

Using Experts and the Valuation of Closely-held Businesses

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Revenue Service Town Meeting

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AGENDA

- ❑ Why use an expert?
- ❑ Who is expert?
- ❑ The factors that determine the value of closely-held businesses: What should you look for in an expert's report?
- ❑ Current trends in the use of experts and the value of closely-held businesses.

Why use an expert ?

The Basics

- ❑ Highly technical area
- ❑ Knowledge base is changing rapidly
- ❑ Time limitations

Why use an expert?

Business Valuation Reasons

- ❑ Increased academic research on factors impacting private firm valuation
- ❑ Increased reliance by courts on new research
- ❑ Need to understand modeling, forecasting and statistical analysis
- ❑ Business valuations will double in the next 5 years.
- ❑ Complexity of what is being valued

Who is an Expert?

- ◆ Daubert v. Merrell Dow Pharmaceuticals, Inc. established the definition of expert testimony
- ◆ "If scientific, technical, or other **specialized knowledge** will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise."

Key Factors to Review When Analyzing an Expert's Business Valuation Report

Fundamental Factors

- ❑ Size of free cash flow
- ❑ Growth in free cash flow:

**The greater the growth,
the greater the value!**

- ❑ Required rate of return

Key Factors: Free Cash Flow

| | |
|---------------------------------------------|-----------------|
| □ Net Revenue | \$1000 |
| 1. Less reported operating costs | <u>(\$ 500)</u> |
| 2. Equals Reported Before Tax Profits | + \$500 |
| 3. Add back owner comp above benchmark wage | + \$200 |
| 4. Add back discretionary expenses | + <u>\$100</u> |
| 5. Equals adjusted before tax cash flow | \$800 |
| for valuation purposes | - |
| 6. Less tax@40% | (\$320) |
| 7. Less Investment Requirements | <u>(\$100)</u> |
| 8. Free Cash Flow | \$380 |

Key Factors: Cash Flow Growth

□ Growth in Cash Flow

□ Client Growth: 3%

□ Growth in products per client: 5%

□ Improvement in after-tax profit margin = 10%

□ Growth in net capital needs = 0%

□ Growth in after-tax free cash flow approximately equals $3\% + 5\% + 10\% = \mathbf{18\%}$

Key Factors: Required Return

□ Required rate of return

- level of long-term interest rates
- uncertainty of expected cash flows

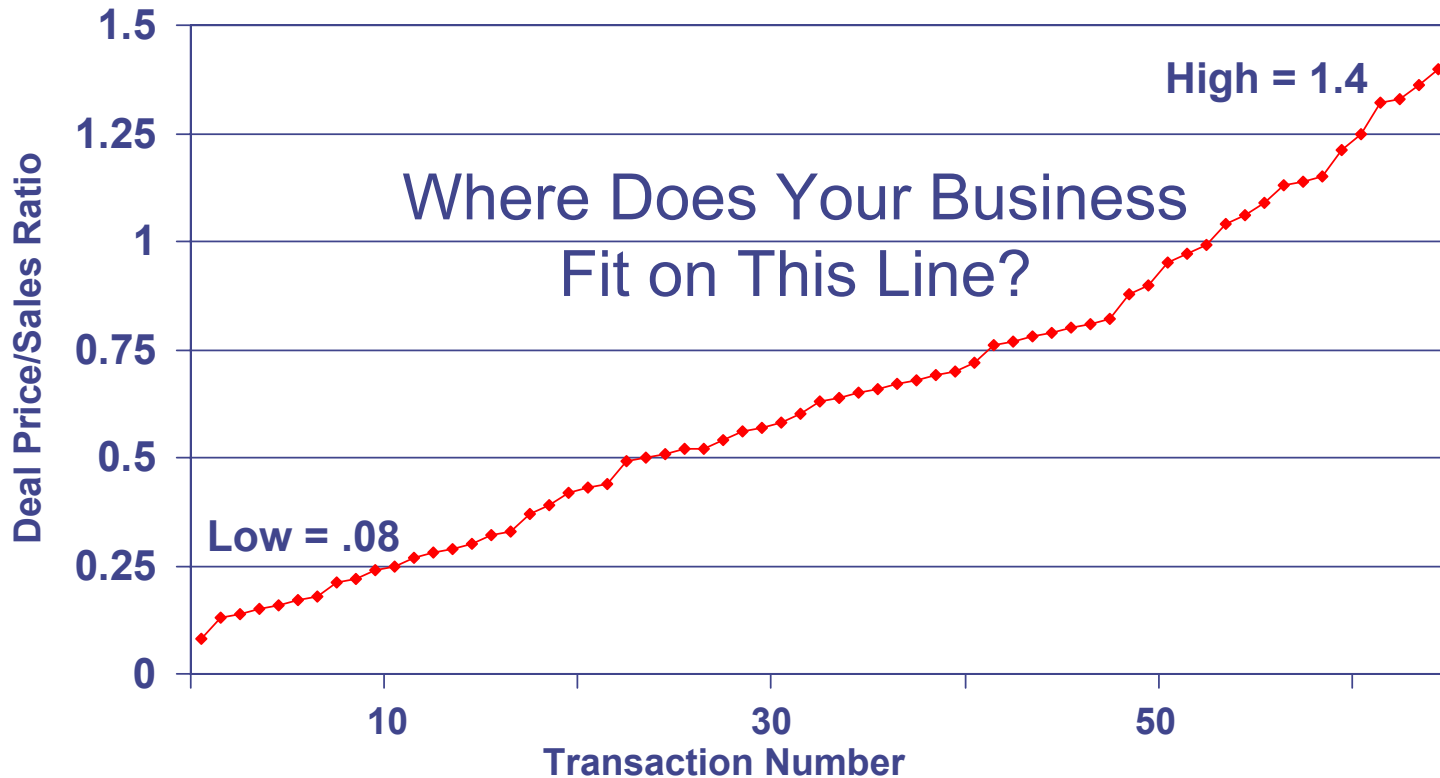
□ Target rate of return in today's market: 20%-25%

Sale Multiples of Revenue Assuming a 20% Return Target for the Buyer

| | After-tax Profit Margin | | | | |
|---------------|-------------------------|------------|------------|------------|------------|
| <i>Growth</i> | 20% | 30% | 40% | 50% | 60% |
| 0 | 1 | 1.5 | 2 | 2.5 | 3 |
| 5% | 1.4 | 2.1 | 2.8 | 3.5 | 4.2 |
| 10% | 2.2 | 3.3 | 4.4 | 5.5 | 6.6 |

Industry Multiples & Rules of Thumb May Be Extremely Misleading

Deal Price to Annual Sales Ratios – Fabricated Metals



Example – Metal Fabricator with \$5M Annual Sales

Valuation

**\$6.6M
Range**

- \$0.4M = Low Firm Value (\$5M Sales x .08 P/S ratio)
- \$7M = High Firm Value (\$5M x 1.4)

Source: BIZCOMPS; N=62

Trends in Business Valuation

◆ Developing Trends

◆ Continuing Trends

◆ Declining Trends

Trends in Business Valuation: Developing Trends

- ◆ Increased reliance on academic research: (e.g. size of liquidity discounts)
- ◆ Courts relying more on what research and theory suggest as opposed to looking at past legal decisions for guidance: e.g. Gross
- ◆ Sarbanes-Oxley
- ◆ Do business valuation professional certifications provide practitioners with a sufficiently rigorous knowledge base?

Trends in Business Valuation: Continuing Trends

- ◆ Proper size of discounts and premiums.
 - Liquidity Discounts
 - Control Premiums
- ◆ Increased scrutiny of FLPs
- ◆ S vs. C corp. controversy rages on

Trends in Business Valuation: Declining Trends

- ◆ Use of book value as a measure of business value
- ◆ Use of business brokers
- ◆ High premium on experience
- ◆ Trade-off between cost of doing business valuations and quality of deliverable

Summary

- ◆ An expert must meet the Daubert standard.
- ◆ Business valuation has become a highly technical discipline and is a full-time job
- ◆ Finance and economic academic research has become more widespread, and it is being relied upon in all valuations settings, particularly in litigation
- ◆ If the key factors that determine business value are not estimated correctly, the resulting business value will always be wrong