

Business Valuation – A Primer

Presentation to the DuPage County Bar Association
December 3, 2012

12/03/2012 DIGIOVINE HNILO JORDAN + JOHNSON LTD. www.dhjj.com

Today's Presenter

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Business Valuation – A Primer

- When do you need to consult with a business valuation professional?

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Business Valuation – A Primer

- When your client has an ownership interest in a non-public entity
 - Corporation
 - S Corporation
 - LLC
 - Partnership
 - Joint Venture
 - Sole proprietorship

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Business Valuation – A Primer

- When does this question become important?
 - Buy-sell agreements
 - Estate planning or gifting
 - Estate tax returns
 - Shareholder changes (stock redemption, stock bonus, stock sale)
 - Divorce or bankruptcy of a shareholder
 - Shareholder disputes or oppression actions

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Business Valuation – A Primer

- So your client asks you how much their ownership interest is worth.
How do you answer that question?
 - Guess!
 - Balance Sheet equity
 - An incomplete picture
 - Formulas
 - One shoe rarely fits all!
 - Business valuation

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Business Valuation – A Primer

- Practicalities – when to consider other options
 - Very small company without intellectual properties
 - Very small ownership interest
 - Existing buy-sell that appears fair & reasonable in the specific circumstances

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Economic Perspectives on BV

- Small businesses without significant intangible value – may not justify a formal valuation
 - Indicators of intangible value
 - Intellectual property (patents, copyrights)
 - Strong cash flows or profits
 - Loyal returning customers
 - Unique product or service with proven track record
 - May be wiser to negotiate from book value (accrual basis) +/- FMV of assets held

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Business Valuation – A Primer

- What to avoid
 - Multiple experts and multiple valuations
 - Gets very expensive very quickly
 - More likely to inject advocacy positions
 - Danger of “splitting the difference”
 - Valuers without a valuation credential (brokers, generalist accountants, bankers)
 - Oral reports
 - Pushing an advocacy position

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☐☐☐ **BV – What is this?**

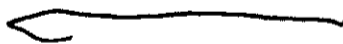
- **What it is not**
 - NOT a broker's estimate of what price they'd list the business for sale
 - NOT the retained earnings of the business from its financial statements or tax returns
 - NOT a quick and dirty calculation
 - NOT a simple formula
 - NOT a black and white decision

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☐☐☐ **BV – What is this?**

- **What it is**
 - Professional analysis of a business ownership interest
 - Applying generally accepted methods (multiple approaches) to estimate the real market value of otherwise non-marketable investment
 - Asset, Income, and Market approaches
 - Applies to ownership interests of all sorts in all industries (manufacturing, retail, service, professionals)

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☐☐☐ **BV – Define the project precisely**

What to talk to the business appraiser about

- Standard and level of value definitions
 - Standard of value
 - FMV? Fair Value? Other?
 - Level of value
 - Control or noncontrolling?
 - Marketable or nonmarketable?

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☐☐☐ **Fair Market Value**

- IRS Rev. Rul. 59-60 and most professional standards:
- "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."

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☐☐☐ **BV – Define the project precisely**

What to talk to the business appraiser about

- Reporting options
 - Litigation exemptions
 - Detailed reports
 - Summary reports
 - Calculation reports

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☐☐☐ **Demystifying Business Valuation**

- What should you expect in a business valuation?
- Duration – 4 – 6 weeks typical
 - Data gathering
 - Analysis
 - Synthesis and conclusion
 - Reporting

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☐☐☐ **What's involved in a BV?**

- Data gathering
 - 5 years financial statements/tax returns
 - 5 years history of distributions/dividends
 - Other specialty appraisals (real estate, equipment)
 - Industry information, publications, associations

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☐☐☐ **What's involved in a BV?**

- Interview & site visit
 - Background on the company, growth, key events
 - Management team background, abilities, compensation
 - Products/services
 - Client concentration
 - Strengths/challenges (SWOT)
 - Outlook

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☐☐☐ **What's involved in a BV?**

- Analysis:
 - 3 approaches must be considered
 - ASSET
 - INCOME
 - MARKET
 - Discounts and/or Premiums

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What's involved in a BV?

ASSET METHOD

- Best for :
 - Holding companies
 - Entities holding marketable securities (FLPs)
- What's involved: Fair Market Value of the balance sheet, line by line

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~~Intangible Value~~ Does Not Get Captured

What's involved in a BV?

INCOME METHODS

- Best for:
 - Operating businesses
 - Professional service corporations
- Focus on cash flows to shareholders
- Introduces Cap Rates / Discount Rates
- Evaluation of earnings streams

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Need Earnings Stream

What's involved in a BV?

MARKET METHODS

- Best for:
 - Operating businesses, less so for professional entities
- Applies market sales data to your company
 - Guideline companies
 - Guideline transactions

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Actual Transactions

Hard to Argue a Public Co is Comparable

Similar Smaller Companies

had to find best new new data bases 15 years data price e... on Broker + internet

Industry Code

What's involved in a BV?

- ASSET issues
 - What's missing from the balance sheet?
 - Nonoperating assets – i.e., idle capacity?
 - Investments not supporting operations
 - Sinking funds
 - Notes receivable – related parties
 - Cash in excess of industry norms?

what's new

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What's involved in a BV?

- INCOME method components
 - Capitalization and Discount rates
 - Develops an investor return expectation for the subject company by
 - Starting with public stock market returns, then adds....
 - Specific Company Risk**
 - Industry
 - Company vs its peers

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AKA "Discounted Cash-Flow"
Most Common

What's involved in a BV?

- Specific Company risk +/-
 - Depth of management *Risk*
 - Importance of key personnel *Risk*
 - Stability of industry
 - Diversification of products & customers
 - Geographic location
 - Stability of earnings and earnings margins
 - Financial structure
 - Additional size adjustment

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Single Product
Dominant Customer
Single Industry

Forward Projections

☐☐☐ What's involved in a BV?

- Earnings stream selection
 - Cash flow based
 - Historical or prospective
 - Historical periods
 - Forecast assumptions
 - Other cash flows
 - Working capital needs
 - Capital expenditure needs
 - Debt requirements

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Look at EBITDA / Cash Flow

→ might need to return + hold someone

☐☐☐ What's involved in a BV?

- MARKET method process
 - Public company comparable
 - Transactions in private company comparables
 - Database searches by industry code
 - Comparability can be measured by:
 - Sales
 - Cash flows
 - Assets

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☐☐☐ What's involved in a BV?

- MARKET method process, cont'd
 - Proximity of transaction dates
 - More is generally better
 - Apply multiples from guidelines to the subject company
 - Price to Revenue
 - Price to Cash Flows

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☐☐☐ **What's involved in a BV?**

DISCOUNTS OR PREMIUMS APPLY?

- Not 100% ownership?
 - Lack of Control discount
 - Swing vote premiums
- Lack of Marketability (liquidity concept)
- Other – such as key man discounts?

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☐☐☐ **Special Topics**

- Major subjective nuances to the process:
 - Normalizing cash flows
 - Goodwill analysis
 - Impact of shareholder agreements
 - Pass – through entities

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☐☐☐ **Normalizing cash flows**

- Remove effects of non-recurring events
- Remove expenses that a potential buyer would not condone
 - Family members on the payroll?
 - Personal expenses? (Clubs, credit cards?)
 - Luxury items
- Adjust owner compensation to “reasonable compensation”

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LLL Goodwill analysis

- Intangible value suggested by the excess of the value indicated by the methods analyzed over the company's recorded net assets, measured at their fair market value.
- Enterprise vs Personal (professional) goodwill?
- Business owner strategy should be on the TRANSFERABILITY of goodwill to a successor owner

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Not Personal Goodwill
that is not real GW

make it

LLL Shareholder agreements

- Buy-Sell agreements
- Shareholder rights and restrictions
 - May impact several of the assumptions in the various approaches
 - Of particular importance:
 - Voting rights?
 - Ability to influence management?
 - Ability to influence distributions/dividends?
 - Formulas to consider

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LLL Pass-Through Entities

- S Corporations, partnerships, FLPs, LLCs
 - Is there a benefit to a hypothetical buyer?
- Is there a value to the single level of tax structure?
 - Do you tax effect earnings in applying the valuation methods?
 - Is there a premium to value?
 - Do you adjust the capitalization rate?

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Business Valuation – A Primer

In summary –

1. Define precisely what you need
 - Define your purpose for the BV and the relevant standard of value
 - Identify the specific interest(s) to be valued
2. Use a properly trained and certified valuation professional. Read the report and ask questions!
3. Monitor and update old agreements that likely contain outdated language and/or formulas

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Business Valuation

BENEFITS

- Transactional or tax support
- Enhanced understanding of value under various scenarios
- Planning
 - Estate tax minimization
 - Succession planning
 - Funding techniques
 - Position to maximize value

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Business Valuation-A Primer

Thank you for coming!

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Buy Sells - look at
 old language
 maybe don't use
 "Fair Market Value"

☐ ☐ ☐

▪ **Mary Lynn Hoffer, Principal**

▪ **DIGIOVINE HNILO JORDAN + JOHNSON LTD.**

- Bradley University, Bachelor of Arts, 1979
- Certified Public Accountant, 1979
- Certified Valuation Analyst, 1996
- Certified in Financial Forensics, 2009

• Significant public accounting experience with entities from start-ups to Fortune 100

• Emphasis on business valuation, forensic accounting and litigation support

- Expert witness services – consulting and testifying expert
- Speaker – customized CLE presentations
- Forensic accounting and fraud consulting services

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