Legacy M&A ADVISORS LLC

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The Asset Method of Valuation

Bart A. Basi, CPA/Attorney at Law
The Center for Financial, Legal & Tax Planning, Inc.

Introduction

In a time of transition in this country, it is unfortunate that the average small business owner knows little or nothing about valuing their business. Many believe they can take a multiple of their company's annual profits (derived from a tax return) and multiply that number by 4 or 5 to get a true value. This is untrue and can be harmful to the business owner.

Because the valuation of closely-held stock is not an exact science, the IRS requires the use of more than one method when computing the value of a closely-held corporation. Don't be fooled by someone that says there is only one method to value your business. The different methods are: the Adjusted Book Value Method (sometimes referred to as the Net Tangible Assets Method), Excess Earnings Capacity Method for valuing intangible assets, such as goodwill, the Present Value of Future Income Stream (sometimes referred to as the Leveraged Debt Method), the Cash Flow Method and several other, lesser known methods. This advisory deals with the one of the major methods, i.e. Adjusted Book Value.

Adjusted Book Value (Net Tangible Assets)

The Asset Method of business valuation is a good starting point in which to value a business. It is the most basic, rawest form of valuation. Oftentimes, it provides a reality check for the owners and stakeholders. It shows them what their business would be worth, if they were no longer there; as opposed to other methods which show the value of an operating business with key employees and the owners still in control.

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Mike Ertel is a Certified M & A Advisor and a Principal Broker with Legacy M&A Advisors, LLC, a full-service M & A Advisory firm with an office in Tampa, Florida specializing in representing sellers and buyers of small- to mid-sized companies. Prior to joining Legacy M&A Advisors, LLC, Mike's business career spanned 30+ years with Fortune 500 and Fortune 1000 Companies, with senior management roles in Marketing, Operations and Logistics. Mike also served as President, COO of a mid-sized Manufacturing company headquartered in Tampa. Mike also holds a BS in Electrical Engineering and an MS in Industrial Administration, both from Purdue.

A CASE STUDY

Fracking

In a Letter Ruling the IRS ruled that income from a hydraulic fracturing (fracking) activity is qualifying income for tax purposes when earned by a Publicly Traded Partnership. Under the Internal Revenue Code, a publicly traded partnership is treated as a corporation if under 90% of its income is qualifying income. Under the specific code section, qualifying income means: "(A) interest, (B) dividends, (C) real property rents, (D) gain from the sale or other disposition of real property (including property described in section 1221(a)(1)), (E) income and gains derived from the refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber), industrial source carbon dioxide, or the transportation or…." In the letter ruling, the taxpayer pointed to their activity including "the removal, treatment, recycling, and disposal of waste products from hydraulic fracturing…" The IRS ruled positively in the taxpayer's favor.

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Cover Story

This method, also referred to as the "Underlying" Asset Value Method, is especially useful in valuing companies that have inventory as a key component of their operations. A good example of this would be that of a small retailer or car dealership. The main component of the business, in these instances would be the cars, building materials, and/or various products. While another valuation method is still required, a snapshot of the Underlying Asset Value is certainly useful in the valuation of a business.

In a liquidation sale, this method is also useful because it provides the "adjusted" asset value, which relates to the fair market value of assets. If a situation arises where a business owner dies and no successor is found, the business may face this possibility. It is here that the assets become the valuable component in a disposition of a business.

The Asset Method is also useful in valuing capital intensive businesses that rely on their asset base to perform work and generate income. An excellent example of this is a construction company. The company's machinery is vital to its operations.

However, keep in mind, the asset method only covers the assets, not the actual operation of the business reflecting relationships, goodwill, contracts, etc. It is here the business owner would be more apt to use a method reflecting cash flow, profitability and goodwill situations.

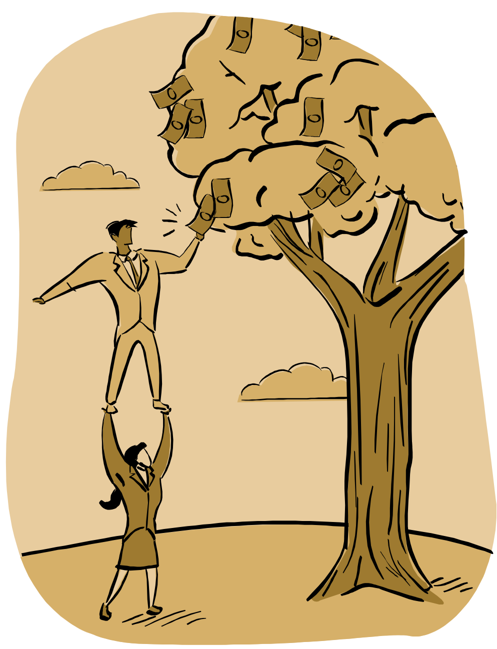
Conclusion

The Underlying Asset Method is merely one method for valuing a company. Alone, it does not accomplish the objective of having a company appraisal. To get an accurate and reliable value in which the owner can use for varying purposes, at least the underlying value of goodwill must be calculated. Whether, the purpose is a business sale, court proceedings, business succession, or estate planning, a mix of valuation methods must be used to arrive at a valid appraisal. If you have any questions regarding business appraisal or would like to have a valuation performed of your business, please call the professionals at (618) 997-3436 at The Center for all of your Tax and Financial Needs.

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

- **Many believe they can take a multiple of their company's annual profits (derived from a tax return) and multiply that number by 4 or 5 to get a true value.**
- **The Asset Method of business valuation is a good starting point in which to value a business.**
- **Whether, the purpose is a business sale, court proceedings, business succession, or estate planning, a mix of valuation methods must be used to arrive at a valid appraisal.**



Legacy M&A Advisors, LLC
970 Lake Carillon Drive, Suite 300
Saint Petersburg, FL 33716

The Center for Financial, Legal & Tax Planning, Inc.
4501 W. DeYoung St., Suite 200
Marion, Illinois 62959

A CASE STUDY CONTINUED:

Editor's Comment: Because the taxpayer's business is derived (but not specifically mentioned in black and white letter of The Code) from mining/exploration, they had a bit of concern that the activity may not be on the dot and therefore receive adverse tax treatment. The counsel made a good call here in asking for a letter ruling on a potentially multi-million dollar venture.

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ESOP's Can Provide Tax Advantages for Departing Owner while Boosting Company Performance

Most business owners are vaguely aware that Employee Stock Ownership Plans (ESOP's) can provide substantial tax advantages when they approach retirement, but they don't have a clear idea of how ESOP's work, nor do they realize how ESOP companies typically outperform non-ESOP companies.

How ESOP's Work - According to information published by the National Center for Employee Ownership (NCEO), about two-thirds of ESOPs are used to provide a market for the shares of a departing owner of a profitable, closely held company. Companies set up a trust fund for employees and contribute either cash to buy company stock, contribute shares directly to the plan, or have the plan borrow money to buy shares. If the plan borrows money, the company makes contributions to the plan to enable it to repay the loan. Contributions to the plan are tax-deductible. Employees pay no tax on the contributions until they receive the stock when they leave or retire. They then either sell it on the market or back to the company, or back to the ESOP trust. Provided that an ESOP owns 30% or more of company stock and the company is a C corporation, owners of a private firm selling to an ESOP can defer taxation on their gains by reinvesting in securities of other companies. S corporations can have ESOPs as well. Earnings attributable to the ESOP's ownership share in S corporations are not taxable.

How ESOP Companies Perform - A 2000 Rutgers study found that ESOP companies grow 2.3% to 2.4% faster after setting up their ESOP than would have been expected without it. Companies that combine employee ownership with employee workplace participation programs show even more substantial gains in performance. A 1986 NCEO study found that employee ownership firms that practice participative management grow 8% to 11% per year faster with their ownership plans than they would have without them. Note, however, that participation plans alone have little impact on company performance. These NCEO data have been confirmed by several subsequent academic studies that find both the same direction and magnitude of results.

How Employees Fare - A 1997 Washington State study found that ESOP participants made 5% to 12% more in wages and had almost three times the retirement assets as did workers in comparable non-ESOP companies. According to a 2010 NCEO analysis of ESOP company government filings in 2008, the average ESOP participant receives about $4,443 per year in company contributions to the ESOP and has an account balance of $55,836. People in the plan for many years would have much larger balances.

Legacy Advisors Group has experience working with ESOP financial advisors, bankers, attorneys, appraisers, etc., and can help you decide if an ESOP is right for your company. To learn more about ESOP's and qualify for a FREE, preliminary feasibility study, contact me at mertel@lmaallc.com

Mike Ertel, CBI, M&AMI, CM&AA
Managing Director, Broker
Legacy Advisors Group
813.299.7862 Direct

Legacy M&A Advisors, LLC
970 Lake Carillon Drive, Suite 300
Saint Petersburg, FL 33716
Phone: 888-864-6610
Fax: 866-353-0382

The Center for Financial, Legal & Tax Planning, Inc.
4501 W. DeYoung St., Suite 200
Marion, Illinois 62959
Phone: 618-997-3436
Fax: 618-997-8370
Satellite Office:
Longboat Key, FL 34228
Phone and Fax: 941-383-3338

We're on the Web!

www.taxplanning.com
www.legacymandaadvisorsgroup.com

Frequently Asked Questions…

Q. I am exchanging property in a 1031 "like-kind-exchange". Can I exchange my one property for more than one property?

A. Yes. As long as the property being exchanged is within the same class, you may exchange the property for more than one property. When dealing with real estate, you can exchange one property for up to 3 properties.

Q. I am thinking about setting up an Individual Retirement Account (IRA). What are the contribution limits for 2013?

A. The 2013 IRA contribution limits are $5500 and allow an additional $1000 "catch up" annual contribution from those turning 50 or more this year.

Q. I would like to value my business so I can sell it. Is there a multiple I could use as a rule of thumb which would be accurate?

A. No. Multiples are not recognized by the IRS as a valid valuation device. When valuing a business for sale, it is wise to invest in a valuation. Valuations of businesses are complex and require expertise. Simply using a multiple ignores too many contingencies and the like to be effective as a valuation device.