

The Business Valuation Process

The business valuation process requires an application of proven analytical methodologies combined with experience and perspective. Business owners and investors are referred to Marshall & Stevens by legal, accounting, and wealth advisors because we listen, we research, we analyze, and we provide supportable value opinions based upon decades of experience. We invest the time to learn about the uniqueness of the subject business, how it earns revenue and generates profit, the market it serves, plans for growth, and the effects the greater economy has on the business.

WHERE TO START

Whether we are engaged to provide an opinion of value of a C corporation, S Corporation, Family Limited Partnership (“FLP”), Limited Liability Company (“LLC”) or Limited Partnership (“LP”), the most important first step in providing an opinion of value for a specific business enterprise is to set three key parameters to define the scope of work:

1. **Date of Value** – Values can differ from one moment in time to another based upon multiple factors.
2. **Definition of Value** – Fair Market Value (FMV) is the most requested opinion of value requested when one wants to understand what his/her business or investment is worth. In some situations, FMV is defined in a shareholder agreement or contract between parties, but the most common definition of FMV in the US, due to its application in all federal tax matters, is defined by the IRS in Revenue Ruling 59-60, Section 2.03:
The price at which an asset or a business enterprise 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 a compulsion to sell, both parties having reasonable knowledge of relevant facts.
3. **Purpose or Intended Use** – The valuation professional must understand and clearly state the purpose/use of the valuation analysis as the purpose/use limits the applicability of the analysis. The defined purpose/use may lead the valuation professional to make specific assumptions and adjustments and to weight specific approaches more than others.

For example, providing a FMV opinion of a business for use by its directors for their consideration in selling the company does not necessarily provide the correct

indication of value of a specific employee's stock option granted six months prior for an IRC 409a filing.

PROFESSIONAL STANDARDS

Marshall & Stevens' valuations comply with **USPAP** (Uniform Standards of Professional Appraisal Practices), **ASA** (American Society of Appraisers) and, depending upon the situation, other applicable standards including **Internal Revenue Ruling 59-60**.

Meeting these standards requires that we review information about the business, interpret the data provided by the client and compare it to information in the marketplace about similar businesses, the industry in which the business works, and then do the same for the projected performance of the subject business, comparing it against industry projections developed by respected market sources.

We take the time to synthesize the information gathered, interview designated company sources and then draft an analysis for review with our client. This quantitative and qualitative analysis requires more than a cold review of historical and project financials. It requires market research, discussions with those instrumental in the success of the business, understanding what market forces may affect the business, and applying professional judgement as to how to apply what has been learned to the valuation analyses. Depending upon the level of report requested, we provide appropriate detail about how we arrived at our opinion of the unique characteristics of the subject business, its "value drivers", its ability to pay a return to its equity holders, its historical and projected financial performance, and the potential to successfully pass the business onto others.

50% of what we do is prepare a well-contemplated supportable analysis.

The other 50% is telling the story of the subject business and how we arrived at our opinion of value in our final report.

A well-prepared business valuation includes the review and consideration of multiple market and industry factors necessary to estimate the sustainability and potential growth of the subject company, its revenue base and profitability, as well as the capital and assets necessary to support the business going forward.

A complete business valuation analysis includes consideration of the three generally accepted valuation methodologies: Cost, Income, and Market approaches. In brief, these methods are defined as follows.

Cost Approach – measures the value of an asset by the cost to reconstruct or replace it with another of like utility. When applied to the valuation of equity in a business, value is based on the net aggregate fair market value of the entity's underlying individual assets ("adjusted book value"). This approach is typically

more important in the valuation of underperforming (early stage or distressed) businesses where the value of the assets (intellectual property or property, plant, and equipment) are more valuable to a potential buyer than the value of the business as a whole.

Income Approach – measures the income-producing capability of an asset or business. The Income Approach estimates value based on the expectation of future cash flows that the asset or business will generate, such as cash earnings, cost savings, tax deductions, and the proceeds from disposition. This approach is very important to understanding the value of a private enterprise, thinly traded public companies and securities.

Market Approach – measures the value of an asset or business through an analysis of recent sales or offerings of comparable investments or assets. The Market Approach can be applied by utilizing either the Guideline Public Company Method (a comparison to trading multiples) or the Guideline Transaction Method (a comparison to market reported transactions), or both. Challenges to applying these market-based methodologies are typically the true comparability of the public companies and market reported transactions selected to the subject company, often due to a greater diversity of products and services, geographic coverage, size disparity, etc. of the selected comparable public companies versus the subject company.

The result of each approach is then reviewed, reconciled, and weighted to form the opinion of value.

VALUING EQUITY

Proceeding from a valuation of a business enterprise to the valuation of a fractional interest in the business or a class of equity, we must subtract the debt from the value of the business. Valuing a specific interest in a business with multiple classes of equity requires that the valuation professional work his/her way down the equity “waterfall” taking into accountant applicable preferences, conversion and other features of each class of equity (preferred stock, common stock, warrants, options, phantom stock, etc.).

FRACTIONAL INTERESTS (aka “Discount Studies”)

To arrive at an opinion of value of a fractional interest in (the equity of) a business, we consider multiple factors in determining whether the value of the equity interest would be reduced from its pro rata value by a lack of control and/or lack of marketability of the interest in a hypothetical sale.

Discounts for Lack of Marketability (DLOM) – Buying or selling a fractional interest in a private business or a thinly-traded public company is not as easy as buying and selling shares in a large publicly traded company. One cannot just call a stockbroker

or log onto a web-based trading site to purchase or sell shares the same day. Many private businesses have provisions in their operating agreements limiting who can own equity, a right of first refusal clause, and no requirement to purchase equity from a seller (put option). This lack of ability to quickly and efficiently buy or sell shares/units (marketability) reduces the value of the equity. These discounts to the pro rata value of the equity is calculated utilizing specific qualitative and quantitative valuation methods, IRS guidance and regulations, and applicable case law.

Discounts for Lack of Control (DLOC) – Owning a minority interest in a business typically means having limited (no) power/control in the way a business is run, including decisions regarding dividend payout, corporate expansion, merger, acquisition, divestiture, financing, personnel, etc. Fractional interests that are greater than 50% may also qualify for discounts for lack of control. Lack of control is calculated utilizing generally accepted qualitative and quantitative methods as well as an understanding of applicable IRS regulations and guidance, market studies, and case law.

This service sheet is a very general overview of what it takes to provide a complete, independent, high-quality opinion of value of a business and equity. Please contact one of the senior professionals listed below to have a more detailed conversation.

MARSHALL & STEVENS

Public and privately held companies rely on Marshall & Stevens to assist them with the valuations they need for planning, executing, and reporting of mergers, acquisitions, divestitures, financings, corporate tax restructuring, wealth transfer, estate tax reporting, dispute resolution and litigation support.



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