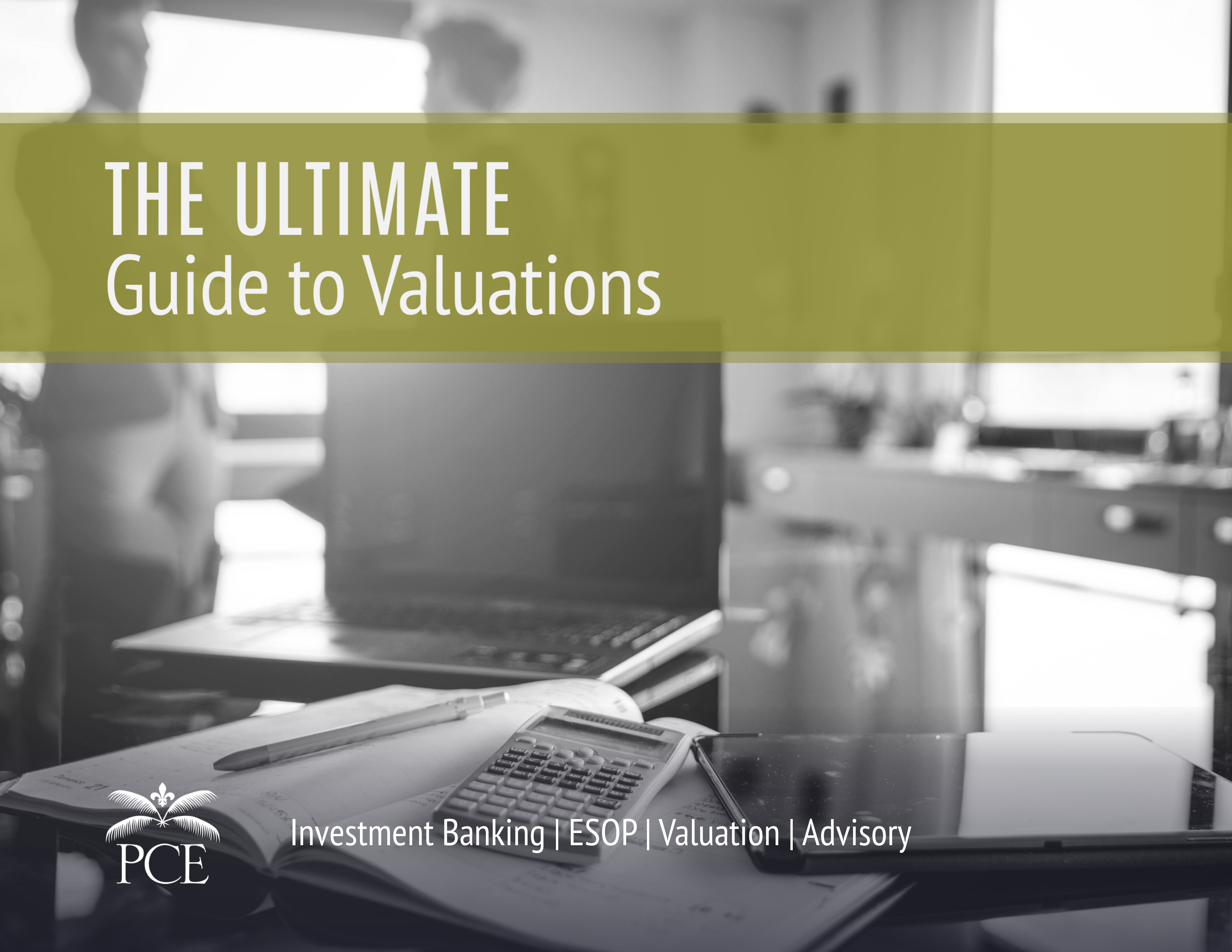
THE ULTIMATE
Guide to Valuations



PCE

Investment Banking | ESOP | Valuation | Advisory

An accredited business appraiser can help you measure what your company is worth today.

Two questions must be answered at the beginning of the valuation process.

1. Why is the valuation being done?

2. What is the appropriate standard of value?

Understanding the value of your business may seem like an accounting task, but it is actually much more complex. Both quantitative financial data and qualitative information must be considered when determining the value of your business. A valuation measures the value of your business at a point in time and within the particular context of your reason for the valuation.

When you prepare to sell or transfer your company or a portion of your company, the valuation process should consider guidelines outlined in the Uniform Standards or Professional Appraisal Practice (USPAP), the Financial Accounting Standards Board (FASB) and all applicable regulatory agencies (SEC, IRS).

For these reasons, professional organizations have been established. Some of these organizations outlined below define the standards for business appraisals. They also offer accreditation for financial professionals who perform business valuations.

- American Society of Appraisers
- Appraisal Foundation
- The Institute of Business Appraisers

Reasons to Get a Valuation

Business owners decide to seek valuations for many reasons. In some cases they are required, and in other instances, they are desired by management to help make business decisions. In all cases, the reason for the valuation influences the methods that are used in arriving at a legitimate valuation.

Required Valuations for Financial Reporting

Both internal and external events can affect the value of your business. An organizational restructuring (internal event) or a new accounting regulation that affects how revenue or an expense is recorded on the income statement (external event) are both examples of events that could impact the value of your business for financial reporting purposes. These events can affect value under financial reporting because of their implications on earnings, as well as their impact on the overall health of your business.

Purchase Price Allocation: When a target company is acquired by another company, the assets and liabilities acquired must be allocated on the buyer's balance sheet at fair value. Not only are the value of tangible assets determined, but the value of intangible assets must be determined as well.

Goodwill Impairment: Goodwill is an intangible asset that a company recognizes on its balance sheet, resulting from an acquisition. Specifically, it represents the excess value paid for a business over and above the value of all assets acquired (tangible and intangible). Goodwill impairment is the result of a decrease in value of goodwill. In other words, if the overall value of a recently acquired company is worth less today than when it was acquired, but the value of all the tangible and intangible assets are the same, the excess value would be lower, and therefore, the value of goodwill would be lower, indicating impairment.

Equity Compensation: Typically, when your company authorizes equity, such as stock options, to be issued as compensation for its employees, a compensation expense is realized on the income statement. Both GAAP and the IRS require this. A valuation of the company and the resulting equity value is required to determine the value of award being issued as compensation.

SEC Filings/IPO: Public companies are required to file annual reports with the Securities and Exchange Commission that include audited financial statements reflecting the company's value. A complete valuation is required when a private company prepares to go public.

Reasons to Get a Valuation – continued

Required Valuations for IRS Reporting

Income Tax (Compensation/409A): Deferred compensation, such as a stock option plan, can have tax implications for the company and the plan recipients. It is critical to know the underlying value of the company stock. This can be determined through a company valuation.

Estate and Gift Tax: When business owners include their company in their estate planning, they must disclose how they valued their stock to the IRS. Often business owners will gift stock to a trust that can convert the shares into cash upon their retirement.

Optional/Desired Valuations for Transactions

There are a variety of situations and events where a valuation is not required. A business owner may choose something less than a full valuation to help them make a financial or strategic decision.

Fairness Opinion: A thorough valuation report that is often prepared for proposed mergers and acquisitions is provided to all stakeholders and board members and represents an unbiased overview of the transaction.

Solvency Opinion: Similar to a fairness opinion, this helps board members and stakeholders in a merger or acquisition understand the risk involved by addressing whether or not a buyer will be able to fulfill the terms of the acquisition.

Reasons to Get a Valuation – continued

Optional/Desired Valuations for Other Situations or Events

Other situations may arise in which it is helpful to gain an understanding of the value of the business.

Disputes/Litigation (Divorce, Shareholder, Estates, etc.): Valuations help settle disputes fairly. For example, in divorce proceedings, a valuation helps the court divide assets equally between both parties.

Non-Profit Enterprises: While these entities do not generate income, determining their value can help them license intellectual property and develop strategic partnerships.

Business Planning: A variety of business decisions like expansion into new territories or product lines may drive the desire for a valuation.

ESOPs: An Employee Stock Ownership Plan is a retirement plan. ESOPs place a portion or all of the company stock into a trust in which employees become vested over time. Valuations may be necessary from time to time to properly value the stock held in trust.

Measurement: Decision makers may want to better understand their company's position in a competitive environment or evaluate options like mergers and acquisitions.

Standards of Value

Standard of value typically refers to the particular buyer and seller and therefore impacts the assumptions and methods used to reach the value of a business. The reason for conducting the valuation determines which standard of value is the most legitimate and the most accurate. Another consideration is the level of scrutiny the valuation will be subject to. For example, a valuation required for IRS reporting will be subject to a higher level of scrutiny than a valuation for the purpose of making internal management decisions.

Why are the standards of value important?

The standard of value determines which valuation approaches and methodologies are most appropriate and most accurate.

Fair Market Value: The most common standard of value, also called the financial value. There are five key elements of fair market value, according to the definition from the American Society of Appraisers.

"The price, expressed in terms of cash equivalents, at which the property would change hands between [1] a hypothetical willing and able buyer, and [2] a hypothetical willing and able seller, [3] acting at arm's length in an open and unrestricted market, [4] neither being under a compulsion to buy or sell and [5] both having reasonable knowledge of relevant facts."

Distinctions: Fair market value does not take into account strategic value. This makes fair market value lower than strategic value, which makes it preferable for minimizing tax liability.

Application: ESOPs, IRS reporting, certain disputes

Standards of Value – continued

Fair Value: Similar to fair market value, but does not include discounts and is often defined in a legal construct. The Financial Accounting Standards Board provides the definition below, which must be used in GAAP accounting.

> "The price received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

Distinction: This standard is often used to maximize payout to the spouse not running the business during a divorce, or to minority shareholders during a dispute.

Application: Financial reporting, SEC reporting, some point of view disputes (including divorce).

Strategic Value: A measure of the value of a company to a specific buyer. There is no standard definition, as strategic value is specific to each transaction.

Distinction: Strategic value is higher than fair market value and considers what a particular buyer would do with the business. It looks at specific rates of return based on all benefits related to synergies.

Application: Used in limited circumstances to preview a specific transaction, in a specific context.

Standards of Value – continued

"Fair from a financial point of view": is a consideration of value and terms. It asks the question, "Are the shareholders at least as well off as they would be if the proposed transaction does not take place?" There is no standard definition.

Distinction: Considers the value of a transaction and its terms, but does not specify whether the proposed transaction is the best transaction that can be made.

Application: Used only for fairness opinions. Fairness opinions are never required. Rather they are to protect the Board of Directors under the business judgment rule.

Solvent: since it is defined by state law, it is not a true "standard" of value. In Florida, there are three tests:

- Cash flow test
- Balance sheet test
- Adequate capitalization test

Distinction: Solvency is very specific and difficult to measure because it must test whether management's projections and forecasts are achievable. The level of due diligence is greater than for fair market value.

Application: Transactions

Valuation Approaches

The standard of value will determine which approaches and methodologies are the most appropriate. There are four common valuation approaches.

Asset Approach: This approach assumes that the value of a company is worth more in liquidation than as a going concern.

Distinction: Considers value solely from a balance sheet view. Not appropriate for a company that is operating in a way that provides adequate returns to its investors based on its assets.

Application: Most appropriate for companies that are asset heavy. Almost never appropriate for service companies.

Market Approach: A method that compares the subject company to comparable companies that are publicly traded or have recently sold.

Guideline Public Companies Method— Uses data from comparable public companies to determine valuation multiples. These multiples are then applied to the subject company's financial metrics and considers appropriate adjustments and discounts.

Merged & Acquired Method—
Uses data from reported transactions of similar companies to determine valuation multiples that are then applied to the subject company's financial metrics.

Income Approach: This approach considers expected future cash flows and the required rate of return of those cash flows.

Discounted Cash Flows—
Forecasts cash flows into the future and applies a discount rate to determine the present value of all future cash flows. If applied properly, this method can produce the most accurate measure of value.

Capitalization of Earnings—
Applies a rate of return to a stabilized income stream. This method is commonly used for mature companies and assumes consistent growth.

Premiums and Discounts

Premiums and discounts are used to add or reduce value based on the specifics of a particular deal. These are often captured in rates of return considerations of financial statement adjustments. The terms and conditions of a negotiated agreement can decrease the importance of premiums and discounts. Discounts are more important for acquisition of a minority interest in a company than for acquisition of the company as a whole.

What value will a buyer pay?

A buyer brings much of the strategic value with them and is usually not willing to pay a seller for that value. Buyers look to pay close to fair market value. Since the overall strategic value of the target company is worth more to the buyer than fair market value, they may be willing to pay a small premium to close the transaction.

- Valuation is under a specific standard at a specific date and time
- Valuation is not necessarily what a company would pay for your business
- Purchase price is more of a strategic valuation
- Private equity groups differ slightly and are more of a fair market value buyer

Control Premium: A premium paid for a controlling interest in a company for the ability to control cash flows and operations. In recent years, the marketplace has shown that premiums paid are more related to strategic value than control.

Lack of Control Discounts: The opposite of a control premium, this discount is for a minority stake in business based on the inability to control cash flows and operations.

Marketability Discounts: Based on the inability to sell shares in a public secondary market. Selling shares of privately held companies is difficult and can take a very long time.

Other Discounts: These discounts are not usually explicit, rather they appear in a higher required rate of return and may account for risks associated with the following:

- Key man
- Customer concentration
- Bad debt, Accounts Receivable

Calculating Discounts

Lack of Control Discounts: Frequently captured in cash flow and not an explicit adjustment to value. If an investor is buying a minority interest, the discount has to bring the price down to the point where it meets the required rate of return.

Lack of Marketability Discounts: More difficult to quantify, specific factors are analyzed in relation to a number of studies. Discounts are calculated for specific rates of return and compared to studies as a reasonableness check.

Value Process Overview

- Consider reason for valuation
- Consider appropriate standard of value
- Determine appropriate approaches/ methodologies
- Determine appropriate rates of return
- Analyze application of discounts
- Determine final value

Value Conclusion

At the end of the valuation process, a final review is conducted. Oftentimes outliers are identified in one or more approaches. Upon further analysis, the most accurate valuation is reached using mathematical tools, thoughtfully challenging the results and using discretion to arrive at the most accurate and appropriate valuation for your business.

- Compare and contrast indications of value
- Re-analyze outliers
- Determine relative applicability of approaches and indications of value
- Determine final value (or value range)

Ready to Move Forward With Your Valuation?

PCE Valuations has a team of credentialed valuation experts and investment bankers available to help you.

We can help you determine whether you need a business valuation for your unique situation. Our services range from straightforward fairness opinions to complete enterprise valuation.

- PCE professionals average 25 years of experience
- Focus on middle-market companies
- Wide range of industries

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