

Valuing Small Businesses for Estate Purposes

Small Does Not Mean Simple

**Presentation to
California Probate Referee Convention**

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Roger is president of the company, and is the principal analyst for the company's business valuation services, including certified business valuation reports, certified valuation reports for non-operating LLCs and FLPs, and business value estimate reports. Dr. Stan Feldman is the chief valuation officer for the company. Roger is a co-author of “What Every Business Owner Should Know About Valuing Their Business”, McGraw-Hill, 2002

Roger is a Certified Machinery and Equipment Appraiser through the National Equipment and Business Builders Institute, www.nebbi.org, and is a member of the Society of Business Analysts.

Roger has over twenty-five years of management experience in small and mid-sized company settings. From 1985 to 1994, he served as Group Vice President for U.S. Sales, Marketing, and Consulting of DRI/Standard & Poor's, the leading U.S. economic analysis and industry forecasting firm.

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Charlie is Managing Director, California, and heads up account management and client development in Los Angeles, Orange County, San Francisco, San Diego, the Inland Empire and elsewhere in the Golden State.

He is a seasoned finance professional, with three decades' experience in investment banking, wealth management, venture capital, private equity, real estate, technology and state politics. He has spent many years serving small and medium-sized companies, with a particular focus on organizations experiencing rapid growth or in need of significant change.

Charlie has also served as senior aide or advisor to two State Controllers in California.

As an investment banker early in his career, Charlie completed \$2 billion in bond financings for state & local governments. He later provided a variety of asset management, lending and estate planning services to high net worth families, businesses and non-profit organizations. Charlie was recognized for his success in financial planning, i.e. providing life goal-based clients.

Charlie completed his MBA (Finance) from Columbia University, and received a B.A. (Political Economy) from Williams College.

About Axiom Valuation Solutions

Axiom Valuation Solutions is a nationally recognized business and financial security valuation firm. We have conducted valuation assignments for clients throughout the U.S., Europe, Asia, and Latin America. We are one of only a few firms that provide only valuation services across all industries nationwide, for fixed prices and on a fixed time frame.

Our Co-founder and Chairman, Dr. Stanley Jay Feldman, was a member of FASB's Valuation Resource Group, an advisory group to FASB, and has published multiple books and articles on valuation. Dr. Feldman taught valuation and corporate finance for twenty years as an Associate Professor of Finance at Bentley University.

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Valuing Businesses for Estate Purposes

1. Millions of “Small Businesses” created over the last 50 years
 - a. Privately held entities
 - b. Typically do not have public company comparables
 - c. Two basic types:
 - a. Operating businesses
 - b. Asset holding entities

Valuing Businesses for Estate Purposes

1. Guideline for Valuations: IRS Rev Ruling 59-60

a. What is the interest being valued?

b. What is the valuation date?

c. Fair market value standard

d. Factors to consider

Question: When was 59-60 issued?

What is the Interest Being Valued?

1. Fundamental difference between the “gifting” standard and the “estate” standard
 - a. Estate: Combining the decedent’s interests into a block
 - b. Gifting: Value interests based on their standalone characteristics

What is the Valuation Date?

1. Estate Administration has unique date standard –
 - a. Date of Death
 - b. Alternate Date: 6 months after
 - c. Have to value all assets at both dates if using alternate date

What is the Valuation Date?

1. Valuation analysis can consider the impact of the death on the business or entity
 - a. Payment of life insurance death benefit to company
 - b. Impact on client relationships
 - c. Impact on business longevity

1. Willing buyer and willing seller – really?
2. Informed
3. Impact of deal terms on value
4. What about strategic buyers?

Question

1. What is the right interest rate a seller should charge a buyer for seller financing of the transaction price so the seller does not lose value?
 - a. Minimum IRS applicable rate
 - b. Prime + 1%
 - c. Prime + 2%
 - d. Cost of capital for the acquired firm

Factors to Consider from 59-60

- The financial condition of the business.
- The earning capacity of the company.
- Whether or not the enterprise has goodwill or other intangible value.
- The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter. (IRS Rev Ruling 59-60)

59-60 Standards Applied to Small Businesses

- Financials are often not transparent
- Income tax minimization is often the primarily objective of financial management
- For many businesses, goodwill is personal not enterprise
- There are rarely appropriate public company comparables
- Many successful businesses are not sellable

Valuing Businesses for Estate Purposes

1. Two Primary Trends in Valuation Cases
 - a. Importance of Facts and Circumstances
 - b. Use of Financial Modeling to Quantify Discounts and Adjustments

Importance of Facts and Circumstances

1. A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. (IRS Revenue Ruling 59-60)

Importance of Facts and Circumstances

1. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance. (IRS Revenue Ruling 59-60)

1. Rev Ruling 59–60 Instruction

- a. Detailed profit-and-loss statements should be obtained and considered for a representative period immediately prior to the required date of appraisal, preferably five or more years.

2. The Last Five Years!

1. Restatements

- a. Cash vs accrual
- b. Tax vs Book for depreciation and amortization
- c. Non-operating assets and liabilities
- d. Excess working capital
- e. Related company transactions

Adjustments for Valuation Purposes

1. Benchmarking to Industry Ratios
2. Adjustments
 - a. Owner Compensation
 - b. Family Member Compensation
 - c. Rent from Related Entities
 - d. Leasing Equipment from Related Entities
 - e. Other Owner Discretionary Expenses

Other Key Factors in Valuation

1. Cost of Capital
2. Calculations for:
 - a. Control Premium
 - b. Minority Discount
 - c. Lack of Liquidity
 - d. Lack of Marketability

1. Calculating Discounts and Control Premiums for an Operating Business
2. Calculating Discounts and Control Premiums for an Asset Holding Entity (FLP, LLC)

Operating Businesses - Case Studies

1. Value of medical practice after a physician-co-owner dies after being arrested for sexual misconduct
2. Value of company after co-owner with large client relationship dies
3. Value of companies with captive real estate and captive equipment leasing companies
4. Value of auto dealership required to invest in new dealership facility

Operating Businesses - Case Studies

1. Value of excess inventory remarketing company with one client
2. Value of notes due to company co-founders (100% financed buy-out by management)
3. Value of 25 year control restriction on control owner

Asset Holding Entities - Case Studies

1. Real Estate Entity with Shared Control – One GP Dies
2. Real Estate C Corporation – Owner Dies
3. Real Estate Corporation Converts from C to S then co-owner dies before 10 years
4. Real Estate Entity with Small Apartment Buildings with substantial repair/renovation needs
5. Fraudulent Assets
6. Fractional Interests- Don't use the 15% rule

1. Construction Companies

- a. Great income business, bad wealth creator
- b. Have to keep retained earnings in business
- c. Cannot get it out – bonding companies and banks
- d. No buyers – Personal Goodwill

1. Machine Tool Companies

- a. Great income business, bad wealth creator
- b. Have to keep buying machines
- c. Machinery is critical but specialized knowledge is more critical
- d. No buyers – Personal Goodwill

Special Cases by Industry

1. Personal Services – medical, dental, psychology, legal, financial
 - a. No buyers unless there is a recurring customer base and a new business generating system that does not rely on key person

Summary

1. Small businesses often have complicated and non-transparent financials
2. Valuing small businesses:
 - a. Importance of facts and circumstances
 - b. Use of financial models and empirical data to support assumptions and adjustments

Thank you for being such an attentive audience!

Questions?