

Viewpoint on Value



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Fair value
Court frowns on speculative adjustments



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7 questions to gauge marketability

Marketability is the ability to quickly convert a business interest into cash, with minimum costs and maximum certainty about the price it will fetch. The higher the costs and the lower the certainty, the less the interest is worth.

A discount for lack of marketability (DLOM) gauges the relative ease of selling a business interest in the marketplace. One of the most subjective, frequently debated valuation adjustments, DLOM can be wide-ranging. To obtain the appropriate percentage for a particular business interest, appraisers must consider a variety of factors. Here are seven questions that help take the guesswork out of quantifying a DLOM.

1. How big is the subject company?

Small companies tend to have less sophisticated internal controls, financial reporting and management. Many are also less diversified and have limited access to financing. Therefore, investors often perceive smaller businesses as riskier than larger businesses. The pool of buyers interested in small businesses is typically smaller than the pool of investors interested in large companies run by professional management teams. This differential reduces marketability.

Size is especially relevant when a valuator compares a small private firm with publicly traded stocks — which can happen when using the income or public guideline company approach to value a private business interest. It's all relative: The greater the difference between the size of the subject company and comparable market data, the higher the DLOM.

When evaluating the effect of size on the DLOM, however, an appraiser needs to avoid double counting what has already been considered in the

company's future income stream projections or discount rate estimations.

2. What's the company's track record?

Financial performance affects an investment's appeal in the marketplace. Investors prefer predictable, positive income streams to volatile, subpar ones. Dividend policy also affects marketability.

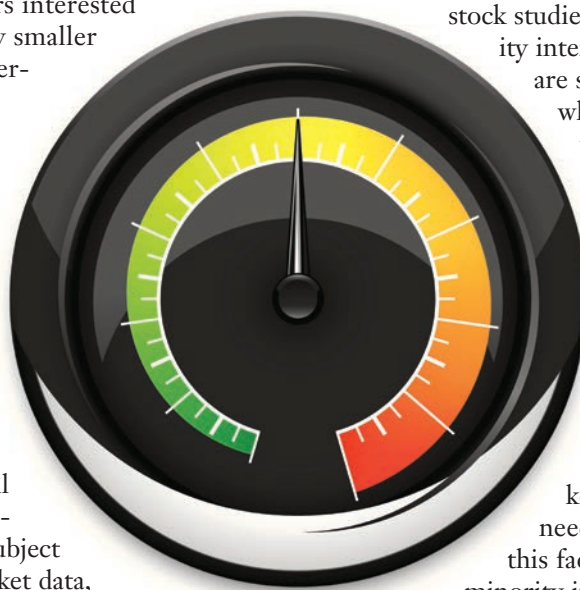
Investors earn their returns in two ways: dividends or capital appreciation. Investors typically prefer to receive interim cash flows through dividends rather than earn their returns solely in the form of capital appreciation upon eventual sale. Companies with histories of paying dividends — or at least the *capacity* to pay dividends — typically warrant lower DLOMs.

3. How big is the business interest?

First, marketability and control are related. DLOMs based on initial public offering (IPO) or restricted stock studies apply exclusively to minority interests. Controlling interests are subject to liquidity discounts, which are beyond the scope of this article. But control is not an absolute “all-or-nothing” concept.

Some minority interests possess elements of control. If a business interest has elements of control — such as the ability to terminate managers or pay out dividends — it may be more marketable. But again, an appraiser needs to avoid double-counting this factor into marketability and minority interest adjustments.

Also consider the flip side of this issue. Some larger blocks of stock are *less* marketable because they would flood the marketplace with excess supply. Fewer buyers also have access to the capital and



financing needed to purchase a large block of stock. So large blocks often warrant a higher DLOM or a separate “blockage” discount.

4. What’s the current industry outlook?

Investors prefer industries with solid growth and income prospects. Strong industries often have more merger and acquisition (M&A) activity than weaker ones. An active M&A market warrants a lower DLOM.

A valuator customarily reduces the discount for lack of marketability if the company is entertaining a purchase offer or plans to go public in the next year.

Conversely, buyers love a bargain. Opportunistic buyers looking to roll up small, weaker competitors into larger entities may target an industry in financial turmoil to take advantage of economies of scale. This phenomenon creates a market for weaker players and lowers marketability — but it also lowers the potential purchase price, because these buyers are seeking deals.

5. Do any contracts or shareholder agreements restrict marketability?

Contractual agreements between owners may contain provisions that restrict transfers (such as a right-of-first-refusal clause, which would increase the DLOM) or that establish buyout protocol (creating an effective “market” for the business interest). Valuators double-check that these agreements are current and legally enforceable, however, before relying on them when quantifying a DLOM.

Put rights, typical in employee stock ownership plans, may lower DLOM by creating a market for transferring ownership. The owner of a put option has the right, but not the obligation, to sell the interest at a prescribed price for a prescribed time period.



6. Is a sale or IPO imminent?

A valuator customarily reduces the DLOM if the company is entertaining a purchase offer or plans to go public in the next year. But these prospective transactions could fall through, so the valuator also considers how far along — and how serious — the plans are.

7. What else impacts marketability?

The last step in quantifying a DLOM is to determine what other factors — such as the national, state and local economic outlook as well as the expected holding period of the subject interest — might affect the marketability of a company’s stock. This step serves as a reminder to extend the analysis as far as necessary to incorporate any particular or unusual factors specific to the subject company’s marketability into the analysis.

Cover all the bases

While these questions are intended to offer a systematic approach to quantifying DLOM (as well as to demystify an appraiser’s thought process), there’s no cookie-cutter approach to valuing a business interest. But asking these seven questions helps ensure all the bases have been covered. ●

Hunting for buried treasure — or traps

Hidden assets and liabilities may affect value

To determine what a business is truly worth, appraisers must consider many aspects of its operations — from management, to products, to the health of its industry. They also need to look beyond the balance sheet, seeking any hidden assets or liabilities that may affect value and bringing them to light.

Whether in divorce matters or other kinds of litigation, appraisers often need to search for unusual, nonrecurring events in a company's financial statements. Such searches can provide a clearer picture of the company's normal operations and help ensure the numbers better reflect reality.

Unearth hidden assets

An appraiser starts with the line that reports total net worth on a company's balance sheet. That's the upfront part of the equation. From there, the appraiser hunts for *unrecorded* liabilities or contra assets, such as those with a negative credit balance. Here are several areas to examine:

Uncollectible receivables. Customer and factory receivables — those related to warranties and incentives — make up a significant portion of many companies' total receivables. Holding items on the books that are overaged, and that the business is unlikely to collect, misrepresents its overall financial picture.

Management should review accounts receivable regularly to determine which accounts they probably won't collect, and then adjust the allowance accordingly. The result after the adjustments is the net realizable value of the receivables.

Inventories. Of course, inventories make up an important part of many companies' net worth. The prevalent use of the last-in, first-out (LIFO) method for valuing inventories could result in undervaluation if proper adjustments aren't made. Thus, it's usually proper to adjust inventory in accordance with the first-in, first-out (FIFO) method.

Fixed assets. For book purposes, companies may record depreciation on fixed assets (such as furniture, fixtures, tools and equipment) in several ways. *Net book value*, for instance, will usually differ drastically from the actual *fair market value*. This difference would alter the business's net worth. The appraiser compares the net book value of a company's fixed assets with their fair market value.

Fine-tune the value

After a valuator makes a preliminary estimate of a company's value, he or she considers additional fine-tuning. Before finalizing the conclusion, the valuator assesses exactly what the preliminary value estimate includes. If anything is missing, the valuator makes a last-minute alteration.



Common last-minute alterations include changes to:

- Excess/deficit working capital (compared with the company's operational needs),
- Contingent or unrecorded assets and liabilities,
- Nonoperating assets, and
- Real estate (if most industry participants rent their facilities).

When making last-minute adjustments, a valuator also adjusts the earnings for any income or expenses these assets or liabilities generate, including any tax benefits or consequences.

Dig up the truth

Digging up hidden assets and liabilities will likely lead to a fairer presentation of a business's true value. To make the appropriate adjustments, an appraiser needs to perform detailed analysis and have a good overview of the company's current and future operations. ●

Detecting fraud

In marital dissolution cases, valutors may have to watch out (and adjust) for spouses trying to dissipate their businesses' values. For instance, the moneyed spouse may attempt to hide business assets, delay revenue recognition or overstate expenses.

A lower bottom line benefits a moneyed spouse in two ways. First, to the extent that a company's value is based on its earnings, reduced income lowers value. Therefore, low profits increase a moneyed spouse's share of the marital estate's remaining assets. Some moneyed spouses will even hide physical assets or use fraudulent accounting tactics to lower profits reported before their divorce.

Of course, the nonmoneyed spouse has less experience and knowledge of the business, and such a charge may be baseless. But to determine whether the claim is justified or is completely without merit, valuation — and forensic accounting — expertise is essential.

Sorting the alphabet soup of valuation credentials

Not every financial professional is qualified to value a business — especially if a third party will rely upon the appraisal. Earning a valuation credential requires specific coursework, testing, peer review and other prerequisites.

Sorting through the alphabet soup of valuation credentials can be daunting. Here, we explain why credentials are a must-have and summarize the

requirements of the most common business valuation designations.

Save now, pay later

Do-it-yourself appraisals might save money up front, but they can be costly later. Consider the owner of a print shop who asked his CFO to testify about the value of his interest at his divorce hearing. The CFO knew the ins and outs of the printing business. And

he was familiar with industry rules of thumb and the rumored purchase price of a nearby competitor three years earlier.

But what the CFO didn't know was how to value a business. The owner's wife hired a credentialed valuation expert who testified about the perils of relying exclusively on industry rules of thumb and hearsay. Instead, she presented a conclusion based on a sophisticated discounted cash flow analysis, which was supported by an alternate calculation based on 25 comparable transactions from a proprietary database.

The court relied exclusively upon the wife's expert's conclusion because her analysis was more thorough and objective. And the requirements the expert had met to earn her valuation designation qualified her to appraise the business.

Valuation's secret code

Several organizations offer business valuation credentials, including the American Institute of Certified Public Accountants (AICPA), the American Society of Appraisers (ASA), and the National Association of Certified Valuation Analysts (NACVA), which merged with the Institute of Business Appraisers (IBA) last summer. The most common business valuation credentials you'll likely encounter are:

Accredited in Business Valuation (ABV). This requires a CPA license and AICPA membership. Candidates also must take 75 hours of coursework, pass an exam and complete six valuations (or 150 hours of valuation experience).

Accredited Senior Appraiser (ASA). These professionals undergo 123 hours of coursework, a series of six exams, approval of a demonstration appraisal report and five years (or 10,000 hours) of full-time

business valuation experience for accreditation. After two years of valuing businesses, a candidate may use the Accredited Member (AM) designation, if all the other requirements have been met.

Certified Valuation Analyst and Accredited Valuation Analyst (CVA/AVA). NACVA merged two credentials into one designation (CVA) in April 2013. Formerly, the only difference was that CVAs were also CPAs, whereas AVAs required an MBA or other business degree. NACVA requires CVAs to take a 45-hour class, pass an exam, submit a case study or demonstration appraisal report for peer review, and complete two years of related experience (or perform ten valuations).

Certified Business Appraiser (CBA). Since the NACVA/IBA merger, CBAs must take the same courses as those who earn the CVA designation. CBAs also must submit two demonstration reports and pass a five-hour exam.

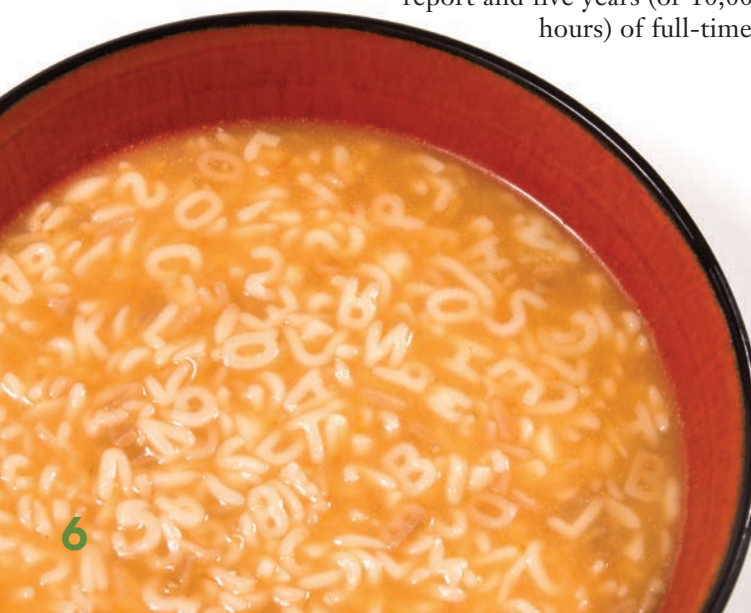
Requisite standards

All appraisal organizations require members to have four-year degrees and to take continuing professional education (CPE) courses. It's a good idea to double-check to ensure your expert is current on his or her CPE requirements.

Each organization also has its code of ethics and professional standards. ASA is the only organization that requires members to follow the *Uniform Standards of Professional Appraisal Practice (USPAP)*, although many nonmembers voluntarily comply with these rigorous standards. All CPAs, regardless of the valuation credentials they hold, must conform to the *Statement on Standards for Valuation Services (SSVS)*. Review a valuator's report to ensure he or she is in compliance with all requisite standards.

Read the signals

No valuation credential necessarily trumps another — and more credentials after an expert's name doesn't necessarily equate with more reliable results. But valuation credentials do demonstrate an expert's experience level and commitment to the appraisal discipline. Those who stay current with their CPE and professional standard requirements also are more likely to be in touch with the latest theories and trends. ●



Fair value

Court frowns on speculative adjustments

The Delaware Chancery Court recently awarded dissenting minority shareholders more than double the merger cash-out price in a fair value appraisal decision. *In Re: Appraisal of Orchard Enterprises Inc.* highlights the importance of using well-supported, objective inputs throughout the appraisal process.

Court sides with dissenters

Public company Orchard Enterprises, an online music provider, was unable to find a third-party buyer. So its controlling shareholder, Dimensional Associates, decided to delist it and buy out the common shareholders for \$2.05 per share in 2010. Orchard sold for \$1.34 per share on the NASDAQ before announcing its going-private transaction.

Dissenting shareholders asserted that the fair value of Orchard's stock was \$5.42 per share. Orchard's expert appraised the stock at \$1.53 per share. The primary reason for the discrepancy was a \$25 million preferred-stock liquidation preference that the respondent's expert subtracted from the equity's value before allocating value to the common shares.

The court decided that the liquidation preference hadn't been triggered and, therefore, shouldn't be subtracted, because it was speculative. The company hadn't dissolved, sold all of its assets or been sold to an unrelated third party.

Orchard argued that potential buyers would discount their offers for the preferred stock liquidation preference. Although the respondent's argument "may be grounded in market realities," the court

ruled that Delaware law and legal precedent require appraisers to focus on going-concern value, not speculative liquidation values.

Breaking ground on other valuation issues

The court also resolved discrepancies between the experts' valuation appraisal methodologies. The market approach was rejected, because the comparables Orchard's expert used were insufficiently similar to the subject company.

When quantifying the cost of equity, the court preferred the capital asset pricing model (CAPM) to the build-up method, because the latter was "larded with subjectivity." Although the court allowed a size premium, it stated that company-specific risk factors belong in cash flow projections, not embedded in the subject company's cost of capital. And the historic equity risk premium was rejected in favor of the supply-side equity risk premium.

Controlling shareholders ante up

The result of these findings was a fair value of \$4.62 per share — more than double the original merger cash-out price. The respondent learned some hard lessons: Use methodologies supported by the latest academic research, minimize the use of subjective data and avoid speculative adjustments when valuing a business. You can avoid the respondent's mistakes by hiring an experienced valuator who knows how to achieve the proper balance between subjective judgment and objective analysis. ●





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John M. Leask II (Mac), CPA/ABV, CVA, values 25 to 50 businesses annually. Often, Mac's valuations, oral or written, are compiled in conjunction with the purchase or sale of a business, to assist shareholders prepare buy/sell agreements, or to set values when shareholders purchase the interest of a retiring shareholder. Here are examples:

- **Due Diligence & Assist with Purchase of a Business.** Mac has assisted purchasers of businesses by determining or reviewing the offer. He helps negotiate the price, perform due diligence prior to closing and/or helps structure and secure financing. Services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to future success, and helping management plan future operations.
- **Family Limited Liability Partnerships, Companies & Closely Held Businesses.** Mac regularly values various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuers.

Mac also helps business owners and their CPAs and/or lawyers in the following ways:

- Planning — prior to buying or selling the business
- Prepare valuation reports in conjunction with filing estate and gift tax returns
- Plan buy/sell agreements and suggest financing arrangements
- Expert witness in divorce & shareholder disputes
- Support charitable contributions
- Document value prior to sale of charitable entities
- Assist during IRS audits involving other valuers' reports
- Succession planning
- Prepare valuation reports in conjunction with pre-nuptial agreements
- Understanding firm operations & improving firm profitability

More information about the firm's valuation services (including case studies) may be found at www.LeaskBV.com.

To schedule an individual consultation or to discuss any other points of interest, Mac may be reached at 203 - 255 - 3805. The fax is 203 - 380 - 1289, and e-mail is Mac@LeaskBV.Com.

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 **John M. Leask II CPA, LLC.**
Business Valuation Services

If you have a business valuation problem, Mac is always available to discuss your options — at no charge.