

## Business Valuation

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## Fair Market Value

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 arms length in an open and unrestricted market, where neither is under compulsion to buy or to sell, and when *both have reasonable knowledge of the relevant facts*.

## Problems in the real world...

- Both parties must be willing and able to act
- Negotiation is in pure equilibrium
- Important facts are made known

## Standards of Value

- Fair Market Value
- Fair Value
- Strategic Value
- Investment Value
- Liquidation Value
- Replacement Value

## Fair Market Value

- In theory...FMV should encompass all potential buyers

## Approaches to Business Valuation

- Asset Approach
- Income Approach
- Market Approach

## Asset Approach

- Fair market value of each asset, less FMV of all debt
- Normally this method ignores intangible value
- Method *should* include goodwill IF goodwill is present
- Typically results in a “Controlling” interest value

## Goodwill

- Performance of the company compared to performance of the industry

## Entity Goodwill

- Benefit is derived from the activity of the enterprise
- Typically is a marital asset

## Professional Goodwill

- Benefit is derived from the shareholders or owners direct involvement or skills
- Has been ruled to not be a marital asset

## Income Approach

Economic Income

Divided by

Risk Adjusted Rate of Return

## What is Economic Income?

- Adjusted Positive Income
- Adjusted Positive Cash Flows

## What are the Adjustments?

- Normalizing Adjustments
- Control Type Adjustments

## Normalizing Adjustments

- Adjust income/cash flow to represent economic income...
  - Depreciation Methods
  - One-time expenses or income
  - Extraordinary expenses
  - Excessive Interest Rates

## Control Type Adjustments

- Owners Excess Compensation and perks
- “Tax Strategy” deductions
- Making these adjustments creates a “controlling” interest income/cash flow stream
- Lack of these adjustments could lead to a minority interest value

## Risk Adjusted Rate of Return

- The rate an investor would require to own an investment of like quality and like risk
- Rate could blend the “equity” rate of return with the “leverage” rate. This is the Weighted Average Cost of Capital

## Market Approach

- Transaction Method
  - Other deals in the market place
  - Returns a Controlling, Marketable Value
- Guideline Companies Method
  - Compares subject company to publicly held companies
  - Apply a derived formula...could be EBIT or EBITDA
  - Returns a Minority, Marketable Value

## Assessing Company Risk

- Company History
  - Financial History
  - Ownership
  - Product Lines
  - Management
  - Access to Capital

## Assessing Company Risk

### ● Industry Comparison

- Benchmark to RMA, or similar index
- Compare to Guideline Companies
- Trade Papers, Trade Groups
- Management Report from 10K's

## Assessing Company Risk

### ● National Economic Factors

- Interest Rates
- GDP
- Trade Information
- Employment
- Inventory Levels
- Money Supply
- Inflation
- Federal Reserve Policy

## Assessing Company Risk

### ● Regional Economy

- Steel Industry
- Auto Industry

### ● Local Economy

- Local Competition
- Bankers' Outlook
- Local Employment
- Market Saturation

## Discounts and Premiums

### ● Control v. Minority

- Control is worth more than Minority
- Control + Minority may not = 100%
- Voting is worth more than Non-voting
- Minority can be greatly discounted
- Important to distinguish where the applied method "Lands"
  - Asset Approach – Typically Controlling
  - Income Approach – Can be either
  - Market Approach- Can be either

## Discounts and Premiums

### ● Lack of Marketability

- How long to sell
- Restrictions on transfers
- Cost of going public
- Cost to Sell
- Be careful on "Landed" value
- Minority interests usually require a higher discount

## 10 Items Affecting Value

- Exceptionally High Dividend Yields
- Exceptionally Bright Growth Prospects
- Degree of Control
- Transfer Restrictions
- Buy-sell Agreements
- Stockholders' Honesty
- Stockholders' Friendliness
- Prospects for the company
- Prospects for the Industry
- Mood of Investing Public

## Current Issues in Today's Market

- Economy
- Banking Climate
- Interest Rates
- Terrorism

## Business Valuation

Thank You ...

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