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Closely Held Businesses Require Complex Calculations

BIGSTOCK

BY THOMAS A. HUTSON AND JOHANNE M. FLOSER

PUBLIC COMPANY STOCK is actively traded at the NYSE, or electronically using the NASDAQ, or through other markets, and the value of shares exchanged is quoted throughout the trading day. But what about businesses that are privately owned and not listed on any of these exchanges: How are they valued?

Valuations are performed for a variety of circumstances including, but not limited to, marital dissolutions, gift and estate tax filings, succession planning, buy-sell transactions, dissenting stockholder and minority oppression actions, and other litigation or alternative methods of dispute resolution.

The first step in valuing an interest in a private company is to identify its legal form.

Operating and Ownership Structures

Businesses are most commonly classified as sole proprietorships, general and limited partnerships, limited liability companies, or corporations. Written ownership or operating agreements, if any, are then gathered so that the rights and duties pertaining to the interest being valued can be analyzed in relation to those of other owners.

Ordinarily, an ownership interest of greater than 50 percent is considered to be a majority interest, but in some cases such interests may not necessarily exhibit the characteristics of control (i.e., the power to conduct or manage the affairs of the enterprise, to transact business and contractually bind the entity, to determine management compensation and perquisites, to acquire or liquidate assets, etc.).

THOMAS A. HUTSON *is a partner with BST Valuation & Litigation Advisors and* JOHANNE M. FLOSER *is a senior manager with the firm.*

Similarly, an ownership interest of less than 50 percent is ordinarily considered a non-controlling interest, which lacks the power to unilaterally exercise such privileges. However, certain circumstances provide minority interests with elements of control in varying degrees.

For example, the number of shareholders and size of their respective interests may provide a minority interest holder with a swing vote (i.e., the ability of two or more minority ownerships to combine efforts to create a majority interest), or a small general partnership interest may be contractually provided all, or nearly all, managerial authority.

A middle ground also exists where an entity is jointly owned by two equal 50 percent partners or shareholders. By definition, a 50 percent interest is neither a majority (i.e., controlling) nor a minority (i.e., non-controlling) interest.

Standards and Factors in Valuation

Fair market value (FMV) is the most widely recognized and accepted standard of value. It applies to virtually all federal and state tax matters such as estate, gift, inheritance, income and ad valorem taxes.

FMV is defined as "the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."[1] Other standards of value include investment value, intrinsic value and fair value.

Internal Revenue Service Revenue Ruling 59-60 is generally recognized as a source of guidance for the valuation of closely held businesses. The following factors are suggested for consideration:[2]

- the nature of the business and the history of the enterprise from its inception;
- the economic outlook in general and the condition and outlook of the specific industry in particular;
- the book value of the stock and the financial condition of the business;
- the earnings capacity of the company;
- the dividend paying capacity;
- whether or not the enterprise has goodwill or other intangible value;
- sales of the stock and the size of the block of stock to be valued; and
- the market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

Data Gathering and Financial Analysis

In order to design and prepare appropriate valuation computations, the valuator needs to gather further information about the company, including, but not limited to, financial statements, tax returns, business plans, budgets and forecasts, contracts and agreements, and descriptive historical and product or service related information and industry data. Site visits to tour the facilities and interview management are often an important part of the information gathering process.

Analysis of the information gathered often reveals that a normalization of the historic financial statements is required. During the normalization process balance sheets are adjusted by identifying and separately categorizing excess and nonoperating assets and liabilities not necessary for the regular ongoing operations of the business.

In addition, income statements are adjusted by removing nonrecurring, nonoperating, or other unusual items that do not contribute to the prospective net income or cash flows from operations of the subject company, thereby eliminating anomalies and facilitating comparisons.

The type of normalization adjustments that are made depend upon the valuation method utilized and whether a controlling interest or a minority interest position is being valued.

Normalization adjustments are generally categorized as follows:

- *Comparability adjustments* are designed to present data in a manner reflective of generally accepted accounting principles (GAAP), and/or industry accounting standards so that the subject company's financial information is comparable to that of other companies in the industry.
- *Non-operating and non-recurring item adjustments* separate nonoperating assets and liabilities from those required for regular business operations in order that they may be separately evaluated. Revenue and expense items that are unrelated to business operations or that are not likely to recur in the future are eliminated so income statements reflect only normal business activities.
- *Discretionary adjustments* normalize expenses that are solely at the discretion of management or owners. They are common for small and medium-sized closely held businesses but may also be appropriate for a large company.
- *Control adjustments* are those that a controlling interest holder or potential owner might make to business operations. Since a minority interest holder does not ordinarily possess the power to effectuate change in company policy, it is generally considered to be inappropriate to make certain controlling adjustments when valuing a minority interest, unless there is reason to believe that the changes are imminent. If such adjustments are made, adequate consideration must be given to the need for a minority interest (or lack of control) discount.

> The **asset-based** approach, which defines the value of the subject company to be **equivalent** to the **fair market value** of its **assets** net of liabilities, is frequently used to value investment or real estate holding companies; it is difficult to employ, and is **generally not used**, when the company has significant intangible asset value and goodwill.

Control adjustments may include the discretionary adjustments described above, the realization of gains or losses and net cash proceeds from the sale of excess assets, the elimination of operational inefficiencies and excess costs or expenses, and changes in capital structure or the level of interest expense.

Approaches and Methodologies

The selection of the appropriate valuation methodology is an important factor in any business valuation.

As noted in Revenue Ruling 59-60, no general formula may be given that is applicable to the many different situations arising in the valuation of a closely held business.[3] When a valuation methodology is applied under the fair market value standard, the chosen methodology should be representative of the analysis that a hypothetical willing buyer and a hypothetical willing seller would undertake in determining the value of the business being considered.

There are three general approaches to valuing a business: 1) the asset-based approach, 2) the market-based approach, and 3) the income-based approach.

The ***asset-based approach*** defines the value of the subject company to be equivalent to the fair market value of its assets net of liabilities. It essentially replaces the historical cost of certain assets reported on the balance sheet with the fair market value for those assets, if readily ascertainable either from independent asset appraisals or through other estimation means.

The asset-based approach is frequently used to value investment or real estate holding companies. It is difficult to employ, and is generally not used, when the subject company has significant intangible asset value and goodwill.

The ***market-based approach*** provides an indication of value based upon historical transactions involving comparable publicly traded securities or closely held business interests. The market approach includes the guideline public company method and the guideline transaction (or market data) method.

The market approach utilizes information gathered from either public or private sources and, through the application of value multiples appropriate to the subject company, can provide a meaningful indication of the subject company's value. In addition, where relevant arm's length sales of comparable ownership interests in the subject company have previously taken place, such historical sales may also be considered in developing appropriate valuation pricing multiples.

The ***income-based approach*** provides an indication of value by either capitalizing the operational results historically achieved by the entity or by discounting its projected future earnings or cash flows. Under this approach, two valuation methods commonly used to provide an indication of fair market value are: 1) the capitalization of earnings method and 2) the discounted future returns method.

The *capitalization of earnings methodology* determines the value of an investment by dividing the subject company's expected earnings, derived from an analysis and normalization of current and historical earnings, by an appropriate capitalization rate (or, equivalently multiplied by a capitalization multiple which is the inverse of a capitalization rate). The capitalization rate is the rate of return a potential investor would require as an enticement to invest, given the nature and risk of the underlying investment, less a long-term sustainable growth rate.

Capitalization is the conversion of a single period of economic benefits into value. Capitalization rates are generally derived from the public markets, supplemented by the judgment of the valuator in assessing company specific factors.

The capitalization rate is often determined through application of a process known as the build-up method, that starts with the long-term Treasury bond yield, which is considered to be a proxy for a risk-free rate, and then adds various components of additional risk including an equity risk premium (i.e., the expected premium for investing in a broad index of common stocks over risk-free instruments), a size risk premium (i.e., the premium for investing in smaller companies), and an adjustment for other factors specific to the company being valued and the industry in which it operates, to arrive at a discount rate.

The capitalization rate is determined by subtracting a long-term average sustainable growth rate from the discount rate. The value of the business is determined by applying the capitalization rate (or multiple) to normalized expected earnings. The subject ownership percentage interest is then determined and appropriate valuation adjustments (discounts or premiums) are applied to arrive at fair market value.

The *discounted future returns methodology* is based on the theoretical principle that an investment in a business is worth the present value of all the future benefits that it will produce for its owners, with each expected future benefit discounted back to present value at a discount rate that reflects investor's assessment of the risk (degree of uncertainty) that those benefits may not be realized. The application of this methodology requires that two principal values be quantified: a projection of expected future net income and an appropriate rate at which to discount expected future net income to a present value.

Under the discounted future returns method, which is a multi-period model, the discount rate is applied to projected earnings or cash flows each year until the income stream is deemed to stabilize in a "terminal" year. Application of the discount rate in this fashion yields a present value of each year's net income or cash flows between the date of valuation and the "terminal" period. A capitalization rate (or multiple) is applied to the terminal year earnings (single period), to determine the future terminal year value of the business, which must also be discounted to present value.

The sum of all these parts provides the value of the business. The subject ownership percentage interest is then determined and appropriate valuation adjustments (discounts or premiums) are applied to arrive at fair market value.

Discounts and Premiums

Valuation adjustments (discounts or premiums) are applied to pre-adjustment values. For closely held businesses, common discounts include a discount for lack of control (minority interest discount) and a discount for lack of marketability or liquidity.

A minority interest discount (or lack of control discount) quantifies the inability of an owner that does not have a controlling interest to exercise the privileges of control. Such privileges include, but are not limited to, the power to conduct or manage the affairs of the enterprise, to transact business and contractually bind the company, to determine management compensation and perquisites, to acquire or liquidate assets, to declare and pay distributions of net earnings, to dissolve, sell or recapitalize the company, etc.

Minority interest discounts can be derived from analyzing the control premiums paid when a public company is acquired. A control premium is the amount, or percentage, by which the pro rata value of a controlling interest exceeds the pro rata value of a noncontrolling interest in a business enterprise.

It is important to recognize that public company acquisitions may involve a buyer that gains synergies, economies of scale, or other benefits or competitive advantages that are paid for in addition to control. The price paid is often more indicative of investment value, i.e., the value to a particular investor based on individual investment requirements and expectations, and may not be appropriate for the hypothetical willing buyer and seller contemplated under the fair market value standard.

A lack of marketability (or illiquidity) discount recognizes the ease with which publicly traded securities can be bought and sold in contrast to minority interests in closely-held businesses. A lack of marketability discount reflects the fact that a ready market does not exist in which closely held ownership interests can be freely bought and sold. This discount quantifies the effect on fair market value of the difficulty of divestiture of a closely held business interest in an environment devoid of the liquidity associated with the public marketplace and the broad universe of potential buyers and sellers that participate in it.

Even a controlling interest, however, can be affected to some extent by a lack of marketability or liquidity. For example, to facilitate the sale of a privately owned business it is often necessary to incur marketing costs, business brokerage commissions, or other transaction costs or professional fees. These costs and fees are incurred to make an otherwise illiquid and difficult to sell business, or interest in a business, more marketable. Such efforts can provide liquidity to an otherwise illiquid investment.

Conclusion

This article provides an overview of basic concepts associated with the valuation of a closely held business and is not intended to be all inclusive. The value of a closely held business is best assessed by a qualified appraiser, which the Internal Revenue Service defines as an individual who has, among other things, earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements.[4]

1. International Glossary of Business Valuation Terms, as adopted by the American Institute of Certified Public Accountants (AICPA), the American Society of Appraisers (ASA), the Institute of Business Appraisers (IBA), the National Association of Certified Valuation Analysts (NACVA), and the Canadian Institute of Chartered Business Valuators (CICBV).

2. Internal Revenue Service Revenue Ruling 59-60 §4.01 (a)-(h).

3. Internal Revenue Service Revenue Ruling 59-60.

4. Internal Revenue Code §170(f)(11)(E)(ii).