Viewpoint on Value

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

John M. Leask, II
(Mac)
CPA/ABV, CVA

765 Post Road, Fairfield, Connecticut 06824
Phone: 203-255-3805 • Fax: 203-380-1289
E-mail: Mac@LeaskBV.Com • Web Page: www.LeaskBV.com

How does industry risk impact business valuation?

There's a trade-off between risk and return in business valuation. Investors expect to receive a higher return as the company exposes them to greater risk. Industry-specific risk is an important consideration when estimating an investor's expected return. Here's how business valuators measure industry risks and factor them into their analyses.

Assessing industry risks

Virtually every business valuation report includes a section on industry risks. Several factors are used to measure industry risk, including:

Growth prospects. Evaluate the industry's future outlook, including its seasonal and cyclical trends and stage of development. For example, emerging industries typically grow faster but face greater uncertainty than mature industries. Strong, predictable growth prospects generally equate with lower industry risk and higher value.

Relative power of suppliers and customers. Look up and down the company's supply chain to determine which players have the greatest negotiating power. For example, the subject company may be at the mercy of vendors if it operates in an industry dominated by a few key suppliers that provide value-added services (as opposed to price-sensitive commodities). Supply chain partners with more power — or supply chains with balanced power — tend to have less industry risk.

Competitive threats. When sizing up the competition, consider geographic location and market position. For example, you obviously wouldn't compare a fast-food taco truck to an upscale five-star restaurant. Large industry segments characterized by intense global price competition are particularly risky.

Risk of product substitution. Evaluate whether customers could use another readily available, less expensive product in lieu of the subject company's offering. If customers can easily switch to a substitute product, the industry's risk is greater.

Defining the subject industry

Appraisers typically define industry in terms of Standard Industrial Classification (SIC) or North American Industry Classification System (NAICS) codes. But it's critical to research the companies that fall under the same code to ensure that they're truly comparable to the subject company.

Sometimes, the code management uses on its tax return is outdated or inaccurate. For example, SIC codes haven't changed since 1987 — when business was conducted without the Internet, cell phones or nearly as many environmental regulations. Many industries have changed dramatically over the last few decades. Other new industries have emerged. But few established companies have bothered to revise their old SIC codes.

Often companies dabble in more than one industry, making accurate comparisons difficult. This may be true of large public conglomerates or companies that are vertically integrated, such as a manufacturer that also distributes or services its products.

Clients and attorneys can help appraisers select an appropriate subject industry. In doing so, evaluate whether the industry description accurately depicts what the subject company does. There should always be a clear link between the subject company and the comparable data underlying the valuator's industry risk assessment.

Barriers to entry. More is at stake when companies participate in industries that require licensing, expensive outlays for equipment, compliance with stringent regulatory requirements, and continual investments in technology or research and development. To illustrate, investors typically demand a higher return for investing in a high-tech manufacturer than in an educational services provider.

Valuators use several resources to assess industry risks, including the company's business plan, industry trade associations and fee-based external sources. Examples include Duff & Phelps' annual *Valuation Handbook*, IBISWorld's Industry Research Reports, First Research's Industry Profiles and Risk Management Association's *Annual Statement Studies*®.

Factoring industry risk into value

Once a valuator understands the subject industry, he or she can evaluate management's cash flow predictions. For example, a valuator may question how realistic it is for management to forecast a 10% growth rate if the industry is declining and management hasn't taken steps to transition the company's offerings to changing consumer demands.

> Under the income approach, the company's discount rate may be adjusted up (or down) depending on how risky the company's industry is compared to the overall market.

Likewise, when selecting comparables from public stock markets or private transaction databases under the market approach, it's important to know where the subject company fits within its industry in terms of size, financial performance, capital structure and market position. Some comparables may be eliminated based on the industry risk assessment — or an industry-based risk adjustment might be factored into the valuator's application of pricing multiples.

Under the income approach, the company's discount rate (also known as its required rate of return) may be adjusted up (or down) depending on how risky the company's industry is compared to the overall market. This adjustment can be made if the appraiser uses the capital asset pricing model or the build-up method to estimate the subject company's discount rate.

Also, under the income approach, industry risks come into play when estimating the company's long-term sustainable growth rate. Valuators generally assume that the subject company's growth will someday even out to a moderate, steady rate into perpetuity. In turn, this growth is used to compute capitalization rates under the income capitalization method and terminal value under the discounted cash flow method.

Getting a handle on industry risks

Industry risks impact the value of a business in many subtle ways. Accurate valuations hinge on taking the time to thoroughly understand the subject industry and where the subject company fits within that group. ●

Look to the future when estimating net cash flow

Historic financial performance trends are often a logical starting point for valuing a business. But that's only true to the extent that the entity's future performance will mirror the past. For many companies — such as those with negative historic cash flow, start-ups and merged entities — valuators may need to build more detailed cash flow estimates or rely on management's estimates.

What is "net cash flow"?

Under the income approach, valuators derive value from the economic benefits that investors expect to receive. A common measure of economic benefits is net cash flow. Unlike net income, which is an artificial accounting concept, net cash flow represents the amount of cash available for investors.

There are two types. Equity net cash flow is the amount available to pay equity holders. It starts with net income and requires adjustments for noncash charges (such as depreciation and amortization), changes in net working capital, additional capital expenditures and net changes in long-term debt. When valuators discount equity net cash flow using the cost of equity, they arrive at the value of equity.

On the other hand, invested capital net cash flow is the amount available to pay both equity and debt holders. It starts with net income but requires an adjustment for interest expense (net of the tax benefit). Then it requires adjustments for noncash charges, changes in net working capital, additional capital expenditures and preferred dividends, if applicable. (No adjustment is made for debt service or proceeds.)

When valuators discount invested capital net cash flow using the weighted average cost of capital — which blends the cost of equity and debt financing — they arrive at the value of invested capital. Interest-bearing debt must be subtracted to arrive at the value of equity under this technique.

What's the difference between forecasts and projections?

When calculating a company's expected net cash flow, it's important to distinguish between forecasts and projections. According to AICPA Attestation Standards Section 301, *Financial Forecasts and Projections*, forecasts are prospective financial statements that present, to the best of management's knowledge and belief, an entity's expected financial position, results of operations and cash flows. A financial forecast is based on assumptions reflecting the conditions management expects to exist and the course of action management expects to take.

In general, valuators use cash flow forecasts — that is, expected results based on the expected course of action — when appraising private business investments.

By comparison, projections are prospective financial statements that present, to the best of management's knowledge and belief, given one or more hypothetical assumptions, an entity's expected financial position, results of operations and cash flows. Projections may present a hypothetical course of action for evaluation, as in response to a question such as, "What would happen if … ?"

In general, valuators use cash flow forecasts — that is, expected results based on the expected course of action — when appraising private business investments. Some noteworthy exceptions include economic damages calculations and capital budgeting decisions. In these situations, a projection based on various hypothetical assumptions may be more appropriate.

How do cash flow estimates impact value?

Small differences in cash flow can have significant impacts on value. To illustrate, suppose a valuator has two estimates of net cash flow to choose from:

1. A speculative projection that estimates equity net cash flow will be $1 million, and
2. A more conservative forecast that estimates equity net cash flow will be $800,000.

If a valuator applies a 20% capitalization rate to both estimates, the resulting values would be $5 million ($1 million divided by 20%) and $4 million ($800,000 divided by 20%). In other words, every $1 of additional net cash flow results in an extra $5 of value at a 20% cap rate.

Who can help?

There are many other pitfalls to watch out for when estimating net cash flow. For example, valuators must remember to always match cash flow with the appropriate type of discount or capitalization rate. And to arrive at the value of equity, they should subtract interest-bearing debt when discounting invested capital net cash flow. Experienced, credentialed valuation professionals understand these nuances and can help you get it right. ●

Cavallaro v. Commissioner

Faulty assumption causes court to discard petitioners' appraisal

A recent Tax Court case demonstrates that a valuation is only as reliable as its underlying assumptions. A faulty assumption can undermine the credibility of an appraiser's testimony and leave the court to rely solely on the opposing expert's conclusion.

Machine shop is a one-hit wonder

In 1979, the petitioners (husband and wife) incorporated Knight Tool, a machine shop that designed components for defense, aerospace and industrial manufacturers. Its primary asset was unpatented technology — including "know-how, trade secrets, assembled work force, and other similar intangible assets" — related to an automated liquid-dispensing machine (called CAM/ALOT) that customers used to manufacture computer circuit boards.

This technology was developed in 1982. But the company failed to profit from it until the petitioners' sons incorporated a separate company (Camelot) in 1987. The new entity was dedicated to improving, marketing and selling CAM/ALOT machines. Each of the petitioners' three sons owned a one-third interest in Camelot, which shared the

same facilities, employees, financing and accounting services as Knight Tool.

Eventually, sales of CAM/ALOT took off. The entities' combined pretax income was more than $5.5 million by 1995.

Experts estimate pre- and postmerger values

The petitioners decided to merge Knight Tool and Camelot for estate planning purposes in 1995. The surviving entity retained the Camelot name. The petitioners' appraiser determined that the value of the merged entity was approximately $72.8 million using the market approach.

He allocated 81% of the combined entity's stock to the sons and 19% to the petitioners, based on the relative premerger value of each company. This allocation effectively valued Camelot at four times the value of Knight. A key assumption underlying this allocation was that ownership of the CAM/ALOT technology was transferred to the sons when they created Camelot in 1987.

In 2010, the IRS challenged this assumption and issued a deficiency notice. Using the discounted cash flow method, the IRS's appraiser valued Camelot at $64.5 million postmerger. He assigned 65% of the postmerger value to Knight Tool.

Merger results in a constructive gift

The petitioners didn't formally document the transfer of the CAM/ALOT technology from Knight Tool to Camelot in 1987. Instead, they claimed that it had occurred when the petitioner handed the corporate minute book to his oldest son and said, "Take it; it's yours." In 1995, the petitioners also signed a confirmation bill of sale to document that Camelot solely owned the CAM/ALOT technology prior to the merger.

But that wasn't enough to persuade the court. It decided that Knight owned the technology and, therefore, the Camelot shares that the petitioners received in the merger for their shares of Knight weren't full and adequate consideration. When property is transferred for less than full and adequate consideration, the amount by which the value of the property exceeds the value of the consideration is deemed a gift. So the petitioners effectively made a $29.6 million gift to their sons in 1995.

In 1996, Camelot was sold to a third party for $57 million in cash plus contingent deferred payments of up to $43 million. Although the case dragged on until Sept. 2014, neither the IRS nor the petitioners considered the subsequent sale of Camelot's stock in its conclusions.

Put it in writing

It's common for family-owned businesses to overlook administrative formalities and engage in sweetheart deals. But failure to document the parties' intentions and engage in arm's-length transactions could trigger unexpected tax liabilities. Involve appraisers early in the estate planning process and openly discuss the assumptions underlying their valuations to help avoid fundamental misunderstandings. ●

Blending appraisal disciplines to value fractional interests in real estate

Valuing undivided interests in real estate requires the use of a real estate appraiser to value the underlying property. Then, a business valuator is needed to determine the appropriate discount for owning a fractional interest in the property. This discount differs from the discounts associated with owning minority interests in closely held businesses.

Factors to consider

Unlike owners of minority business interests, owners of fractional interests generally have significant rights under state law with respect to the property, such as the rights to receive a pro rata share of the income, to partition or to veto decisions about property use.

These rights have led the IRS to argue that fractional interest discounts should be limited to the cost of partition. Generally, the U.S. Tax Court and federal appellate courts have rejected the IRS stance as overly simplistic. Among other things, it ignores the fact that partition may not be a viable option. Partition proceedings are often protracted disputes and a court-ordered partition or forced sale can diminish the underlying property's value.

Most courts agree that the cost of partition is merely one of several factors to consider in quantifying discounts for fractional interests. Other risks that may impair value include the inability of fractional interest owners to manage the property or force its sale or development. General factors listed in the *IRS Valuation Training for Appeals Officers Coursebook* include the interest's size, number of owners, tract size, land use and financing availability for undivided interests.

Imputed discounts

Valuators often use the discounted cash flow method to value fractional interests. Here, expected future

cash flows or other economic benefits derived from the fractional interest are discounted to present value. This approach contemplates an eventual partition (if viable) or sale of the property. The valuator estimates the time it would take to bring about an orderly disposition of the property and incorporates an expected growth rate to arrive at a terminal value at the date of partition or sale.

Next, the valuator estimates the owner's net cash flows between the valuation date and the terminal date, taking into account the cost of partition and other expenses. An appropriate discount rate is applied to interim cash flows and the terminal value to determine the fractional interest's value as of the valuation date. The difference between this value and the owner's pro rata share of the underlying property's value represents the valuation discount.

Experience needed

Courts in recent cases have accepted fractional interest discounts ranging from 10% to 60%, depending on the facts of the case. So it's important to use a valuator who's experienced in supporting these discounts. ●

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

765 Post Road, Fairfield, Connecticut 06824

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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 valuators.

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 valuators' 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****.*

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