



Difficult Valuation Issues

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What's Difficult About Business Valuation?

- All of it!
- The more you know the less you realize you know
 - And the more you understand “how bad” the data we rely on is...
 - but--its all we've got.
- In the brief time we've got, we'll talk about just a few of the more problematic areas.

Before We Do: The *Basics of the Basics* of Valuation-- Generalizations

- A buyer acquires a business to make money in the future.
- So, the price he will pay is based on an expectation of how much money he will make in the future:
 - If the company is profitable, value can be measured by “discounting” expected future cash flow.
 - A shortcut for discounting is either capitalizing next year’s cash flow, or applying a multiple to cash flows.
 - If a company is not profitable, value is measured as the money an investor could realize from selling the assets and paying off the liabilities.

Examples of Calculations of Value for Profitable Company

Growth Rate	5%		
Discount Rate	20%		
Year	1	2	
Next Year's Cash Flow	\$ 1,000	\$ 1,050	➔
Present Value	833	729	
Sum, Discounted Cash Flow	\$ 6,667		
Next Year's Cash Flow	\$ 1,000		
Capitalization Rate	15%		
Capitalized Cash Flow	\$ 6,667		
Next Year's Cash Flow	\$ 1,000		
Multiple (100/15)	6.667		
Value, Market Multiple	\$ 6,667		

So, Key Elements of Valuation Are:

- For a Profitable Company
 - Future cash flow
 - Discount Rate, Rate of Expected Future Growth, and/or Market Multiple
- For an unprofitable company:
 - The value of the company's assets net of its liabilities

Just a Few (of the Many) Problematic Areas:

1. Determining future cash flow
2. Deriving a meaningful market multiple; and
3. Minority Interests for unprofitable companies.

Determining Future Cash Flow—Historical Averaging

- Some people rely on various ways of averaging historical results—which can produce wildly different results.

	Five years ago	Four years ago	Three years ago	Two years ago	Last year
Net after tax cash flow	\$ 1,500,000	\$ 2,250,000	\$ 2,500,000	\$1,500,000	\$ 900,000
Weighting	1	2	3	4	5
	\$ 1,500,000	\$ 4,500,000	\$ 7,500,000	\$6,000,000	\$ 4,500,000
Sum					\$24,000,000
Sum of weights					15
Indicated earnings--weighted average?					\$ 1,600,000
Straight average?					\$ 1,730,000
Just last year?					\$ 900,000

As a predictor of next year's cash flow:

Given last three year's trends, do either of these make sense?

Given volatility of cash flow over time, does this make sense?

Rote averaging of historical results may result in a meaningless value conclusion—what matters is: *What is expected to happen in the future?*

Determining Future Cash Flow—Deductions for Taxes by Pass-Through Entities

- The IRS has taken the position (and, lacking a shred of evidence to the contrary, the tax court has agreed 7 times) that it makes *no difference to an investor in a PTE whether they have to pay taxes on the PTE's earnings, or not*.
 - According to the IRS, if your client buys an S corporation that has an annual profit of \$1 million, upon which he pays annual taxes of \$400,000 and therefore nets \$600,000 annually—he'll value it as if he pocketed \$1 million.
- REALLY? Yes. Really.

Determining Future Cash Flow—Deductions for Taxes by Pass-Through Entities

- Valuation analysts are all over the board on this issue (and if you don't ask, they won't tell you what they do):
 - Some deduct taxes in full (resulting in an under-valuation, if no other adjustment is made);
 - Some deduct no taxes (resulting in an over-valuation);
 - Some deduct somewhere in between (which is the right answer, but “where in-between” matters a lot).
- On an order of magnitude basis, if your expert accepts the IRS position (and many do), your client's company may be over valued by as much as 67%!
 - *This is the single most material issue affecting PTE valuations*—and most people are unaware of the implications of how their appraiser has handled it.

Determining a Meaningful Market Multiple

- Valuation analysts have access to a number of databases that accumulate information from private company transactions.
- From this data, analysts find companies that are similar to the company being valued, and determine what multiple (of revenue or profits) comparable companies sold for.
- Example:
 - A company with \$1 million of revenue and \$200,000 of profits sold for \$750,000.
 - From this, the database provides:
 - A multiple of revenue of .75, and
 - A multiple of profit of .25.

Determining a Meaningful Market Multiple

- Any given database will report anywhere from a few, to hundreds, of transactions.
- Valuation analysts typically accumulate as many relevant transaction multiples as they can, and then (often) simply take an average of them.
- Let's see what pitfalls may occur in doing so.

Determining a Meaningful Market Multiple

- In reviewing one valuation, we found the valuation analyst had used the following data (among others...) to determine value:

	Price/Revenue Multiple
Comparable Company A	0.85
Comparable Company B	1.66
Comparable Company C	1.82
Average multiple	1.44
Times subject company revenue	\$ 1,000,000
Equals value	\$ 1,443,333

Here are the Transactions The Appraiser Relied Upon:

	<u>Pratt's Stats</u>	<u>Done Deals</u>		<u>Mergerstat</u>
Seller SIC	3541	3569		3566
Sales	\$9,439,346	\$8,200,000		\$8,620,000
Sales as of	12/31/97	Annualized – 3 months		LTM
Price (EV)	\$8,037,500	\$13,600,000		\$15,520,000
Note:	✓Notes in terms that buyer's stock is valued @ \$500,000, value includes CNTC, and mentions earn-out.	✓Adds earn-out and stock valued at \$425,000; no debt.		✓Provides revenues for ea. Of 10Q latest, 10K latest, and 10K prior; EV calculated off LTM revenue.
P/R Multiple	0.85	1.66		1.82

They were all the same deal...!!

- For assets of the Company, the owner was paid:
 - ✓ \$7.2 million cash at closing
 - ✓ 250,000 shares of buyer's stock—restricted, could be put at \$4, 8K noted \$2 value and 15% discount
 - ✓ 3-year CNTC @ \$300,000
 - ✓ Employment contract
 - ✓ 5-year lease with 5-year renewal
 - ✓ 3-year, performance-based earn-out

There was nothing wrong with how these transactions were reported

- Each database reported the transaction *according to their own instructions*
- The user—e.g., the appraiser—has to know what the multiple includes, or doesn't include, and then:
 - Adjust the multiple as necessary, and
 - Add or subtract assets and liabilities that the company being valued has (or doesn't have), compared with the multiple derived from each particular database.

Here's Another Example

Price	19,838,000
Earnings	996,679
Price/Earnings Multiple	19.9

- *Notes to the Transaction:*

- “Consideration paid as follows: \$17,138,000 cash, \$2.7 million promissory note for real estate...”
- “EBT includes stockholder bonuses expense of \$3,449,000 and other income of \$101,824.”

Adjusting the Price and Earnings Results in a VERY Different Multiple

	<u>Unadjusted</u>	<u>Adjusted</u>
Price	19,838,00 Remove Real Estate of \$2.7 million	17,138,000
Earnings	996,679 Add back Bonus Expense of \$3.4 million	4,343,855
Price/Earnings Multiple	19.904	3.95 *
		*(adjusted by PS)

Minority Interests for Unprofitable Companies

- What if you're valuing a 90% controlling interest in a company that is losing money (or making very little), but the value of its net assets is \$5 million?
 - The value would be \$5 million.
- What if you had the same circumstances, but now, you're valuing the 10% non-controlling interest?
 - Clearly, the 10% owner can't make the 90% owner sell so that he can get his share of the \$5 million—and the 90% owner may have no intent to sell.
 - *What to do??*

Estate of Giustina v Commissioner: Minority Interest, Low Income, High Asset Value

- Tax court: weighted income approach 75%, asset 25%.
- Appealed to 9th circuit—remanded back for tax court’s reliance on “Imaginary Scenarios”.
- Remand: Tax Court weighted income approach 100%.
- The Ninth Circuit equated the asset approach with liquidation, concluding the weightings of the methods must mirror the likelihood of liquidation. In other words, the asset value is virtually meaningless unless the hypothetical buyer can access it.



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Nancy J. Fannon, CPA, ASA, ABV, MCBA, is the Partner in Charge of Litigation Support Services at Marcum, LLP. Ms. Fannon has more than twenty-five years of professional valuation and damages experience, and is frequently retained to provide expert witness services relating to the value of a business; an opinion on the amount of financial damages relating to the lost profits or the loss of a business or segment of a business; a determination damages related to copyrights, trademarks, or trade secrets; and other financial matters.

Nancy is a frequent speaker both locally and nationally on the topic of business valuation and damages. She is a regular contributing author and editorial board member for several national valuation and financial expert journals, and has written and/or technically reviewed several valuation and commercial damage textbooks.

In 2007 and 2008 she published two professional reference books on valuation. Her most recent publication, *Taxes and Value: The Ongoing Research and Analysis Relating to the S Corporation Valuation Puzzle*, was published in April 2015. The fourth edition of her publication, *The Comprehensive Guide to Economic Damages*, was published in 2016.