rationale for this discount is that the lack of control features of a minority interest make it less attractive to investors, who are not necessarily willing to pay the pro-rata value of 100% of a closely held company. Minority discounts can vary widely depending on the specific circumstances and assumptions used.

Lack of Marketability

When there is no ready market for the sale of a closely held business interest, the IRS and the courts may allow a discount for lack of marketability, regardless of the percentage ownership being acquired. Courts have held that a controlling interest in a non-public company can suffer from a lack of a ready resale market. Like minority discounts, lack of marketability discounts can vary widely among appraisers and situations. Minority and lack of marketability discounts may be combined into one calculation by an appraiser.

Conclusion

It should be clear that business valuation is an area in which the stakes are high and mistakes can be costly. Seasoned professional appraisers with proper credentials and training are required to determine an accurate value that can be supported with documentation and survive challenges from the IRS or in court. To arrive at a fair market value, the appraiser must weigh both internal business factors (e.g., management talent and financial condition) and external factors (e.g., economy, competition, and regulatory environment). Qualified appraisers may have different views, may use different methods, and may arrive at different valuations; therefore, it may be helpful to average the results of two different valuation methods or two different appraisers. Business valuation is not an exact science, so an appraiser’s ability to defend his/her work and negotiate resolutions with the IRS can be critical.