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BUSINESS VALUATION
MORE ART THAN SCIENCE

Presented by:

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AGENDA

- What is Fair Market Value
- Book Value
- Adjusted Book Value
- Capitalization of Earnings
- Discounted Cash Flow (DCF)
- Comparables
- Discounts
- Conclusion

WHAT IS FAIR MARKET VALUE

- According to Treasury Regulations, "*The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the facts*"
- Easy right?
- Not so fast, providing a definition is not the same thing as providing a valuation

FAIR MARKET VALUE FACTORS

The IRS has tried to give guidance and issued 8 factors that should be relevant in determining FMV:

- Nature of the business and its history
- General economic outlook and specific industry outlook
- Book value of the business and general financial condition
- Earnings history and future earnings capacity
- Dividend/Distribution paying capabilities
- Goodwill or brandname recognition
- Recent sales of an interest in the business, or sales of similar businesses
- Market valuations of similar businesses that are publicly traded

TYPES OF VALUATION METHODOLOGIES

BOOK VALUE

Assets – Liabilities = Book Value (or equity value) > Simplest method, but rarely used

The problem is historical cost and depreciation. An old factory may be depreciated over 20 years to almost nothing, but it still operates and has a fair market value over depreciated cost

IRS sometimes frowns on BV in family related business transactions

ADJUSTED BOOK VALUE

- Adjusts for the depreciation factor (Land or buildings are usually appraised to find out current value)
- May not reflect goodwill (brands, customer relationships, etc.)
- Often does not reflect future earnings capacity of a growth business

CAPITALIZATION OF EARNINGS

- Similar to a P/E ratio for larger companies, but the inverse
- Earnings ÷ Capitalization Rate (%) = Estimated Business Value
- $100,000 ÷ 5% = $2 million business value
- Higher Cap Rate = lower value

- Challenges
  - What earnings to use – current year, past 3 years average, projected
  - What rate to use – Risk free rate (T-Bills) plus Equity Risk Premium

DISCOUNTED CASH FLOW

- Widely accepted due to ability to capture future growth (as opposed to current value only)
- Major inputs include:
  - **Forecast of future cash flows (5-10 years)**
  - **A residual value at the end of forecast**
  - **Discount rate (or Weighted Average Cost of Capital)**
- Required relatively sophisticated modeling tools
- Subject to overly optimistic projections
- Subject to interest rate anomalies

Recent sales of similar private companies

Recent sales of similar public companies

Sales of an interest in the same business

COMPARABLES

These comps can also be used to determine Capitalization Rates

MINORITY INTEREST WORTH LESS THAN MAJORITY CONTROL

LACK OF MARKETABILITY

MANAGEMENT DEPARTURE

PRODUCT OBSOLESCENCE

Can be applied to all valuation methodologies

DISCOUNTS

Valuation

			Value	
			2018	2019
Multiple of Operating Income				
	3.0	EBITDA	$ 1,098,119	$ 1,164,016
	6.0	EBITDA	$ 2,196,238	$ 2,328,032
Various Comparable values (% of sales)				
Typical _______	0.50	Gross Sales	$ 1,039,580	$ 1,081,163
Discounted Cash Flow (15% discount rate)				
	1.0%	LT Gr Rate	$ 2,165,884	$ 2,228,781
	5.0%	LT Gr Rate	$ 2,365,155	$ 2,493,026
Book Value / Liquidation Value				
Value of Land				
Value of Building & Fixtures			$ 50,000	$ 50,000
Value of Inventory				
Debt				
Cash			$ 456,000	$ 456,000
Line of Credit			$ (30,000)	$ (30,000)
AVERAGE of ALL METHODS + Inventory			$2,248,995	$2,335,004

MAYBE USE AVERAGE OF ALL METHODS

In business valuation, the stakes are high and mistakes can be costly

There is not one single best solution for all companies

Experience appraisers may be necessary (or even two)

Internal factors and external factors must both be considered

The IRS plays a role in business valuations (eventually)

CONCLUSION

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- **Tom Kerr** has worked in the financial services industry for over 25 years. Currently he is a Senior Investment Specialist at WestPac Wealth Partners in Missoula, MT. Prior to that he was Chief Investment Officer and Director of Research of SGL Investment Advisors. He was also a Portfolio Manager and Equity Analyst for a $4 billion investment firm in Los Angeles, CA. There he was the co-manager of the Smallcap Value strategy and RCB Smallcap Value Mutual Fund as well an Equity Analyst covering consumer products, business services, retail and media industries. At RCB he was instrumental in developing an innovative and original research process and investment philosophy for the firm. Prior to that he was a financial analyst at a large international bank as well as at one of the world's largest corporations. Mr. Kerr has also been a contributing writer to TheStreet.com and RagingBull.com. Mr. Kerr is a CFA charterholder and obtained a B.B.A in Finance from Texas Tech University. He serves on the boards of CASA of Missoula and the Montana State Parks Foundation. He is also a member of the Montana Snowbowl Volunteer Ski Patrol.

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