M & A UPDATE®

September 2011 Volume 7, Issue 9

The Need and Methods Behind a Valuation

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Introduction

Along with deciding to engage in business succession planning and finding a successor, it is necessary to value a business. A valuation is necessary whether the business is to be transferred to an heir or third party or for retirement purposes. If the business is transferred to an heir, it is critical that the fair market value of the business be established in a well-supported form. If the business is to be sold to a third party, a valuation will ensure maximum value will be achieved.

A business valuation is a report written by a qualified appraiser for purposes including business succession, estate and tax planning, litigation, buy-sell situations and many other purposes. Given that purposes behind business valuations differ, methodologies also differ. Some methods are imposed by the Internal Revenue Code, others by common law, some by contractual agreement, and others by industry. The following is a brief discussion of different valuation methodologies that are used by appraisers.

Comparables Price

The comparable price method operates under the assumption that there are other companies comparable to the business being valued that are either publicly-held or privately-held that recently sold. The IRS suggests that when using this method, at least three comparable companies must be used. Once the comparables have been found, the net income, cash flow, EBITDA, and the price/earnings ratio is used to compute a benchmark value. The individual company values can then be weighted and an industry benchmark can then be established. Many appraisers use this method to verify their own work using some of the following methods.

Capitalization of Earnings

The consensus among appraisers is that the capitalization of earning power is "the most important single factor in the valuation of most operating companies, such as manufacturers, merchandisers, and companies providing various services." At the end of the life of a company, the total worth of that company can be found in the ability it had to generate earnings. This method uses historical data to project future earnings. The method goes back up to a maximum of five years and projects the earnings potential for up to five years in the future, using a growth rate, present value calculation, and expected earnings figures.

Adjusted Book Value (Net Tangible Assets)

This method, also referred to as the underlying asset value method, is especially useful in valuing holding companies versus operating companies. Investment houses and real estate companies are

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A CASE STUDY

The Tax Court ruled that a minority interest discount and lack of marketability discount applied to the valuation of a family limited partnership (FLP) interest. In the case, the decedent, daughter, and son-in law formed an FLP and a limited liability company (LLC). When the decedent died, he owned a majority interest in the FLP and a one-third interest in the LLC. The estate hired a valuation expert to appraise the estate and FLP. The expert applied a 53% discount based on several factors such as minority interest and lack of marketability. The IRS disputed the large discounts and assessed a deficiency against the estate of a net discount of 25%. In usual fashion, the Tax Court ruled a net discount of 35.5% was appropriate, reflecting minority shareholder status and lack of marketability.

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Cover Story

examples of holding companies. This method is also useful for liquidation purposes because it provides the "adjusted" asset value which relates to the fair market value of assets. It is also useful in valuing capital intensive businesses that rely on their asset base to perform work and generate income and create goodwill. An excellent example of this is a construction company. The company's machinery is vital to their operations. This idea can be contrasted with a law practice whose income generating ability does not rest on physical assets of the firm but, rather, on personal ability. The key to this method is to determine the fair market value of all useful assets versus the value as stated on the books of the company.

Excess Earnings Capacity (Goodwill)

This method is based on the theory that the value of a company is equal to the value of the net tangible assets (as calculated in the adjusted book value method) plus the value of excess earnings (e.g. goodwill, patents, trademarks, copyrights, etc.). Eight factors are typically considered when calculating goodwill: age of the company, employee turnover, the value of the suppliers and the products sold, market area, potential growth, inventory efficiency, company location, and banking relationships. Excess earnings attributable to intangible assets are the foundation of the value of goodwill. Once this calculation is made, the result is added to the adjusted asset value as determined above to arrive at a total value of a company.

Present Value of Future Income Stream (Leveraged Cash Flow Debt Method)

A variation of the capitalization of earnings method is referred to as the "Leveraged Debt Concept". This concept takes into consideration the fact that an outside party may leverage an acquisition of the current company and use all of the income to pay the interest on borrowed money. Currently the cash flow method is becoming more important in valuations as companies tend to determine their "free cash", i.e. earnings before interest, taxes, depreciation, and amortization (EBITDA).

Net Income Residual Approach or Dividend Paying Capacity

This method looks at the income that is left over for the stockholders as it relates to a company's return on investment. Effectively, it can be referred to as the ability of the company to pay dividends to the stockholders using income that is not needed to operate the business in the future. Dividends are based on earnings after taxes as they relate to investment (stockholder's equity) at the beginning of the year. Dividends represent the after-tax earnings that are distributed to the stockholder instead of being kept in retained earnings to help finance future projects. This is a key method to determining what an investor would pay for participating in the operations of a privately-held company.

Conclusion

Each method has its advantages and disadvantages. Furthermore, no single method provides the absolute value of a company. The courts, as well as the IRS, have determined that more than one method must be used to value a closely-held corporation. The type of company, the purchaser, and the reason the company is being valued are important.

Dr. Bart A. Basi is an attorney, CPA, and the Senior Advisor of The Center for Financial, Legal & Tax Planning, Inc, a full service company specializing in financial, legal & tax matters. Basi is a nationally recognized author, lecturer, and advisor on how to structure deals to minimize taxes. Tax structure makes the difference between getting the deal done and watching the deal fall apart. Many of you may be familiar with Basi and the topics he covers in the Financial, Legal & Tax Advisory which may be read in various industry-specific trade publications.

Points of Interest

- **A valuation is necessary whether the business is to be transferred to an heir or third party or for retirement purposes.**
- **A business valuation is a report written by a qualified appraiser for purposes including business succession, estate and tax planning, litigation, buy-sell situations and many other purposes.**
- **No single method provides the absolute value of a company.**

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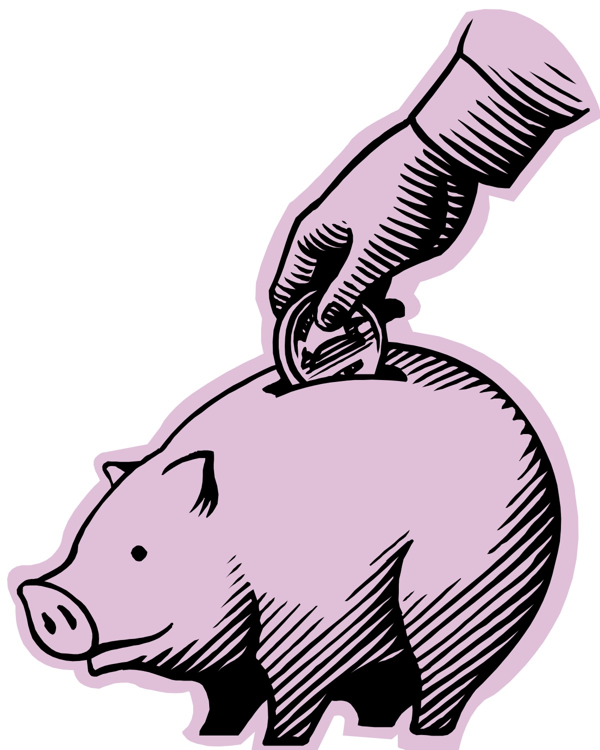
A CASE STUDY CONTINUED:

Editor's Comment: The Tax Court is filled with truly intelligent and well educated men of tax law. Yet, it never ceases to amaze me how many of these cases end in a result which is essentially the mathematical mean between the estate's discount and the IRS's discount plus or minus a few points.

FLP vehicles are appropriate for estate planning in limited situations; however, most situations are such in nature that other planning instruments lead to better results. Business sales, for one, to children lead to fool-proof results most of the time. In FLP planning, the value and discounts are subject to challenge and audit which are usually avoided in sales to children or heirs.



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Legacy Advisors Is Growing & Relocating

Legacy Advisors is pleased to announce the latest expansion our professional service offerings.

Mike Ertel, Managing Director/ Broker of Legacy M&A Advisors, LLC, is now affiliated as a registered rep with StillPoint Capital, LLC, an international investment banking firm serving primarily small- to mid-sized companies. We can now handle a much wider range of deal structures, including deals where an all-cash-for-assets transaction morphs to a securities transaction because it involves stock, or an earn-out, or a seller's note.

Effective September 15th, we will also be relocating our offices. Please note our new address: 1101 Channelside Drive, Suite 416, Tampa, FL 33602-3614. The suite number and the zip have changed but the phone numbers, street address, and e-mail addresses remain the same.

Why Consider Legacy M&A Advisors, LLC?

- We act as Single Agents, not Transaction Brokers. We represent you as our Client; we are your Agent.
- We're not Wall Street, and we're not Main Street. Mid-sized companies are our sole focus.
- We're in regular, direct contact with hundreds of private equity groups and strategic buyers who are actively acquiring middle market companies.
- We work with all qualified buyers, not just those who come to us directly.
- We cooperate with any qualified broker who brings a qualified buyer.
- We offer a unique, Marketability Assessment to assist a business owner in determining if his business is ready for sale, as well as identifying steps the owner can take to increase the ultimate selling price of his business.
- We can assist in securing an independent, certified business valuation from a nationally recognized firm.
- We offer a unique, 2nd opinion service to ensure that the proposed deal structure maximizes your net proceeds after tax.
- We'll work with you at a substantially reduced fee if you believe you might already have a buyer for your business.
- We're affiliated with a securities broker dealer[1], so collectively we can:
    - Legally handle most any deal structure, including when a cash-for-assets sale morphs to a securities transaction
    - Assist clients who may be looking to raise capital

[1]Securities transactions conducted through StillPoint Capital LLC, Member FINRA/SIPC

If you know of a business owner who's thinking of selling or buying a business and who might benefit from a free, confidential, consultation with us, have them contact me directly, and in strictest confidence, at 813.299.7862, or via e-mail at mertel@legacymandaadvisorsgroup.com

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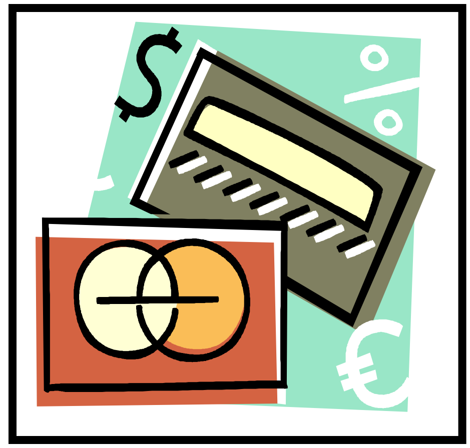

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Frequently Asked Questions…

Q: When the Budget Control Act of 2011 passed, were any tax provisions included within it?

A: A full read of the text has not revealed any new tax provisions within the law. However, it is apparent that this act will likely have effects on future tax laws in so far as requirements within the law must be reached.

Q: I am a business owner and I pay some personal expenses out of my business accounts from time to time. Must I include this amount in my income?

A: First of all, no matter how big or small your business is, it is not advised to follow this course of action. Intermingling funds is never a good thing in front of the IRS. However, if this is done from time to time, the amounts used for personal expenses cannot be deducted for business expenses as they do not come within the meaning of ordinary and necessary.

Q: What is the maximum that can be contributed to an IRA?

A: In 2011, the maximum contribution is $5000 in both Traditional and Roth IRA accounts. If the taxpayer turns 50 this year, then an additional $1000 contribution is allowed.