South Carolina Bar
Continuing Legal Education Division

2018 SC BAR CONVENTION

Family Law Section

"Show Me the Money—The Financial Ins & Outs of Your Family Court Case"

Friday, January 19

SC Supreme Court Commission on CLE Course No. 180804

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ABC's of Business Valuation

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ABC's of Business Valuation
South Carolina Bar Convention
Family Law Section
Kiawah, South Carolina
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Learning Objectives

1. Be able to assess the facts, analysis and judgments made by the business valuation experts and the conclusions they draw.
2. Understand:
   a. The terms Standard of Value, Premise of Value and how the Standard of Value affects the conclusion of value.
   b. Approaches to valuing a business
      i. Market
      ii. Income
      iii. Asset-Based

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Learning Objectives

c. Critical Components of a Business Valuation, including:

iii. Normalized Earning Adjustments

- Revenue
- Expense
- Reasonable compensation

3. Be able to compare and critique expert reports.

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Business Valuation Concepts

PREMISE OF VALUE

- **Value in Exchange**: Owner realizes the benefits of ownership by selling the business.
- **Value to the Holder**: Owner realizes the benefits of ownership by the cash flow[1] received while owning the business.

STANDARDS OF VALUE

- **Fair Market Value:** Value in exchange concept. The business is valued assuming a hypothetical sale between a willing buyer and a willing seller if appropriate minority and marketability discounts are allowed.
- **Fair Value:** Can be similar to Fair Market Value, but, minority discounts are not typically applied and marketability discounts are only applied under extraordinary circumstances. Can include the value to the holder premise because the business cannot be sold or there is no intention to sell.

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Approaches to Value

Market Approach

- *If you sell your house, you look at sales of houses similar to yours and make adjustments for amenities and other differences to arrive at an asking price. This is known in the valuation of real property as the Sales Comparison Approach*

Income Approach

- *If you rent your house, you can determine the value of your house by estimating the total rental income the house could generate over the years and assuming that a dollar today is worth more than a dollar in the future.*

Asset-based Approach

- *If you were to buy a new house, the builder would charge for the price of the land, the costs to construct the house and a profit. This is referred to in the valuation of real property as the Cost Approach*

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Expert Report Comparison

	Initial Report	Revised Report
FISHMAN FAIR MARKET VALUE	$ 8,520,000	$ 7,960,000
Adjustments the Other Expert Made:		
Subsequent Distributions	(5,000,000)	(5,000,000)
Accrued Vacation	(14,900)	(14,900)
Chargebacks	(660,000)	(660,000)
Legal Expenses	(50,000)	(50,000)
A/D Comp W/C Liability	(113,239)	(113,239)
Net Impact of Taxes	352,018	352,018
Fishman Adjustments:		
Adjustment to M&E	(196,556)	(328,468)
Difference in Goodwill	(1,176,844)	703,912
Difference in Tax on LIFO (Fishman 40%, Other 42%)	(24,804)	(24,804)
Total Enterprise Level Adjustments	(6,884,325)	(5,135,481)
50% of Enterprise Level Adjustments	(3,442,163)	(2,567,741)
Difference in Discounts	(2,384,724)	(2,611,496)
Other items (Rounding and Ownership Interest)	(88,404)	(85,902)
OTHER EXPERT FAIR MARKET VALUE (50%)	2,604,710	2,694,861
OTHER EXPERT FAIR MARKET VALUE (49%)	$ 2,552,616	$ 2,640,964

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Because of the limited time we will focus on the Income Capitalization Method of the Income Approach.

Income Approach

- Value is the present worth of future benefits of ownership.
- The present value of a dollar ($1) today is worth more than $1 in the future.

At a 5% interest factor, $1 today will be worth $1.05 in one year. Consequently, $1.05 payable in one year is worth $1 today and $ .95 paid in one year is worth $.90 today.

Income Capitalization Method

- Used when the expected future income or cash flow can be determined as one normalized amount which will grow at an average annual rate, for instance, 3%.
- Value is calculated as:

VALUE = INCOME / CAP RATE
$900,000 = $180,000 / 20%
$900,000 = $180,000 x 5

P/E Ratios and Implied Cap Rates

The following are examples of P/E ratios for publicly traded stocks as of June 30, 2016 and the implied cap rate:

	P/E Ratios	Implied Cap Rates
International Business Machine (IBM)	11.52	8.68%
Coca-Cola Company	27.28	3.67%
Apple, Inc.	10.62	9.42%

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In the Income Capitalization Method, the expert will:

- Make normalized earnings adjustments
  - Revenue
  - Expense
  - Reasonable compensation
- Determine income to capitalize
- Determine the tax affect
- Determine an appropriate capitalization rate
  - Discount rate
  - Growth rate

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Factors to Consider

- Nature and history of the business
- Economic and industry conditions
- Book value and financial condition
- Earning capacity
- Dividend-paying capacity
- Goodwill or other intangible value
- Prior sales of the stock and percentage of the business being valued
- Market price for corporations in the same, or similar, line of business

The Eight Factors of *Revenue Ruling 59-60*

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Factors to Consider

- Has the expert considered the eight factors of RR 59:60?
- Usually, the expert who **understands the business best** is the one who is most able to make sound valuation judgments.
- When the expert makes seemingly small changes in critical components, these changes can have a large effect on the conclusion of value.

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Normalized Earnings

- Most closely held business owners attempt to minimize taxes.
- They pay themselves what the business can afford to pay and typically report little, if any, earnings.
- Closely held businesses normally distribute profits as salary and other benefits.
- Public companies maximize profits and distribute them to shareholders as dividends.
- Therefore, the expert adjusts financial statements to report the earnings as if the business was run by a third party whose goal was to maximize profit, not to minimize taxes. In other words, the expert adjusts the income as if the owner is preparing to sell the company.

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Adjustments to Revenue

- Most adjustments will increase income.
- Examples of adjustments to revenue include:
  - Unreported cash or other proceeds
  - Deferred revenue – the net change for each year is what is important
  - Nonrecurring revenue

Adjustments to Expenses

- Most often, but not always, these adjustments increase income.
  - Personal expenses
  - Non-recurring expenses
  - Extraordinary expenses
  - Normalization adjustments

Reasonable Compensation

Adjusts the amount paid to the owner to an amount that a non-owner employee would receive to perform the same services.

Considers the age, experience, productivity, locale, education and expertise of the owner/employee, and the location of the business.

Often one of the biggest differences between two experts.

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NORMALIZATION ADJUSTMENTS COMPARISON

	EXPERT #1	EXPERT #2	JUDGE
Income	$100,000	$100,000	$100,000
Add:			
Unreported Income	24,000	50,000	
Personal Purchases	20,000	40,000	
Auto & Truck	6,000	9,000	
Employee Benefits	-	13,000	
Legal & Professional	-	13,000	
Reasonable Compensation	50,000	75,000	
Income Before Tax	$200,000	$300,000	

Income to Capitalize

- Choose a period to capitalize. Some typical periods used are:
  - The most recent operations of the past twelve months or fiscal year.
  - A forecast (projection) of the next year.
  - An average of the operations for several past years.
  - Median or average profit margins for the past several years

Tax Affecting the Income to Capitalize

- The buildup method used to calculate the cap rate is used with after tax income.
- Whether to tax affect and how much to tax affect the income of flow through entities is an issue in controversy in the valuation community.

INCOME TO CAPITALIZE COMPARISON

YEAR	EXPERT #1	EXPERT #2	JUDGE
1	200,000	300,000	
2	180,000		
3	160,000		
4	175,000		
5	150,000		
	2,700,000		
Divided by	15		
Pre-Tax Income to Capitalize	180,000	300,000	
Taxes	<63,000)	<75,000>	
After Tax Income to Capitalize	$117,000	$225,000	
Other (i.e. Projection)			

Capitalization Rate[2]

- The discount rate minus the long term growth rate is known as the capitalization rate.
- Two critical components in the cap rate are risk (“R”) and growth (“G”).

[2] A capitalization rate is the rate used to convert income or cash flows into value

Discount Rate

Batting Average Statistics - Standard Deviation

Batting Average	**Batter A**			
Batter B				
Year 1	0.295		0.300	
Year 2	0.300		0.250	
Year 3	0.310		0.350	
Year 4	0.290		0.250	
Year 5	0.305		0.350	
Average		**0.300**		**0.300**
Standard Deviation	**0.79%**		**5.00%**	

Discount Rate

- Think of a discount rate in terms of an interest rate. Converting a future income stream to its present worth is the opposite of compounding. Meaning because you have to wait for the money and lose the opportunity to invest it and get interest, a dollar a year from now is not worth a dollar today.
- Generally, there are two methodologies used to calculate a discount rate:
  - *Capital Asset Pricing Model (CAPM)*
  - *Build-Up Method*
- These methods begin with risk free rate usually the 20 year treasury bonds and increase the discount rate to account for the fact that stocks are riskier than bonds especially ownership interests in closely held businesses.

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Discount Rate

Components of the Discount Rate→

- **RISK FREE RATE** is the 20 year Treasury bond rate as of the valuation date. There is no judgment; the expert looks up this number in a chart.

- **EQUITY RISK PREMIUM** (ERP) is the rate of return added to the risk free rate to reflect additional risks of large company stocks (i.e. S&P 500) over a risk free government backed 20 year Treasury Bond.

- **INDUSTRY RISK PREMIUM** measures whether the industry in which the company operates is more or less risky than the market as a whole.

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Discount Rate

Components of the Discount Rate→

- **SIZE PREMIUM** increases the rate of return when the subject company is smaller than the average size of a publicly traded company.

- **SPECIFIC COMPANY RISK PREMIUM** is this adjustment is based on the Expert's judgment. As such it is typically the largest area of disagreement if not the only area of disagreement between the experts. Typical areas which affect the risk of a business are the depth of management, competition, customer concentration, product lines, geographic locations, debt, shrinking or expanding profit margins, etc.

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Discount Rate

↑ Risk

↑ Discount Rate

↓ Value

	Risk Free Rate	1.87
+	Equity Risk Premium	6.03
+ or -	Industry Risk	---
+	Size Premium	5.60
+ or -	Specific Company Risk	9.50
=	Discount Rate	.23

This adjustment is particularly prone to abuse

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Growth Rate

- This rate is the company's average long term sustainable growth rate.
- The growth rate can dramatically affect value because it increases both income and the cap rate.

Operation of Cap Rate

- Even small changes to the discount rate or the growth rate can have a large effect on value.

As discussed earlier, the formula for the computation of the cap rate is:

Discount Rate (R)

- Growth (G)

= Cap Rate

Operation of Cap Rate

The full formula for the computation of value is:

$$\frac{(\text{Income})\ (1 + G)}{R - G}$$

OR

$$\frac{(\text{Income})\ \ (1 + G)}{\text{Cap Rate}}$$

CAP RATE COMPARISON CHART

	EXPERT #1	EXPERT #2	JUDGE
Risk Free Rate	0.04	0.04	0.04
+ Equity Risk	0.07	0.07	0.07
+ or – Industry Risk	0.02	-	
+ Size Premium	0.03	0.03	0.03
Specific Company Risk	0.11	0.07	
Discount Rate	0.25	0.21	
Less: Growth Rate	(0.02)	0.06	
Cap Rate	23	15	

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Makes Adjustments to Income	• Compare the adjustments • Do the adjustments make sense?
Determines Income to Capitalize	• Compare Reasons
Determines the Tax Effect on the Income	• Compare Reasons
Determines the Cap Rate	• Discount Rate • Compare Reasons • Long Term Growth Rate • Compare Reasons

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Moore v. Moore

Valuation Issues Related to Goodwill

- Identifying Personal Goodwill
  - Based on skill, knowledge, reputation, personality and business relationships
  - Centers on the stage of development of the business
  - Has the individual's reputation been institutionalized
  - How much does the success or failure of the business depend on the individual's personal services
  - Surviving the 'walk away"
  - Other intangibles

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Methods to Quantify Personal Goodwill

- Top-Down
  - Value entire entity then separately identify and eliminate personal goodwill

- Bottom-Up
  - Value net tangible assets then identify transferable intangible value

Questions

2018 SC BAR CONVENTION

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Income—Let's Think Outside the W-2

Richard Livingston
Cindy MacAulay

No Materials Available

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Family Law Section

Friday, January 19

A Complete Overhaul of Military Retirement System & How to Protect Your Client

Mary Fran Quindlen

No Materials Available

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Legislative Update

Rep. Bruce Bannister

No Materials Available