Business Valuations Demystified & Buy-Sell Agreements

HOW FINANCIAL PROFESSIONALS CAN ASSIST IN BUILDING BUSINESS VALUE

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Agenda

Start time: 1:45

- When is a valuation needed?
- What valuation credentials do I look for?
- What is the real business income?
- Business Valuation Basics
- Tax Cuts & Jobs Act – Business Value Implications
- Shareholder Buy-outs and Buy-Sell Agreement terms

Conclude: 2:35 pm

When is a valuation needed?

- Business Transactions
  - Shareholder Buy-outs
  - Stock Sales
  - ESOPs – Annual Valuation
  - A sale or merger of a business
  - A Sale to Management or Related Parties

When is a valuation needed?

- Tax & Financial Reporting
  - Gift tax and Estate tax
  - Real estate holdings companies (gift & estate)
  - “C” Corp to “S” Corp conversions
  - Restricted stock grants (income tax)
  - Stock Option exercise price (ASC 718/409a)

When is a valuation needed?

- Litigation
  - Shareholder disputes
  - Marital dissolutions
  - Economic damages (loss in business value)
  - Franchise Disputes
  - Eminent Domain

Credentials to Look For

Designation	Organization	Required Experience in BV
CFA	CFA Institute	None; but Respected
ASA	American Society of Appraisers	5 years
AM	American Society of Appraisers	2 years
CPA/ABV	AICPA	6 valuations or 150 hours

Business Valuation Methodology

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Is it a Job or a Business?

- You have a client with a small services business and the 100 percent owner does most of the work himself/herself…
- A job is <u>not</u> an asset to be divided. Is it a Job or a Business?
- Need to determine:
  - Is there Debt Free Cash Flow greater than reasonable compensation to the owner(s)?
  - Is there something of value to a hypothetical buyer?

Business Defined – ASU 2017-01

- My definition not same as FASB's
- ASC-805 discusses accounting for a "business combination" vs. an "asset acquisition"
- A business if there is:
  - An input
  - A substantive process (such as organized workforce)
  - Output (i.e. – revenue)

- Per EY, if revenues are generated before and after a transaction, the set is typically considered a business.

Cash Flows for Business Valuation

- **Debt Free Cash Flow**– The cash flows available to pay out to **equity** holders (dividends) **and debt** holders (principal and interest).

	Earnings Before Interest and Taxes (**after** owner comp)
+	Non-cash charges (e.g., depreciation & amortization)
-	Capital expenditures necessary to support on-going operations ("Economic Depreciation")
-	Additions to net working capital
-	Taxes due on Business income
=	***Debt Free Cash Flow (after-tax)***

** **Also Called "Free Cash Flow to Invested Capital"***

Step 1: Adjusting EBITDA

- Reasonable Owner's Compensation
  - Debt Free Cash Flow is **<u>after</u> owner's reasonable market compensation**
  - Thus determining reasonable compensation is critical to determining business value

- Adjusting EBITDA
  - Add back actual owner compensation
  - Subtract market compensation

Step 1: Adjusting EBITDA

- **Non-Cash expenses** such as depreciation and amortization are added back

- **Discretionary Expenses** include:
  - Personal expenses run through the Business
  - Other expenses that a hypothetical buyer of the Business would not incur (i.e., not required for operations)

Step 1: Adjusting EBITDA

- **Non-recurring expenses**
  - Are normally added back for a business valuation
  - ***Defined***: Material expenses not expected to continue going forward in the Business, such as:
    - One-time legal fees
    - Large one-time software/computer upgrades
    - Yacht repairs (discretionary and non-recurring)

Reasonable Compensation

- Ways to determine reasonable compensation:
  - **Cost of hiring a non-owner outsider** to perform similar services
  - What would the business owner make **working for someone else**? (i.e., a typical salaried employee)
  - The **annual salary of a typical salaried employee** who has experience commensurate with the owner/CEO
  - What would a **similarly situated professional** make?

Case Study – A Business?

- Manufacturer – Business to Business sales
- 20 employees
- Owner is key to the business operations and sales efforts

Adjustments (Add-back's)

Operating income	**$332,820**
<u>Discretionary and other adjustments:</u>	
Amortization	$900
Depreciation	$48,000
Interest	$34,704
Contributions	$1,000
Rent	$50,006
less: Market rent	($97,200)
Officer's gross wages	$80,000
<u>Non-recurring expense adjustments:</u>	
Advertising	$5,000
Computer software	$13,000
Total adjustments	$135,410
Adjusted EBITDA, Before Owner Comp	**$468,230**

Normalized Earnings

Adjusted EBITDA, Before Owner Comp	**$468,230**
Less: Market CEO compensation	($200,000)
Less: Economic Depreciation	($30,000)
Adjusted Operating Income (EBIT)	**$238,230**

Debt Free Cash Flow

Normalized Operating Income (EBIT)		$238,230
less: Estimated income taxes	27.98%	($66,657)
add: *Economic* Depreciation		$30,000
less: Ongoing capital expenditures		($30,900)
less: Incremental debt-free working capital	5.0%	($3,216)
Debt-free net cash flow - after reasonable owner comp.		**$167,500**

Valuation Approaches

- 3 Legs to the Stool:
  - Income Approach
    - Cap of Earnings, or
    - Discounted Cash Flow
  - Market Approach
    - Sales of Businesses, and/or
    - Public Companies
  - Cost Approach

Income Approach – Cap of Earnings

Debt-free net cash flow - after reasonable owner comp.	**$167,500**
divide: Capitalization rate	15.0%
Estimated business enterprise value (rounded)	**$1,117,000**

Note: If Tangible Assets worth $512k, then Intangible/Goodwill value is $605k.

Calculating the Cap Rate

Weighted Average Cost of Capital (WACC)	Cost of Capital	% in Capital Structure	Weighted Cost
Debt	2.6%	25.0%	0.6%
Equity	23.0%	75.0%	17.2%
Weighted average cost of capital (Rounded)			18.0%

Cost of Equity - Build-up Method	
Risk-free rate	2.8%
Market equity risk premium	6.2%
Size premium	8.9%
Company-specific risk adjustment	5.0%
Estimated cost of equity	**23.0%**

The Cap Rate = (WACC – 3% Long-term growth rate)

Excess Earnings – Professional Services

Normalized debt-free net cash flow - after reasonable owner compensation		$167,500
Net tangible operating assets	$512,177	
Reasonable rate of return	8.8%	
less: Reasonable return on net tangible operating assets		($45,072)
Excess earnings		$122,428
divide: Capitalization rate for goodwill		20.0%
Implied value of goodwill		$612,142
Net tangible operating assets		$512,177
Implied Business Enterprise Value		$1,124,319
Estimated business enterprise value (rounded)		**$1,120,000**

Market Approach – Sales of Businesses

Normalized			
Revenue	$2,144,300	0.50 x	$1,072,150
Seller's Discretionary Earnings (SDE)	$468,230	2.25 x	$1,053,518
Indicated range of values of fixed assets, inventory and intangibles (rounded)			$1,063,000
Plus: Working Capital			$155,708
Estimated business enterprise value (BEV) range (rounded)			$1,219,000
Estimated BEV, controlling, marketable interest (rounded)			**$1,219,000**

Valuation Summary

Income Approach	
Capitalization of earnings method	$1,117,000
Capitalization of excess earnings method	$1,120,000
Market Approach	
Guideline transaction method - Pratt's Stats	$1,219,000
Cost Approach	
Adjusted Book Value, Plus: Interest- bearing Debt	$512,000
Estimated business enterprise value, marketable, controlling	**$1,170,000**

Getting to Equity Value

Business enterprise value	$1,170,000
less: Working Capital Deficit	($49,058)
Market value of invested capital ("MVIC")	$1,120,942
Bank Line of Credit	($150,000)
Total equity value	$970,942
Estimated total equity value (rounded)	**$971,000**

Case Study - Conclusion

- The Income Approach, Excess Earnings Method and Market Approach, all indicate a positive value
- All methods conclude to a value higher than the Net Tangible Operating Assets (of $512k)
- This is a Business with Intangible/Goodwill value!!!

Is there Business Value?

- Is there future or continued public patronage?
- Are there intangible assets that can be transferred to a buyer?
- Will the business continue in the future as in the past, and generating a profit?
- A business can have goodwill even if it is conducted by a sole practitioner

Is there Business Value?

- What are the intangible assets that can be transferred to a buyer?
  - Customer Lists or contracts
  - Key vendor relationships
  - Trademark/Tradename, business name recognition
  - Business processes
  - Assembled workforce
  - Custom software or specialized equipment
  - Specialized know-how that can be transferred
  - Licenses
  - Patents, copyrights, trade-secrets

Insider Secrets to Increase Value

- Buyer must be able to hire someone to run it:
  - Hire Middle Management
  - Research the cost to hire someone to replace CEO
- Can Buyer make a profit without operating the day to day?
- If CEO is primary sales person – Hire a VP Sales
- Recurring revenues? - Increase if you can

Insider Secrets to Increase Value

- Create a history of Revenue and EBITDA growth
- Focus sales on high gross profit margin products/services
- Diversify the customer base
- Grow EBITDA to over $2.0 million
- Identify and protect your proprietary products/services

Summary – Business Valuation Methods

- Step 1: Adjustments
  - Discretionary expenses, non-recurring expenses, owner market compensation
- Valuation Approaches:
  - Income Approach
  - Market Approach
  - Cost Approach (Adjust Balance Sheet to FMV)
  - Excess Earnings Method (If Services Company)
- Calculate Equity Value after Debt & Working Capital

TCJA and Valuation

C Corp vs. S Corp

- Under TCJA, a C Corp - unlimited deduction for state and local corporate income taxes
- The tax liability associated with S Corp income is paid at personal level, so distributions are tax-free
- For Pass-through entities, the deduction for state and local income taxes is limited to $10,000 (New TCJA)
- Pass-through entities may qualify for the 20% Qualified Business Income deduction.

What is the issue?

- The Tax Court started the controversy with “Walter L. Gross v. Commissioner” case in 1999.
- The court held that tax affecting the income of an S corporation is an inappropriate valuation technique.
- *Yet, by failing to appropriately reflect tax liabilities, the value of an S corporation might be dramatically overstated!*

    - ***$8.2 million vs. $4.3 million***

Market vs. Income Approach

- **Market Approach:**
  - From public companies or M&A transactions
  - Typically uses either Revenue or EBITDA
  - Both financial measures are before corporate tax!
  - Studies have shown for most S Corp's sold, no premium paid due to tax advantages
- **Income Approach** – After Tax
  - What tax rate?

Summary of S-Corp Valuation Results

Model	Indicated Value (Tax Cuts and Jobs Act)		Indicated Value (Tax Rates prior to 12/31/2017)	
Tax-Affect (As if a C-Corp)	$	1,207	$	1,007
Treharne - S Corp Model	$	1,541	$	1,384
Delaware Chancery - S Corp Model	$	1,645	$	1,496
No Tax-Affect	$	1,670	$	1,670
Percentage Increase in Value		13%		

Tax Court Cases – Tax Affecting

Court Case	Pass-Through Topic
Gross v. Commissioner , T.C. Memo. 1999-254	No Tax Affecting for 100% distributions; Why appraisers tax affect
Wall v. Commissioner , T.C. Memo. 2001-75	Relied on Market Approach; avoided issue
Heck v. Commissioner , T.C. Memo. 2002-34	Neither expert deducted taxes
Adams v. Commissioner , T.C. Memo. 2002-80	Can't adjust capitalization rate for taxes
Dallas v. Commissioner , T.C. Memo. 2006-12	No Tax Affecting; Why appraisers tax affect
Giustina v. Commissioner , T.C. Memo. 2011-141	No Tax Affecting for Limited Partnership
Gallagher v. Commissioner , T.C. Memo. 2011-148	No Tax Affecting for LLC
Ringgold Telephone Company , T.C. Memo. 2010-103	Built-in-gain case. Tax Affecting used.

Pending: *Estate of William Cecil v. Commissioner*, Cause Nos. 14639-14 and 14640-14 (Trial held Feb. 2016)

Buy-Sell Agreements

Buy/Sell Agreements

- Advantages:
  - Regulates transfers of an interest on (a "Trigger Event"):
    - Disagreement
    - Divorce
    - Disability
    - Death
    - Retirement
    - Bankruptcy

Buy-Sell Agreements

- Advantages:
  - Can **require** remaining owners to buy share or it may give them **an option** to buy.
  - Sets **valuation methodology** and process for a buy-out/sale of shares
  - Require S corp or LLC distributions for taxes

Buy/Sell Agreements

- Advantages:
  - Regulates the terms of sale:
    - Use Life Insurance for buy-out?
    - All cash?
    - Down payment, plus a note?
    - Term, interest rate and security on note?

Definition of Fair Market Value

- Most agreements say “fair market value”
  - For minority interest, FMV means **with** “minority and marketability discounts”
  - Needs to be clear if No or **fixed discounts** agreed to by shareholders.
- What is the Date of Valuation?
- Use C Corp tax rates, or an S Corp valuation method to value the equity?

Buy-Sell – Typical Valuation Language

- Annual valuation by principals/owners
- Have two appraiser pick a third that rules
- Hire three appraisers and average the two closest
- Formulas (multiple of EBITDA or Revenue, etc.)
- Book Value

Buy-Sell Recommendations

- Have business appraiser review the buy/sell language
- Select ONE independent valuation firm
- Establish a current value
- Value every one to 3 years, so that:
  - Shareholders understand value of shares
  - Shareholders agree on valuation methods and assumptions while they still like each other

Contact

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Bio – Cheryl Kessler

Cheryl Kessler is an expert in business valuations specializing in valuation opinions for martial dissolutions, gift and estate tax planning purposes, mergers & acquisitions, shareholder disputes and ESOPs. For over 20 years, Ms. Kessler has helped closely-held companies in many industries determine the value of their equity. Ms. Kessler presents a credible, defensible and easy to understand analysis of financial and complex valuation issues in concise reports and/or via expert testimony. She prides herself on timely, thorough, and cost effective analysis. Ms. Kessler has the experience, knowledge and expertise to perform business valuations for litigation, and has served as a 730 neutral expert and an expert witness at trial.

Experience includes:

Business valuation

Lost Profits/Economic damages

Financial analysis of complex, high income cases encompassing numerous entities

Analysis of income available for support (Divorce)

Analysis of Pereira/Van Camp allocation issues (Divorce)

Moore/Marsden analysis for family residence (Divorce)

Bio – Cheryl Kessler

PROFESSIONAL EXPERIENCE

- Brinig Taylor Zimmer, Inc. – Director – Business Valuations
- Vantage Point Advisors, Inc. – Director – Business Valuations
- Customatrix, Inc. – Principal - Business Valuations
- Open Energy Corporation - CFO, VP Financial Planning & Analysis
- Brodshatzer, Wallace, Spoon & Yip - Senior Manager - Business Valuations
- Ehrhardt Keefe Steiner & Hottman, CPA's - Senior Manager - Business Valuations
- Clifton Gunderson, CPA's – Senior Analyst - Business Valuations
- JWGenesis Financial Corp./GSG – VP Corporate Finance – IPOs & equity research
- EBI Securities, Inc./Cohig & Associates – VP Corporate Finance – IPOs
- Houlihan Valuation Advisors – Business Valuations
- Xerox Corporation – Electrical Engineer

ACCREDITATIONS, LICENSES

- Accredited Senior Appraiser (ASA), Business Valuation, American Society of Appraisers
- Chartered Financial Analyst (CFA), CFA Institute
- Formerly held Series 7, 24, 63 NASD Licenses

EDUCATION

- Cornell University, B.S. - Electrical Engineering
- Loyola Marymount University, M.B.A - Finance & Entrepreneurship