



The Valuation of Interests in Business Entities

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Reasonable values can be derived for business interests by adhering to valuation fundamentals and by using common sense.

Most people have heard the axiom that valuation is an art, not a science. This is especially true for business valuations where value depends not only on objective evidence, but on very subjective data such as the strength of management, the ability of the business to attract new customers and hypothetical investors' attitudes about the business.

In one case, the court held that valuation involves a "plaguingly elusive question of fact ... which should frankly be recognized as inherently imprecise and capable of resolution only by a Solomon-like pronouncement."¹

In other fields of appraisal, such as real estate, historical performance is often strong evidence of future performance. But in the valuation of businesses, expected future performance is often very different than historical performance. In most businesses, revenues and earnings vary considerably from year to year, making

the estimation of future revenues and earnings difficult. This is one of the reasons that the value of a business is often the subject of litigation.

Rules of Thumb

Business appraisers are often asked "How much are businesses selling for?" (ie how many times net income, revenues, book value, etc.) An experienced business appraiser will answer that there is no one multiple or rule of thumb for which businesses sell. Businesses are as unique and complex as the people that run them, and as such, are not capable of being valued by a simplistic multiple or rule of thumb. Two businesses in the same industry with identical sales and earnings could have very different values. "Easy" valuations usually produce uneasy results.

Revenue Ruling 59-60

Virtually every business appraiser is familiar with Revenue Ruling 59-60². This ruling presents eight general factors that should be considered in the valuation of a closely-held business. Although the context of this ruling is related to gift and estate taxes, it has of-

ten been cited in divorce cases, damage cases, corporate dissolution cases, and a derivation is also used in employee stock ownership (ESOP) valuations.

These eight factors can generally be summarized as follows:

1. The type of business and company history.
2. The status of the national economy, and more importantly, the subject industry as of the date of valuation.
3. The financial position of the company.
4. The company's earnings record and potential.
5. The dividend history of the company, as well as the capacity it has to pay dividends.
6. Prior sales of stock and the size of the block of stock.
7. The existence of, or lack of, goodwill and other intangible assets.
8. The market value of the stocks of similar corporations, if any, whose securities are traded actively on the public market.

Although these eight factors provide some guidance, they are not exclusive. All relevant factors must be considered, utiliz-

ing judgment and common sense.

Standards of Value

One of the first things that a business appraiser does after receiving a valuation engagement is to ascertain what standard of value should be used. Usually the standard of value is "fair market value", which is used for estate and gift tax valuations, but other standards of value include investment value, fair value, and liquidation value.

Fair market value is usually defined as "the price at which property or common stock would exchange between a willing buyer and a willing seller, neither being under compulsion to buy or sell, and both having reasonable knowledge of relevant facts". Investment value is the value to a particular person, fair value is often associated with an equitable value, and liquidation value assumes a sale of the assets.

Courts have held that business interests should be valued, at least under the fair market value standard, as if a hypothetical buyer and a hypothetical seller concluded a hypothetical sale of the stock. The following are quotes from tax cases discussing the fair market value standard.

(T)he hypothetical sale should not be construed in a vacuum isolated from the actual facts that affect the value of the stock.³

The "willing buyer-seller" rule renders irrelevant only the real seller and buyer, not the other stockholders. Thus, while the identities of decedent, the decedent's estate and the decedent's legatee are irrelevant, the remaining stockholders in the corporation are in no

sense hypothetical.⁴

I agree . . . that basing value on assumptions concerning the identity of the parties or on findings about the intent of the parties as to how they will deal with their respective interests would be inappropriate. It is appropriate, however, to take into account all legal interests in a corporation, the stock of which is being valued, as those interests bear upon the practical likelihood and the effect on value, as of the time of the gift, of the future exercise of options legitimately available to the owners of various interests.⁵

There are essentially two approaches used to value an interest in a business entity. The first is the asset approach, and the second is the earnings approach.

Asset Approach

Asset approaches to valuation of a business interest are usually applicable when there is, or might be, a reasonable prospect of liquidation, or if liquidation could be forced by the subject interest. Holding companies are also often valued, at least in part, by use of an asset approach.

Asset approaches have a multitude of names but the most common include net asset approach, adjusted book value approach, discounted net asset valuation and liquidation approach.

The first step in utilizing an asset approach is to determine the value of the company's assets and liabilities. Although fair market value of the underlying assets and liabilities is the most common standard of value, when liquidation is imminent or is a strong probabil-

ity, then liquidation value is a more common standard. Once the value of the assets are determined, the value of the liabilities are subtracted to arrive at the "net asset value" or "adjusted book value".

The next step is to apply discounts. The most common discounts are for lack of control (a minority discount) and a discount for lack of marketability. In holding company valuations, one commonly used approach to determine a minority discount is the price to net asset value approach. This approach utilizes the discounts from net asset value that often occur with publicly traded and secondary market holding companies. This discount is alternatively referred to as a "holding company discount". These comparable holding companies' financial history, dividend history, asset quality and diversity, etc. are considered in arriving at a reasonable discount to be applied the subject interest. After this discount, another discount for "lack of marketability" is normally warranted. This will be discussed later.

Another adjustment that could be applicable is a "portfolio discount". This is utilized when the assets of the company are less desirable as a portfolio than the sum of the individual assets.

One unsettled issue in the asset approach is whether built-in capital gains taxes are a valid liability of the company. The courts have been split on this issue and the IRS is most often against it. However, after the repeal of the General Utilities by IRC Section 336, it would be difficult, if not impossible, for a shareholder to obtain the assets of a company without incurring this tax. Some authors have stated their opinions that capital gains taxes should be considered a liability.⁶ This issue di-

rectly relates to whether the asset approach assumes liquidation or a going concern.

Another issue is whether costs of liquidation should be considered a liability of the company. Most often these expenses are considered a liability if liquidation is likely. These costs may include sales commissions, legal fees, accounting fees, and any other fees or expenses that are not part of normal operations.

Earnings Approach

The earnings approach to valuing a business interest usually consists of converting an earnings stream into value by use of a capitalization rate, discount rate or market multiple.

The first step in the earnings approach is to develop an earnings stream to capitalize, or convert into value. Earnings can mean net income, pre-tax income, gross cash flow, net cash flow, revenues, or a number of other measures. The appropriate stream of earnings to capitalize is future earnings, not past earnings, as investors receive their return on investment from future earnings. If earnings are projected, it is often for a period of five years. However, since future earnings are often difficult to predict, historical earnings are often capitalized as a proxy for future earnings. Five years of earnings are normally considered, and can be averaged or weighted toward more recent years. However, judgment is always the key to what earnings figure is used, remembering that the earnings figure used should reasonably represent future earnings.

If historical earnings are capitalized, they must be "normalized" in order to accurately reflect future

earnings. Non-recurring items must be adjusted out of the earnings stream and, if a controlling interest is being valued, discretionary expenses must be adjusted as well. Discretionary expenses are ones that could be reduced at the discretion of the controlling shareholder without adversely affecting the company. The most common discretionary expense adjustment to historical earnings, for a controlling interest, is for owner's compensation that is higher than that which would be paid to a non-owner. Owners of closely-held businesses often compensate themselves at the highest level possible to avoid double taxation. This adjustment is not made when valuing a minority interest, as a minority interest does not have the power to alter compensation.

The next step is to capitalize the earnings into value. This can be done by discounting projected earnings to present value with a typical present value analysis, or by capitalizing normalized historical earnings by dividing by a capitalization rate, or by multiplying by a market multiple derived from comparable companies.

The theoretically correct calculation of the capitalization rate for historical earnings is the formula: $(\text{Discount Rate} - \text{Growth}) / (1 + \text{Growth})$.

The "discount rate" is essentially the required rate of return on the investment and the growth rate is the estimated long-term annual rate of growth. For example, if the required rate of return was 26% and long-term growth was estimated to be 5%, the capitalization rate would be 20%, after rounding $((.26 - .05) / (1 + .05))$.

If the normalized earnings were \$100,000 and the capitalization

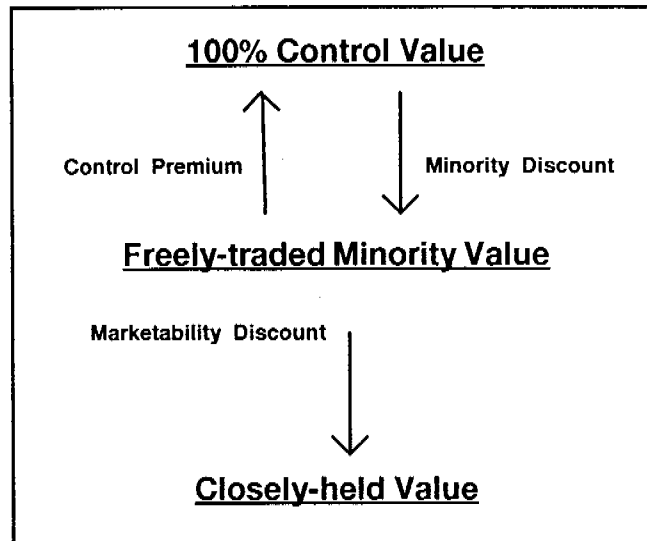
rate was 20%, the value would be \$500,000 ($\$100,000 / .20$).

The discount rate is normally determined by using benchmarks derived from public market data. Publications are available that present historical data on total rates of return of equity investments. In the alternative, discount rates can be calculated from information on publicly-traded companies in the same industry. For instance, a price to earnings (P/E) can be converted to a discount rate by taking its inverse and adding estimated growth. For example, a price to earnings ratio of 20 has an inverse of 5% (1/20). If estimated long-term growth is 15%, the discount rate is 20% (5% + 15%). The long-term growth rates of publicly-traded companies are published by various investment companies.

If the capitalization rates are derived from data of publicly-traded companies, more often than not they are reflective of a minority interest. Therefore, if the subject interest is a minority interest, no additional discount for a minority interest would be necessary. If the data was derived from mergers and acquisitions, which are normally of controlling interests, the capitalization rates are reflective of a controlling interest. If the subject interest is a minority interest, then an additional discount for a minority interest would be necessary.

Levels of Value

The following describes some of the discounts that are used in business valuations. However, one must have an understanding of the different levels of value. The following graphic shows the three major levels of value.



The 100% Control Value is the value as if the whole business was sold. The Freely-traded Minority Value is reflective of how most publicly-traded securities are priced. The Closely-held Value is the value of a relatively unmarketable minority interest in a private business.

Minority Discounts

Minority discounts are applied to take into account minority shareholders' lack of control over the subject business. Minority interest shareholders do not have any of the benefits of control, which include:

- (1) The ability to change the company's articles of incorporation or by-laws.
- (2) The ability to elect directors and, through the directors, appoint officers of the company and set their compensation.
- (3) The ability to liquidate, dissolve, merge, acquire, or distribute assets of the company.
- (4) The ability to recapitalize the company.
- (5) The ability to declare and pay dividends.
- (6) The ability to control the policies and direction of the company.

There is a long string of court cases that have allowed minority interest discounts in estate and gift tax situations, even when a family has complete control of the business. In 1993, the Internal Revenue Service essentially acquiesced when Revenue Ruling 93-12⁷ was issued. This ruling held that minority discounts will not be disallowed solely because the family has control of the business. However, the extent of the discount will still be subject to review.

The minority discount is not an "either or" issue. Any interest in a company that is less than 100 percent may require some discount. As the subject interest falls below various thresholds, the minority interest discount becomes greater. The minority discount increases when the percentage interest can no longer force liquidation. It increases even further when the interest doesn't have enough votes to control the board of directors, typically at 50%. The minority discount increases even further when the interest doesn't have the power to block certain actions of the business such as mergers and consolidations.

In certain situations the minority discount may be mitigated by a "swing block" factor. This is present when the subject block could be combined with another minority block to exercise control of the business. The actual intent, and financial ability, of the other interest holders should be examined with respect to whether or not a combination would be likely. For example, if two shareholders each had 40% of a company's stock, and one shareholder had 20%, the 20% interest could be worth more than a typical minority interest if one of the other shareholders would be willing and able to purchase the 20% interest to effectuate control. However, one should not blindly assume that any block that could be combined with another block to obtain control is a swing block. There must be a willingness and an ability of the other shareholder to purchase the subject stock. This is important in a family situation, where a family member shareholder often would not be willing to purchase a hypothetical shareholder's stock to make a "power play", especially when there is no evidence of disagreement among family members.

A benchmark for a minority interest discount can be estimated by examining tender offers to acquire control of companies, and using the control premium's mathematical equivalent to determine an appropriate minority discount. Tender offers to acquire control in companies are reported regularly in the financial press.

The formula used to convert a control premium to a minority discount is (control premium/(1 + control premium)).

According to Merrill Lynch's *1993 Mergerstat Review*, the average control premium paid in 1993 was 38.7%. This 38.7% control premium translates into a 27.9% minority discount (.387/1.387), or 28%, after rounding.

Using this and/or other benchmarks, business appraisers must assess what discount is reasonable for the subject business interest. Some of the factors considered are the historical and prospective financial performance of the business, the size of the interest, the size of other interests of the same business, the level of dividends or distributions, the risk level of the business, and most importantly, the attitude of the holder of the controlling interest with respect to minority interests. If the controlling interest holder is hostile toward the minority interest holder, the minority interest could be worth very little. On the other hand, if the controlling interest holder pays dividends or distributions, and treats minority interest holders well, the minority discount could be very low.

The business appraiser must assess all relevant factors associated with the business before deciding what minority discount is appropriate.

Lack of Marketability Discount

As stated earlier, an interest in a closely-held entity suffers from lack of marketability, or the ability to be readily converted to cash. For this reason, a lack of marketability discount is usually necessary when valuing a closely-held business.

This discount is articulated in *Central Trust Co.*⁸ as follows:

It seems clear, . . . that an unlisted closely held stock of a corporation such as Heekin, in which trading is infrequent and which therefore lacks marketability, is less attractive than a similar stock which is listed on an exchange and has ready access to the investing public.

Some of the factors in determining the extent of the "lack of marketability" discount are the historical and prospective financial condition of the subject entity, its distribution pay-out expectations, its level of risk, the control powers of the subject interest, and any restrictions upon transferability.

The methods used for determining a lack of marketability discount for a controlling interest are different than those used for a minority interest. There are generally two methods used to derive a lack of marketability discount for a controlling interest. The first involves estimating the cost of taking the company public, and, therefore, achieving liquidity. The second involves estimating the costs of selling the interest through an investment banker or business broker.

A lack of marketability discount for a minority interest is usually determined by using published

studies as benchmarks. These studies, generally, are either restricted stock studies or initial public offering studies. The earlier restricted stock studies demonstrated smaller discounts as the restrictions on the SEC Rule 144 letter stocks normally expired at some point. The more recent initial public offering studies are probably more accurate in that they used actual transactions of closely-held stocks versus the price of the same company's stock in an initial public offering. Since only the more desirable companies go public, these studies probably understate the discount for the average closely-held minority interest. On the following page is shown some of the average discounts from some of the studies.

Key Man Discount

In addition to minority and lack of marketability discounts, other discounts may be applicable. Due to the relatively small size of most closely-held companies, management is usually concentrated in one or a few individuals. This concentration causes additional risk, and is considered in the valuation process by a "key man" discount. According to a 1992 article,⁹ when a discount is warranted, the discount ranges from 0 to 30%. This range of discounts was quantified by analyzing the changes in the stock prices of public companies that lost their chief executive officer. Presumably, the discount for smaller closely-held companies, which typically have less back-up management, would be even higher. This discount can be mitigated, in varying degrees, by the existence of key man life insurance payable to the company, and by adequate successor management.

Chronological Studies

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|---------------------------|--|
| 1972 — Gelman Study | |
| 1973 — Moroney Study | |
| 1975 — H. Calvin Coolidge | |
| 1976 — J. Michael Maher | |
| 1977 — Standard Research | |
| 1985 — John D. Emory | |
| 1986 — John D. Emory | |
| 1989 — Willamette Study | |
| 1991 — Willamette Study | |
| 1993 — John D. Emory | |

Average Lack of Marketability Discount

| |
|-----------|
| 33% |
| 36.3% |
| 35% |
| 35% |
| 45% |
| 60% |
| 43% |
| 56.8% |
| 42% - 80% |
| 45% - 60% |

Blockage Discounts

Blockage discounts are often applied to the *publicly-traded* price of a stock when the subject block is so large that it could not be sold without a discount. When determining the size of the blockage discount, the business appraiser should examine historical trading volume, financial performance, prices, earnings, size of other blocks of stocks of the company, and past sales of large blocks of stock of the subject company. Sales of large blocks of comparable companies should also be examined.

The business appraiser should also examine other avenues for selling the block, including small sales over a period of time, a secondary offering and a private placement. Sometimes, if the block is large enough, it could be considered a swing block to another shareholder.

Common Mistakes

The following is a list of common mistakes that I have seen in reviewing other business appraiser's reports.

Use of Averages

Novice business appraisers will often use average discounts, aver-

age discount rates, average market multiples and average growth rates. Very seldom does a business deserve a valuation based on averages. An in-depth business valuation will use averages as benchmarks, but then deviate from them based on the unique facts surrounding the subject business.

Reliance on Past Performance

As stated earlier, past performance should only be a proxy for future earnings when it is reasonable. The prospects for future performance should be examined, and historical performance should be given weight only when it will likely reflect future performance.

Inappropriate Comparison to Public Companies

Although Revenue Ruling 59-60 suggests an examination of the prices of public companies, the differences between the public companies and the subject must be considered. Public companies tend to be stronger, more diverse, larger, and subject to less risk than a closely-held company. Also, I often see price to earnings ratios of high growth public companies used to value low growth closely-held companies, which is clearly erroneous.

Inappropriate Adjustments to Earnings

If a minority interest is being valued, it is usually inappropriate to make an adjustment for excess owner's compensation. A minority shareholder does not have the power to alter compensation, which is cash flowing out of the business to the minority interest's detriment. Likewise, any other adjustment that is out of the control of the minority shareholder would be inappropriate when valuing a minority interest.

Conclusion

In conclusion, if the fundamentals of business valuation are followed, and good common sense is utilized, a reasonable value for a business interest can be developed. The key to any business valuation is the risk and growth associated with the assets or earnings, for these two factors determine an investors ultimate return on investment.

The following page presents a list of typical information needed to perform a business valuation, along with topics of discussion in the management interview.

Information Needs

- Company brochures/catalogs
- Breakdown of last year's sales by product/service category
- List of customers/clients that exceeded 5% of last year's sales, with percentages
- Examples of advertising
- List of major trade associations in industry
- List of major competitors
- Description of facilities and equipment, with appraisals, if any
- Copies of leases of real estate and equipment
- Plans for future expansion and capital expenditures for next 5 years
- Budgets/projections for next 5 years
- List of officers and board members, with biographical information
- Total compensation of officer/owners for last 5 years
- Total number of employees with breakdown by type
- Summary of union contracts, if any
- Summary of insurance coverages, including key man insurance
- Summary of any contingent liabilities or assets such as lawsuits

- Copies of any major contracts
- Articles of incorporation and by-laws
- Shareholder agreements
- 5 years of annual financial statements and most recent interim statement
- 5 years of income tax returns
- Organization chart
- List of stockholders
- Summary of stock transactions in last 5 years

Topics of Discussion

- History of the Company
- Products/services
- Anticipated avenues for future growth
- Stability of customers/clients
- Advantages/disadvantages compared to competition
- Company's share of market
- Company's market niche
- Capacity of facility and current utilization
- Related party transactions
- Strength of management team
- Positive factors affecting Company
- Risk factors affecting Company

FOOTNOTES

¹ Messing, 48 T.C. 502 (1967).

² Revenue Ruling 59-60, 159-1 CB 237.

³ Est. of Andrews, 79 T.C. 938 (1982).

⁴ Est. of Bright, 658 F.2d 999 (1981).

⁵ Est. of Wallace, 82-1 USTC 84223.

⁶ See *Is a Discount for Built-in Capital Gain Tax Justified?*, Busi-

ness Valuation Review, June 1993, and a letter from a past ASA Chairman, Business Valuation Review, March 1991.

⁷ Revenue Ruling 93-12, 7 I.R.B. 1993.

⁸ Central Trust Co., 305 F.2d 393, 405 (Ct. Cl. 1962).

⁹ *Discount for Key Man Loss: A Quantitative Analysis*, Business Valuation Review, December 1992.

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