

GENERAL VALUATION METHODOLOGY

The appraisal of any property, tangible or intangible, is a process in which one or more of three approaches to value is employed. These methods are the *asset-based*, *income*, and *market* approaches to value. Value indications developed in applying each of these methodologies are weighed and reconciled with other facts and the quantity and quality of the data available in order to form a conclusive opinion of fair market value.

Appraisal Process

The appraisal process includes consideration of elements of appraisal affecting the operation of the business and its ability to generate future investment returns. Revenue Ruling 59-60 provides guidelines for the valuation of closely held stocks and states that the following factors, although not all-inclusive, are fundamental and require careful analysis:

- The nature of the business and the history of the enterprise from its inception;
- The economic outlook in general and the condition and outlook of the specific industry in particular;
- The book value of the stock and the financial condition of the business;
- The earning capacity of the company;
- The dividend-paying capacity;
- Whether or not the enterprise has goodwill or other intangible value;
- Sales of the stock and the size of the block of stock to be valued;
- The market prices of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

Appraisal Approaches

The asset-based approach recognizes the value of an asset based on the cost to reconstruct or replace the asset with another of like utility. As applied to the valuation of stockholders' equity or partners' capital, the asset-based approach entails a restatement of the balance sheet of the enterprise. This includes substituting the fair market values of the assets and liabilities for their book values. The resultant equity or capital position is reflective of a 100% ownership interest.

The income approach recognizes the value of an asset as the expected receipt of future economic benefits. These benefits can include earnings, cost savings, tax deductions, and gains on the disposition of the asset. Value indications are developed by discounting expected cash flows to their present values at a rate of return that incorporates the risks associated with a particular investment. The discount rate selected is based on rates of return available from alternative investments of similar type and quality as the property being appraised.

The market approach measures the value of an asset by comparing it to similar property that was sold or is offered for sale. In using this approach for tangible or intangible assets, consideration is given to the degree of comparability between each property sold or offered for sale and the property under appraisal. When applying this technique to the valuation of a business interest, weight is given to the financial condition and operating results of the entity being appraised relative to companies operating in the same or similar lines of business as the subject enterprise and that are thought to be influenced by corresponding economic, environmental, and political factors.

Adjustments to Financial Statements

Regardless of approach, the appraiser analyzes the Company to determine the benefits that flow to the owner or to a potential purchaser. An owner of a closely held business has discretion in determining tax strategy, financial risk, profitability, etc. Therefore, certain adjustments are necessary.

In a typical closely held business, the owner may also be an employee and the landlord. The owner has wide latitude in setting compensation levels (i.e., his own and that of his family) and in determining the lease rates to be paid to himself as landlord. It is not unusual for a closely held company to report little (if any) earnings.

It is important to separate the benefits of ownership from the benefits of labor and lease. In a typical valuation, owners' compensation is adjusted to industry standards. Also lease rates would typically be adjusted to market rent. It is through this process that I can determine the return that a "typical" owner of the business could expect as a return on his investment.

The owner also has the ability (within economic parameters) in determining the capital structure of the business. One owner may be risk averse and use little debt while another may prefer to be highly leveraged. This choice should not affect the value of the enterprise. I, therefore, value businesses using "debt-free" methodologies. I ignore the actual capital structure and substitute a "typical" one based on industry statistics. This methodology, therefore, excludes both interest expense and borrowings (a cash flow item). The resultant analysis values total capital from which actual debt principal is deducted to arrive at an equity figure.

Similarly, the owner chooses the type of business organization. The choice to be taxed as an "S" corporation, partnership, limited liability company, or sole proprietorship eliminates federal income taxes and some state taxes at the entity level. Such a choice has less to do with the enterprise and more to do with the personal situation of the owner(s). A potential purchaser may have an entirely different tax strategy. This should not affect the value of the business.

There are several ways in which the tax situation for pass-through entities could be handled, all of which arrive at essentially the same conclusion at the entity level. Some appraisers use a pre-tax discount rate applied to pre-tax income. Others include shareholder pass-through taxes to which a discount rate adjusted for shareholder rates is applied. I choose to include income taxes based on federal and corporate tax rates as if the company were a regular "C" corporation and apply an after-tax discount rate. There

may, however, be significant differences at the minority shareholder level depending on the circumstances. Such differences are taken into account in the analysis.

Adjustments to Value

In addition, these value indications could require modifications to reflect the rights of the holder. Where the interest appraised represents less than control, a discount may be recognized from the value of the shares on a majority basis. Because the shares are those of a closely held company, the lack of a market and the illiquid nature of the investment would be recognized in the analysis. Other adjustments could be required to recognize the presence of non-operating assets or the level of required working capital.