TOP TEN QUESTIONS OF VALUE

Throughout my career as a business valuation professional (business appraiser), I have been asked a number of questions repeatedly from the end users of the valuation report—business owners, attorneys, accountants, etc. These questions stem from the fact that, not only is the valuation profession highly specialized, valuation reports may be quite lengthy in the appraiser's effort to clearly delineate the methodology and rationale for the numerous assumptions that must be made. Indeed, business valuation is as much an art as it is a science. As such, some of the methodology, theory, and application of financial principles may be very unfamiliar to the average user of the valuation report. The following top ten questions of value have been compiled in an effort to briefly address some of the most frequent concerns business owners and others may have regarding a valuation.

1. What Is the Capitalization of Earnings Method?

In its simplest form, the Capitalization of Earnings Method provides an estimate of value of a company by converting the future income stream into value by dividing by a capitalization rate that incorporates a required rate of return for risk assumed by an investor along with a factor for future growth in the earnings stream being capitalized. This results in a value based on the present value of the future economic benefits that the willing buyer will receive through earnings, dividends, or cash flow. The capitalization method is based on the Gordon constant growth model which uses a single period proxy of future earnings to determine the present value of the asset. This method is usually employed when a company is expected to experience steady financial performance for the foreseeable future and when growth is expected to remain fairly constant. Extreme caution should be used when attempting to use this method, as applying a capitalization rate to the wrong "type" of earnings could spell disaster.

2. What "Discounts" Are Applicable When Gifting a Business Interest?

Generally there are two discounts considered in the valuation of a closely held business: 1) Lack of Marketability (Liquidity) and 2) Minority Interest (Lack of Control). The marketability (or liquidity) discount will apply in most valuation situations of privately-held companies. The data used in developing the appropriate discount or capitalization rate applicable to the subject company's cash flow measure is based upon empirical evidence associated with publicly traded companies. As the interest being valued is likely not actively or

A MEMBER OF THE NATIONAL ASSOCIATION OF CERTIFIED VALUATION ANALYSTS &
THE INSTITUTE OF BUSINESS APPRAISERS
1221 BRICKELL AVENUE, 9TH FL, MIAMI, FL 33131 > 888.537.5380 T > 760.457.2545 F
FOUNDERS CENTRE, 2411 NORTH OAK STREET, SUITE 305, MYRTLE BEACH, SC 29577 > 843.278.5437

freely traded on an open market, the degree of marketability (liquidity of the interest) between the privately-held company interest and that of the shares on which the discount data is derived is materially different, giving rise to the concept of a lack of marketability discount. The minority discount will only apply when the interest being valued is a minority or non-controlling interest. The valuation conclusion is made only after the minority interest discount and the lack of marketability discount have been applied. However, the two discounts are not unrelated. In fact, a marketability discount might be higher because the valued interest is a minority interest. While the two discounts should be applied separately, they should be considered together.

3. Are Business Valuations Needed for Gift and Estate Tax Purposes?

Yes! Business valuations are a must for estate and gift tax purposes. Estate valuation principles relating to business interests are in Regs. 20-2031-2 (f) and 20-2031-3. Gift tax valuation principles relating to gifts and bargain sales of a business interest are in Reg. 25.2512.3. Valuations for estate tax purposes are critical because the valuation determines the extent of federal estate taxes and tax basis of the business interest for the beneficiaries of the estate. Court cases have emphasized the need for contemporaneous valuations before filing gift and estate tax returns! These same cases stress the need for having a valuation professional with experience, training, and credentials. Upon IRS challenge, a professional valuation provides strong evidence of the value of a given interest established using widely-accepted methodologies.

4. What Is Goodwill?

Goodwill is defined as the intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified. The notion of goodwill has existed since mankind first entered into commercial activity. In ancient Egyptian bazaars, merchants knew the location closest to the city gates would provide the best opportunity to sell goods. In theory, merchants with the best locations could sell their businesses for a higher price. Location is only one example of why an ongoing business is worth more than the sum total of its property or tangible assets. Other elements might include reputation for good products and service, established customers, profitable history, reliable workforce, etc. Tax courts have held that goodwill represents the price paid for a business in excess of the value of tangible assets. But in many cases, determining the value of goodwill is not cut and dried and great differences of opinion will exist as to the value of goodwill.

A MEMBER OF THE NATIONAL ASSOCIATION OF CERTIFIED VALUATION ANALYSTS &
THE INSTITUTE OF BUSINESS APPRAISERS
1221 BRICKELL AVENUE, 9TH FL, MIAMI, FL 33131 > 888.537.5380 T > 760.457.2545 F
FOUNDERS CENTRE, 2411 NORTH OAK STREET, SUITE 305, MYRTLE BEACH, SC 29577 > 843.278.5437

5. What Are the Qualification of an Accredited Valuation Analyst and a Certified Business Appraiser?

An Accredited Valuation Analyst (AVA) is a valuation professional who has completed specialized advanced training in business valuations through the National Association of Certified Valuation Analysts (NACVA) and who has also completed a comprehensive examination and submitted a complete written valuation report to examiners. AVAs receive continuing education in valuations each year and observe the ethics, reporting standards, and practice standards of NACVA.

To be awarded the Certified Business Appraiser (CBA) designation from the Institute of Business Appraisers (IBA), the candidate is required to successfully complete educational requirements, testing, and peer review through the IBA. Requirements to earn the designation include holding a business degree from an accredited institution of higher education, possessing a prerequisite understanding of business valuation theory and practice, and demonstrating a minimum of 10,000 hours of prior work experience in business valuation. The candidate must also complete in-depth IBA coursework covering various aspects of valuation theory and application, methodology, and report writing and pass a comprehensive examination. The final step in earning the CBA designation is the successful completion of the rigorous peer review of two demonstration reports submitted by the candidate. To maintain the designation, a CBA will be required to obtain continuing professional education in business valuation and participate in periodic peer review programs aimed at promoting quality and adherence to IBA standards.

6. Are "Rules of Thumb" Useful in Business Valuations?

Rules of Thumb are generally expressed as multipliers. A common example would be that some particular type of business will sell for .75 to 1.50 times annual revenues. Another popular multiple is a multiple of discretionary earnings. For example, a particular type of business is said to sell for X times Seller's Discretionary Cash Flow (SDCF), or Owner's Cash Flow (OCF). There may also be other rules of thumb relating to some measure of physical volume, such as X dollars times each keg of beer sold per month.

Are such rules of thumb useful? Generally, rules of thumb should not be used as a primary method of business valuation. The valuation of any type of business can change over time due to changes in technology, economic and industry conditions. Rules of thumb may be useful as "sanity checks" or

HIGHLAND GLOBAL, LLC
www.HighlandGlobal.com
A MEMBER OF THE NATIONAL ASSOCIATION OF CERTIFIED VALUATION ANALYSTS &
THE INSTITUTE OF BUSINESS APPRAISERS
1221 BRICKELL AVENUE, 9TH FL, MIAMI, FL 33131 > 888.537.5380 T > 760.457.2545 F
FOUNDERS CENTRE, 2411 NORTH OAK STREET, SUITE 305, MYRTLE BEACH, SC 29577 > 843.278.5437

guessing ballpark ranges but will seldom be accepted by courts as a substitute for a qualified valuation.

7. How Is a Valuation Useful when Drafting Buy-Sell Agreements?

Buy-sell agreements for privately-held companies provide the shareholders with a mechanism by which the interest of a deceased or withdrawing shareholder may be liquidated through a repurchase agreement, a cross-purchase agreement, or a hybrid agreement. Providing for how the value of the shares is established is critical for a successful buy-sell agreement. Generally, there are three methods through which the value of the shares may be established: 1) specific formula approach based on a financial metric such as book value, earnings, etc., 2) negotiation between the parties, 3) independent outside appraisals. While the value determined by a specific formula may be manipulated by the controlling shareholders who have some discretion over how the financial statements are reported and the negotiation between the parties may fail when the parties are unable to agree on terms, an independent outside valuation conducted as part of an annual valuation program provides a clear means of establishing the value of an interest over time.

8. What Is the Difference Between an Expert Consultant and Expert Witness?

As an expert consultant, the valuation professional is engaged to develop information that will be used by the attorney in a variety of ways, including settlement negotiations with the opposing side. In these instances, the valuation professional is usually not expected to testify or to develop an opinion of value that will be entered into the court records. The documents created by the valuation professional may be protected by attorney-client privilege. In this situation, the valuation professional is working as the client's advocate.

When hired as an expert witness, the valuation professional will often have to provide deposition and courtroom testimony, and all of the documents created, including reports relating to the case, are subject to "discovery" by the opposing side. Professional standards prohibit the valuation professional from being an advocate for the client in situations where an opinion of value is rendered. A valuation professional is considered to be acting in an unethical manner if he or she advocates the client's position. The valuation professional, however, may be an advocate for his or her own opinion of value. The valuation analyst is supposed to be unbiased and completely independent in rendering an opinion of value.

HIGHLAND GLOBAL, LLC
www.HighlandGlobal.com
A MEMBER OF THE NATIONAL ASSOCIATION OF CERTIFIED VALUATION ANALYSTS &
THE INSTITUTE OF BUSINESS APPRAISERS
1221 BRICKELL AVENUE, 9TH FL, MIAMI, FL 33131 > 888.537.5380 T > 760.457.2545 F
FOUNDERS CENTRE, 2411 NORTH OAK STREET, SUITE 305, MYRTLE BEACH, SC 29577 > 843.278.5437

Accredited Valuation Analysts and Certified Business Appraisers are highly trained ethical professionals who have earned the respect of the professional community.

9. What Is the Difference between Enterprise Value and Equity Value?

Sometimes people use the two terms interchangeably. However, for valuation purposes there may be a significant difference in the two terms. **Enterprise value** is often referred to as the value of the invested capital which includes the value of the equity and the value of the firm's liabilities. This could represent the asset side of the balance sheet and would likely include the hard business assets (property, equipment, etc.), cash, receivables, inventory, and the goodwill of the business. **Equity Value** is the enterprise value LESS all liabilities of the business. As various professionals may define these levels of value differently, it is important to understand exactly what a definition of a level of value includes or excludes under specific circumstances delineated in the valuation report.

10. What is the Difference between EBITDA and Seller's Discretionary Earnings and Why are they Important in Financial Analysis?

EBITDA stands for **E**arnings **B**efore **I**nterest, **T**axes, **D**epreciation and **A**mortization. EBITDA earnings are used by many valuation professionals and financial analysts as a method to compare the cash earnings of a subject company with cash earnings of comparable companies. This method of earnings comparison is useful because it equalizes differences between or among companies in their capital structures, their depreciation methods and tax rates. This "equalization" allows the analyst to make informed judgments about earning capabilities of each company.

Accountants and lawyers often think of earnings in terms of "net profit" or "net after-tax income." For closely-held businesses, however, do those measurements tell the whole story? Business brokers and some valuation professionals tend to disregard the historical income figures in favor of "Seller's Discretionary Earnings" (SDE) generated by the business. There are different versions of SDE, but all have the same goal: Determining the amount of actual benefit that is provided to the business owner. Typically, SDE may be defined as net income plus non-cash items (depreciation and amortization) plus any owner benefits (salary, insurance, discretionary spending/personal expenses paid by the company).

HIGHLAND GLOBAL, LLC
A MEMBER OF THE NATIONAL ASSOCIATION OF CERTIFIED VALUATION ANALYSTS & THE INSTITUTE OF BUSINESS APPRAISERS
1221 BRICKELL AVENUE, 9TH FL, MIAMI, FL 33131 > 888.537.5380 T > 760.457.2545 F
FOUNDERS CENTRE, 2411 NORTH OAK STREET, SUITE 305, MYRTLE BEACH, SC 29577 > 843.278.5437
www.HighlandGlobal.com