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Corporate Valuation and Estate Planning

A "Grievous" Valuation Error

Tax Court Protects Boundaries of Fair Market Value in *Grieve* Decision

All fair market determinations involve assumptions regarding how buyers and sellers would behave in a transaction involving the subject asset. **In a recent Tax Court case**, the IRS appraiser applied a novel valuation rationale predicated on transactions that would occur involving assets other than the subject interests being valued. In its ruling, the Court concluded that this approach transgressed the boundaries of what may be assumed in a valuation.

Background

At issue in *Grieve* was the fair market value of non-voting Class B interests in two family LLCs.

- The first, Rabbit, owned a portfolio of marketable securities having a net asset value of approximately $9 million.
- The second, Angus, owned a portfolio of cash, private equity investments, and promissory notes having a net asset value of approximately $32 million.

Both Rabbit and Angus were capitalized with Class A voting and Class B non-voting interests. The Class A voting interests comprised 0.2% of the total economic interest in each entity. The Class A voting interests were owned by the taxpayer's daughter, who exercised control over the investments and operations of the entities.

Valuation Conclusion – Taxpayer

The taxpayer measured the fair market value of the Class B non-voting interests using commonly accepted methods for family LLCs.

- The net asset value of each LLC was deemed to represent the value on a controlling interest basis.
- Since the subject Class B non-voting interests did not possess control over either entity, the net asset value was reduced by a minority interest discount. The taxpayer estimated the magnitude of the minority interest discount with reference to studies of minority shares in closed end funds.
- Unlike the minority shares in closed end funds, there was no active market for the Class B non-voting interests in Rabbit and Angus. As a result, the taxpayer applied a marketability discount to the marketable minority indication of value. The taxpayer estimated the marketability discount with reference to restricted stock studies.

The combined valuation discount applied to the Class B non-voting interests was on the order of 35% for both Rabbit and Angus, as shown in Exhibit 1 on the following page.

Valuation Conclusion – IRS

The IRS adopted a novel approach for determining the fair market value of the Class B non-voting interests.

Noting the disparity in economic interests between the Class A voting (0.2%) and Class B non-voting interests (99.8%), the IRS concluded that a hypothetical willing seller of the Class B non-voting interest would sell the subject interest only after having first acquired the Class A voting interest. Having done so, the owner of the class B non-voting interest could then sell both the Class A voting and Class B non-voting interests in a single transaction, presumably for net asset value.

If the dollar amount paid of the premium paid for the Class A voting interest is less than the aggregate valuation discount applicable to the Class B non-voting interest, the hypothesized series of transactions would yield more net proceeds

Exhibit 1: Taxpayer Appraisals

	Rabbit		Angus	
	Class A	Class B	Class A	Class B
Step #1 - Sell Class B Non-Voting Interests				
Net Asset Value (Control)	$18,206	$9,084,594	$63,941	$31,906,759
less: Minority Interest Discount		13.4%		12.7%
Marketable Minority Value		$7,871,692		$27,854,579
less: Marketability Discount		25.0%		25.0%
Nonmarketable Minority Value		$5,903,769		$20,890,934

Exhibit 2: IRS Appraisals

	Rabbit		Angus	
	Class A	Class B	Class A	Class B
Step #1 - Acquire Class A Voting Interests				
Net Asset Value (Control)	$18,134	$9,048,940	$63,941	$31,906,742
plus: Acquisition Premium for Class A	130,000		450,000	
Purchase Price - Class A Voting Interests	$148,134		$513,941	
Step #2 - Sell Class A Voting and Class B Non-Voting Interests				
Net Asset Value (Control)	$18,134	$9,048,940	$63,941	$31,906,742
less: Valuation Discounts	0.0%	0.0%	0.0%	0.0%
Sale Price - LLC Interests	$18,134	$9,048,940	$63,941	$31,906,742
Step #3 - Net Proceeds for Sale of Class B Non-Voting Interests				
Sale Price - LLC Interests	$18,134	$9,048,940	$63,941	$31,906,742
less: Acquisition Premium for Class A		(130,000)		(450,000)
Net Proceeds - Class B Non-Voting Interests		$8,918,940		$31,456,742
Conclusion of FMV - Class B Non-Voting Interests		$8,918,940		$31,456,742

than simply selling the Class B non-voting interest by itself. The sequence of transactions assumed in the IRS determination of fair market value is summarized in Exhibit 2 on page 2.

Tax Court Conclusion

It is certainly true that – if the Class A voting interests could, in fact, be acquired at the proposed prices – the sequence of transactions assumed by the IRS yield greater net proceeds for the owner of the subject Class B non-voting interests than a direct sale of those interests. However, is the assumed sequence of transactions proposed by the IRS consistent with fair market value?

The Tax Court concluded that the IRS valuation over-stepped the bounds of fair market value. The crux of the Court's reasoning is summarized in a single sentence from the opinion: "We are looking at the value of the Class B Units on the date of the gifts and not the value of the class B units on the basis of subsequent events that, while within the realm of possibilities, are not reasonably probable, nor the value of the class A units." Citing a 1934 Supreme Court decision (*Olson*), the Tax Court notes that "[e]lements affecting the value that depend upon events within the realm of possibility should not be considered if the events are not shown to be reasonably probable." In view of the fact that (1) the owner of the Class A voting interests expressly denied any willingness to sell the units, (2) the speculative nature of the assumed premiums associated with purchase of those interests, and (3) the absence of any peer review or caselaw support for the IRS valuation methodology, the Tax Court concluded that the sequence of transactions proposed by the IRS were not reasonably probable. As a result, the Tax Court rejected the IRS valuations.

The *Grieve* decision is a positive outcome for taxpayers. In addition to affirming the propriety of traditional valuation approaches for minority interests in family LLCs, the decision clarified the boundaries of fair market value, rejecting a novel valuation approach that assumes specific attributes of the subject interest of the valuation that do not, in fact, exist. As the Court concluded, fair market value is determined by considering the motivations of willing buyers and sellers of the subject asset, and not the willing buyers and sellers of other assets.

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Corporate Valuation and Estate Planning

Indiana Court of Appeals:

No Discounts in Unclear and Mandatory Shareholder Agreement Buyout

Excerpted from www.ChrisMercer.net Blog

Blake B. Hartman, Appellant – Plaintiff v. BigInch Fabricators & Construction Holding Company, Inc., Appellee-Defentant. This case is fresh off the press from the Court of Appeals of Indiana. *Hartman v. BigInch* is a case about a buy-out provision in a Shareholder Agreement that required BigInch ("the Company") purchase the shares of any officer or director who was involuntarily terminated.

Basic Facts of the Case

Mr. Hartman was involuntarily terminated as an officer and director of BigInch in March 2018. At the time of his termination, he owned 8,884 shares of the Company, which represented 17.7% of the outstanding shares. There were nine other shareholders, and no shareholder held control.

Pursuant to the Shareholder Agreement, the Company retained an appraisal firm to provide the appraisal required by the Agreement. Readers of my blog have heard me say (or write) that the "words on the pages" of buy-sell agreements are important. In this case, they proved to be critical to the matter on appeal.

The Shareholder Agreement provided for the "Valuation and Payment for the Shares," and the section was partially quoted by the Court of Appeals.

> "The price per Share for the Shares of the Corporation to be sold pursuant to Article III or Article IV of this Agreement shall be the **appraised market value** on the last day of the year preceding the valuation, determined in accordance with generally accepted accounting principles by a third party valuation company within the twenty-four months preceding the transfer of shares..." (emphasis added)

The Agreement is unclear on a number of things. However, there was apparently no disagreement about the valuation date or the financial statements to be used. The instructions called for a "third party valuation company," and a credentialed appraiser was retained. He provided an appraisal of the "fair market value" of the Shares owned by Hartman.

Appraisal Summary

The appraiser first determined what the Court of Appeals called the "market value" of the Shares (which I would refer to as the financial control value) and "then applied the open market concepts of minority and marketability discounts, as required by the concept of fair market value."

The appraisal summary can be found on the following page.

The 17.7% interest was appraised initially at an appraised market value (financial control value) of $3.53 million. A discount for lack of control and a discount for lack of market-

Appraisal Summary		Estimated Discounts	Appraisal
Hartman at Appraised Market Value			$3,526,060
Estimated Lack of Control		-10%	($352,606)
Estimated Marketable Minority			$3,173,454
Estimated DLOM		-24%	($775,454)
FMV - Nonmarketable Minority	$269.92		$2,398,000
Total Discounts	-32%		

ability were then applied, lowering the appraiser's conclusion of fair market value at the nonmarketable minority level of value to $2.40 million. I have estimated the discounts above because the actual discounts, which totaled 32% after application, were not provided in the opinion.

The Legal Setup

In September 2018, Hartman filed a petition for declaratory judgment seeking an opinion that the Company had improperly applied discounts to the mandatory sale of the Shares. The Company filed an Answer and Counterclaim for declaratory judgment. Following additional legal maneuvering on both sides, the trial court issued summary judgment in September 2019, concluding that the Company could discount the value of the Shares for lack of control and marketability.

Hartman then appealed and the cited opinion is the result.

Hartman contended that the trial court had improperly allowed for the application of lack of control and marketability discounts because these discounts should not be allowed in a forced sale as called for by the Shareholder Agreement. He further argued that the language in the Agreement, i.e., appraised market value, should not be equated with the willing buyer and willing seller concept of fair market value. The Company obviously argued otherwise.

The Court of Appeals cited precedent Indiana cases regarding statutory fair value and one involving divorce. To cut through the analysis, the Court of Appeals found that the fact that the Company had an obligation to purchase the Shares and therefore, an obligation to create a market for them, rendered the "open market" concepts of fair market value moot.

The Court of Appeals observed, citing the Wenzel case regarding statutory fair value:

> "[i]t would be incongruous to discount the shares of the minority shareholder for lack of liquidity when valuation is being done in connection with a proceeding that creates liquidity." When there is a "ready-made market" for shares through a mandatory purchase agreement, "[a]llowing a minority or non-marketability discount to be deducted from their value would indeed amount to a windfall to the [buyer] and its majority shareholders, which is precisely what the Wenzel court sought to avoid."

Wenzel was a case to determine statutory fair value, unlike the present shareholder buyout case. However, the "windfall" that the Court of Appeals recognized lies in the fact that if the Company were to purchase the Shares at a discounted value, they could then potentially sell them at an undiscounted value, therefore recognizing a windfall.

The Math Behind the Decision

Since the idea of a windfall is not obvious, we look at the underlying arithmetic of the repurchase of the Hartman

Repurchase at No Discount	Amounts	Shares	
Appraised Market Value - Implied	$19,921,243	$50,192	Total Shares
Transaction at Discount	($2,398,000)	(8,884)	Repurchased Shares
Remaining Value	$17,523,243	41,308	Remaining Shares
Controllers' Value Per Share	$424.21 / share		

Repurchase at Discount	Amounts	Shares	
Appraised Market Value - Implied	$19,921,243	$50,192	Total Shares
Transaction at No Discount	($3,526,060)	(8,884)	Repurchased Shares
Remaining Value	$16,395,183	41,308	Remaining Shares
Controllers' Value Per Share	$396.90 / share		

"Windfall" Analysis	
$ "Windfall" to Controllers	$1,128,060
Per Share "Windfall" to Controllers	$27.31 / share

Shares at a discounted price (i.e., their fair market value) and an undiscounted price (i.e., their appraised market value, or financial control value).

Based on the undiscounted appraisal at $3.53 million for 17.7%, we estimate the undiscounted value of BigInch to be $19.92 million ($3.53 million / 17.7%). If the Hartman Shares are purchased at their discounted price ($2.4 million), the remaining equity value after the repurchase is $17.52 million, or $424.21 per share for the remaining shares.

On the other hand, if the purchase is at the undiscounted price of $3.53 million, the remaining equity value after the repurchase is $16.40 million, or $396.90 per share. In other words, the remaining shareholders have exactly the same per share value both before and after the repurchase.

The windfall to which the Court of Appeals objected is the difference between the two remaining values for the remaining shareholders, or $1.13 million (or an extra $27.31 per share).

The Court of Appeals reversed the trial court judge and concluded that the Company could not use a discounted value as a substitute for its appraised market value.

The Rest of the Story

The Court of Appeals used statutory fair value precedent opinions to argue against discounting. But underlying the Court's analysis there is likely something like the following logic, in addition to the scholarly legal analysis.

When the Shareholders Agreement was signed years ago, there were ten minority shareholders.

The Hartman matter was the first exercise of the triggering clause regarding involuntary termination, which had to be agreed upon by the remaining shareholders.

The remaining shareholders, by offering a discounted value, stood to gain advantage to the disadvantage of the shareholder they had terminated and were forcing to sell.

The Shareholders Agreement was designed to create a market for the shares, so it makes little sense to discount for lack of control or liquidity.

Let's conclude that discounting is impermissible.

There is another aspect to this analysis. Given that ten minority shareholders agreed on the Agreement years ago, it is unlikely that they, individually or collectively, would have agreed on a discounted value for the Agreement. To do so would be to punish the first to have to sell at the benefit of the remaining owners. Had they discussed this fact, the likelihood they would have agreed on a discounted value is nil.

All of This Because

The BigInch Shareholders Agreement was a buy-sell agreement. The parties agreed to its terms in 2006, and it had not been revised since then. Had the parties put plain language in the Agreement regarding the desire that the appraised value would be discounted, or undiscounted, all this litigation could have been avoided.

The solution to problems like this lies in crystal clear language defining the kind of value that is desired for purpose of buy-sell agreements. Before now, such language has not existed.

That is changing shortly, when my new book, ***Buy-Sell Agreements: Valuation Handbook for Attorneys,*** will be published. The book, in addition to providing the best and most informative discussion of buy-sell agreements from business and valuation perspectives available, will have draft template language for four buy-sell agreement valuation processes.

Let me be clear — the book is written from business and valuation perspectives. I do not draft buy-sell agreements. But the experience reflected in this new book will help attorneys across the nation draft better valuation processes in buy-sell agreements, and will provide the basis for amending existing agreements to avoid problems like we see in *Hartman v. BigInch.*

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Corporate Valuation and Estate Planning

When Is It Too Late to Plan?

Takeaways from *Moore v. Commissioner*

Excerpted from Mercer Capital's *Family Business Director Blog*

If the senior generation of your family business has not yet crafted their estate tax plan, today is the best day to start. A new decision handed down from the Tax Court provides a timely reminder that the costs of procrastination can be very high.

The case ***Moore v. Commissioner*** addresses the estate of Howard Moore, who passed away in March 2005 at the age of 89.[1] Mr. Moore was a classic self-made man, building an approximately 1,000 acre farm in Arizona ("Moore Farms") which he sold for $16.5 million shortly before his death. As described in the opinion, Mr. Moore and his family were a rather colorful cast of characters.

The Plan

In a deft bit of foreshadowing, the introductory paragraphs of the Court's opinion described the genesis of Mr. Moore's ill-fated estate plan:

> "Howard Moore was born into rural poverty but over a long life built a thriving and very lucrative farm in Arizona. In September 2004 he began negotiating its sale, but his health went bad. He was released from the hospital and entered hospice care by the end of that year. Then he began to plan his estate."

One of the principal elements of the estate plan was the formation of the Howard V. Moore Family Limited Partnership ("the FLP"), to which Mr. Moore contributed an 80% interest in Moore Farms. The plan included a number of other moving parts that we will ignore for the sake of brevity.

The FLP included various restrictions on transfer. Through a living trust, Mr. Moore sold his ownership interest in the FLP to an irrevocable trust at a 53% discount to the pro rata net asset value of the FLP. Although the opinion does not directly say so, the discount was presumably a combined discount for lack of control and lack of marketability. Upon Mr. Moore's death, the tax return filed by the estate included the proceeds from the sale to the irrevocable trust among the estate's assets.

The Problems

In general, the Court was troubled by the timeline of events from late 2004 through Mr. Moore's death in March 2005.

- In September 2004, Mr. Moore began negotiating the sale of Moore Farms to its eventual acquirer.
- In December 2004, Mr. Moore suffered a serious health setback, resulting in his entering hospice care.
- Following the beginning of his hospice care, Mr. Moore retained an attorney to prepare an estate plan. Within a matter of days in late December 2004, Mr. Moore set up the FLP, a charitable foundation, and a series of trusts.
- Within a few days of contributing Moore Farms to the FLP, Mr. Moore executed a contract for the sale of the farm.
- The sale of Moore Farms closed on February 4, 2005.

The Court acknowledged that families often use partnerships such as the FLP. However, to be effective for estate planning, there needs to be evidence of a "legitimate and significant nontax reason for creation of the family limited partnership and the transfer of assets to it" (page 31). The Court rejected the estate's contention that the principal reason for the FLP "was to bring the Moore family together so that they could learn how to manage the business without [Mr. Moore]" (page 32).

- The Court concluded that the sale of Moore Farms – which was contemplated prior to the formation of the FLP and executed within days of the FLP's formation – undermined the estate's argument.

- Further, following the sale of Moore Farms, the members of the FLP never met to discuss management of the FLP's remaining assets.

- The estate also cited the need for creditor protection as a nontax motivation for the FLP, but at trial, none of the FLP members could identify either creditors or potential litigation threats.

- The Court found that Mr. Moore's health problems and the short time from the implementation of his estate plan to Mr. Moore's death undermined the purported nontax reasons for the FLP.

- The Court also concluded that the absence of any arm's length negotiations among the members of the FLP as to its principal terms or relative ownership allocation indicated that the FLP was, in substance, a testamentary instrument for Mr. Moore.

- Finally, following the transfer of Moore Farms to the FLP, Mr. Moore continued unilaterally to manage the operations of the farm and live on the farm until his death. The Court found that, even though Mr. Moore was not the general partner of the FLP, he continued to make all decisions regarding the FLP's operations. With respect to the FLP itself, Mr. Moore used FLP assets to pay personal expenses.

In short, the Court found that the FLP did not have any bona fide nontax purpose, and therefore, Mr. Moore's estate properly included the proceeds from the sale of Moore Farms prior to his death.

The Pain

In the case of the Moore estate, the valuation discounts applied to determine the fair market value of the interest in the FLP were ultimately irrelevant, and the Court does not address the value of the FLP interests transferred in its opinion. Instead, the Court found that the estate included the value of Moore Farms as if the FLP did not exist (and, essentially, as if the estate plan had never been made).

The moral of the story? By waiting too long, Mr. Moore's estate plan was ineffective, and the expenses of creating and executing the plan, which were not insubstantial, were wasted. With an earlier start to the planning process, it seems much more likely that the nontax purposes for the formation of the FLP could have been demonstrable and convincing. Had the Court found the FLP to be valid for estate purposes, the savings to Mr. Moore's heirs would have been substantial.

Conclusion

Proper estate planning is a priority for well-run multi-generation family businesses. Don't wait until it's too late to plan. **As we recently pointed out,** there's a good chance we will look back on the current period of depressed asset prices as a uniquely efficient opportunity to accomplish estate planning goals. We understand that may family businesses are facing very pressing and difficult challenges, but try not to let this opportunity pass you by.

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[1] We are not attorneys, and our summary of the case and the conclusions that follow are offered from a strictly lay perspective.

Industry Spotlight: Auto Dealerships

Complex Valuation Issues in Auto Dealer Litigation

Solving the Puzzle

Excerpted from Mercer Capital's *Auto Dealer Valuation Insights Blog*

Litigation engagements are generally very complex, consisting of many moving parts. The analogy that comes to mind is the nostalgic game of Tetris. While invented in 1984 by a Russian named Alexey Pajitnov, most of us remember the iconic version popularized through the Nintendo Gameboy in the 1990s. The game featured seven game pieces cascading down at increasing speed forcing the game player to manipulate them by rotating and placing them, trying to create a flat surface. As anyone that has played can attest, the game creates more anxiety and stress as the pieces cascade faster and begin to pile up.

Like the game, many clients involved in auto dealer valuation disputes also experience anxiety and stress as problems begin to pile up. When assisting these clients in our family law and commercial litigation practices, we strive to help alleviate the pain points, or "clear the blocks."

We hope you never find yourself a party to a legal dispute; however, we offer the following words of wisdom based upon our experience working in these valuation-related disputes.

The following topics, posed as questions, have been points of contention or common issues that have arisen in recent litigation engagements. We present them here so that if you are ever party to a dispute, you will be a more informed user of valuation and expert witness services.

We begin with seven questions to represent each of the original Tetris pieces, and we've added two questions to consider additional issues raised during the COVID-19 crisis.

Should Your Expert Witness Be a Valuation or an Industry Expert?

Oftentimes, the financial and business valuation portion of a litigation is referred to as a "battle of the experts" because you have at least two valuation experts – one for the plaintiff and one for the defendant. In the auto dealer world, you are hopefully combining valuation expertise with a highly-specialized industry.

It is critical to engage an expert who is both a valuation expert and an industry expert – one who holds valuation credentials and has deep valuation knowledge and also understands and employs accepted industry-specific valuation techniques. Look with caution upon valuation experts with minimal industry experience who utilize general valuation methodologies often reserved for other industries (for example, Discounted Cash Flow (DCF)[1] or multiples of Earnings Before Interest, Taxes and Depreciation (EBITDA)) with no discussion of Blue Sky multiples.

Does the Appraisal Discuss Local Economic Conditions and Competition Adequately?

The auto industry, like most industries, is dependent on the climate of the national economy. Additionally, auto dealers can be dependent or affected by conditions that are unique to their local economy. The type of franchise relative to the local demographics can also have a direct impact on the suc-

[1] DCF methodology might have to be considered in the early stages of a Company's lifecycle where the presence of historical financials either do not exist or are limited.

cess/profitability of a particular auto dealer. For example, a luxury or high-line franchise in a smaller or rural market would not be expected to fare as well as one in a market that has a larger and wealthier demographic.

In certain markets, an understanding of the local economy/industry is more important than an understanding of the overall auto dealer industry and national economy. Common examples are local markets that are home to a military base, oil & gas markets in Western Texas or natural gas in Pennsylvania, or fishing industries in coastal areas. There's also a balance between understanding and acknowledging the impact of that local economy without overstating it. Often some of the risks of the local economy are already reflected in the historical operating results of the dealership.

If There Are Governing Corporate Documents, What Do They Say About Value, and Should They Be Relied Upon?

Many of the corporate entities involved in litigation have sophisticated governance documents that include operating agreements, buy-sell agreements, and the like. These documents often contain provisions to value the stock or entity through the use of a formula or process. Whether or not these agreements are to be relied upon in whole or in part in a litigated matter is not always clear. In litigation, the focus will be placed on whether the value concluded from a governance document represents fair market value, fair value, or some other standard of value. However, the formulas contained in these agreements are not always specific to the industry and may not include accepted valuation methodology for auto dealers.

Two common questions that arise concerning these agreements are 1) has an indication of value ever been concluded using the governance document in the dealership's history (in other words, has the dealership been valued using the methodology set out in the document)?; and 2) have there been any transactions, buy-ins, or redemptions utilizing the values concluded in a governance document? These are important questions to consider when determining the appropriate weight to place on a value indication from a governance document. If they've never been used, and don't conform to accepted valuation methodologies for auto dealers, then how reliable can these be?

Additionally, some litigation matters (such as divorce) state that the non-business party to the litigation is not bound by the value indicated by the governance document since they were not a signed party to that particular agreement. It is always important to discuss this issue with your attorney.

Have There Been Prior Internal Transactions of Company Stock and at What Price?

Similar to governance documents, another possible data point(s) in valuing an automotive dealership are internal transactions. A good appraiser will always ask if there have been prior transactions of company stock and, if so, how many have occurred, when did they occur, and at what terms did they occur? There is no magic number, but as with most statistics, more transactions closer to the date of valuation can often be considered as better indicators of value than fewer transactions further from the date of valuation.

An important consideration is the motivation of the buyer and seller in these internal transactions. Motivations may not always be known, but it's important for the financial expert to try to obtain that information. If there have been multiple internal transactions, appraisers have to determine the appropriateness of which transactions to possibly include and which to possibly exclude in their determination of value. Without an understanding of the motivation of the parties and specific facts of the transactions, it becomes trickier to include some, but exclude others. The more logical conclusion would be to include all of the transactions or exclude all of the transactions with a stated explanation.

What Do the Owner's Personal Financial Statements Say and Are They Important?

Most owners of an auto dealership have to submit personal financial statements as part of the guarantee on the floor plan and other financing. The personal financial statement includes a listing of all of the dealer's assets and liabilities, typically including some value assigned to the value of the dealership. In litigated matters, the stated value by the dealer principal on their personal financial statement provides another data point to valuation.

One view of a personal financial statement is that no formal valuation process was used; so at best, it's a thumb in the air, blind estimate of value of the business. The opposing view would say the individual submitting the personal financial statement is attesting to the accuracy and reliability of the financial figures contained in a document under penalty of perjury. Further, some would say that the business owner is the most informed person regarding the business, its future growth opportunities, competition, and the impact of economic and industry factors on the business. While they are not business appraisers, they are instrumental to a valuation expert's understanding of risk and growth in their business.

It's never a good situation to be surprised by the existence of these documents. A good business appraiser will always ask for them. The value indicated in a personal financial statement should be viewed in the light of value indications under other methodologies and sources of information. At a minimum, personal financial statements may require the expert to ask more questions or use other factors, such as national and local economy to explain the difference and changes in values over time. If an expert opines the value is X, but the personal financial statements says 3X or 1/3X, an expert must be prepared to explain the difference.

Does the Appraiser Understand the Industry and How to Use Comparable Industry Profitability Data?

The auto dealer industry is highly specialized and unique and should not be compared to general retail or manufacturing industries. As such, any sole comparison to general industry profitability data should be avoided. If your appraiser solely uses the Annual Statement Studies provided by the Risk Management Association (RMA) as a source of comparison for the balance sheet and income statement of your dealership to the industry, this could be problematic. RMA's studies are organized by the North American Industry Classification System (NAICS). Typical new and used retail auto dealers would fall under NAICS #441110 or #441120. This general data may do the trick in certain industries, but most dealers sell both new and used vehicles. Further, RMA does not distinguish between different franchises.

The National Automobile Dealers Association (NADA) publishes monthly Dealership Financial Profiles broken down by Average Dealerships, which would be comparable to RMA data. However, NADA drills down further, segmenting the industry into the four following categories: domestic dealerships, import dealerships, luxury dealerships, and mass market dealerships.

While no single comparison is perfect, an appraiser should know to consult more specific industry profitability data when available.

Do You Understand Actual Profitability vs. Expected Profitability and Why Is It Important?

Either through an income or Blue Sky approach, auto dealers are typically valued based upon expected profitability rather than actual profitability of the business.

The difference between actual and expected profitability generally consists of normalization adjustments. Normalization adjustments are made for any unusual or non-recurring items that do not reflect normal business operations. During the due diligence interview with management, an appraiser should ask, "Does the dealership have non-recurring or personal expenses of the owner being paid by the business?" Comparing the dealership to industry profitability data as discussed earlier can help the appraiser understand the degree to which the dealership may be underperforming.

If a dealership has historically reported 2% earnings before taxes (EBT) and the NADA data suggests 5%, the financial expert must analyze why there is a difference between these two data points and determine if there are normalizing adjustments to be applied. Let's use some numbers to illustrate this point. For a dealership with revenue of $25 million, historical profitability at 2% would suggest EBT of $500,000. At 5%, expected EBT would be $1,250,000, or an increase of $750,000. In this case, the financial expert should analyze the financial statements and the dealership to determine if normalization adjustments are appropriate which, when made, will reflect a more realistic figure of the expected profitability of the dealership without non-recurring or personal owner expenses. This is important because, hypothetically, a new owner could optimize the business and eliminate some of these expenses; therefore, even dealerships with a history of negative or lower earnings can receive higher Blue Sky multiples because a buyer believes they can improve the performance of the dealership. However, as noted earlier, the dealership may be affected by the local economy and other issues that cannot be fixed so the lower historical EBT may be justified.

For more information on normalizing adjustments, see our article, **Automobile Dealership Valuation 101.**

What Is the Date of Valuation and Why Does It Matter?

Depending on the state, family law matters might require the date of valuation to be the date of filing, the date of separation, the date of the trial (current), or some other date. Commercial litigation can require the date of valuation to be the date of a certain event, the date of trial (current), or some other date. Why does the date matter? In addition to the standard of value (generally fair market value or fair value), a business valuation contemplates a premise of value – often a going-concern business. The business appraiser must use the relevant known and knowable facts at the date of valuation to incorporate into a valuation conclusion. These facts reflected in historical financial performance, anticipated future operations, and industry/economic conditions can differ depending on the proper date of valuation.

As we are all experiencing during COVID-19, the conditions of March/April 2020 are vastly different than year-end 2019. It would be incorrect, however, to consider the impact of COVID-19 for a valuation date prior to Spring 2020.

How Have Auto Dealer Valuations Been Affected by COVID-19?

Valuations of auto dealers involve many factors. We also try to avoid absolutes in valuation such as "always" and "never." The true answer to the question of how auto dealer valuations have been affected by COVID-19 is "it depends."

As a general benchmark, the overall performance of the stock market from the beginning of 2020 until now can serve as a barometer. Depending on the day, the stock market has declined anywhere between 20-30% during that time from previous highs. Specific indicators of each auto dealer, such as actual performance and the economic/industry conditions relative to their geographic footprint, also govern the impact of any potential change in valuation.

The litigation environment is already rife with doom and gloom expectations and we've previously written about the phenomenon referred to as **divorce recession in family law engagements.** While some auto dealers may go out of business as a result of COVID-19, the valuation of most may be deflated from prior indications of value, but generally, the conclusion is not zero. As always, it depends on the specific facts and circumstances of each particular auto dealer under examination.

Putting It All Together

As with all litigation engagements, the valuation of automobile dealerships can also be complex. A deep knowledge of the industry along with valuation expertise is the optimal combination for general valuation needs and certainly for valuation-related disputes. Understanding how these components fit together is important to a successful resolution, just like the assembly and combination of pieces in a game of Tetris. If you have a valuation issue, feel free to contact us to discuss it in confidence.

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Industry Spotlight: Professional Sports

Major League Sports Teams' Valuations

Beware of Averages and the DCF Method

In valuations of major league sports teams, specifically the NFL, NBA, MLB, or NHL, it is crucial to ensure the valuation expert correctly uses the measurement criteria currently applicable to each league. In years past, the discounted cash flow (DCF) method was acceptable to value an NFL team. For example, when Daniel Snyder bought the Washington Redskins in 1999, the DCF method was applicable to value the team. Today the DCF method is non-sensical, as non-profitable teams such as the Buffalo Bills sell for $1.4 billion.

In most industries, the DCF method or another form of the income method, is meaningful to value established manufacturing or service businesses.

Sports teams are unique. Teams are trophy assets, therefore the comparable company method applied with specific sports teams' adjustments, is the only method that approximates fair market value. Adjustments to the value are made for the location of the team, its franchise territory, stadium rights, future prospects for revenue growth, and in some cases profitability.

Case Study

In a past assignment, our client engaged us to review two other appraisals of large interests in a major league sports team located in a large city.

One appraisal used the DCF method, which valued the subject interests about 75% lower than our valuation estimate. We dismissed this appraisal as it was not reliable and informed our client that it lacked support in the marketplace. The second appraisal, which valued a similar sized interest in the same team using comparables, but from much smaller markets, taking large discounts for minority interest which were not justified by market transactions.

In our valuation process, we discarded all non-arm's length transactions between family members, and only included comparable transactions between independent third parties. In their critique of our valuation, an opposing valuation firm with a national reputation said we should have used the average of all the transactions, including the non-arm's length transactions between family members.

Our subject team was in one of the largest markets in the U.S. and had a very successful financial history. In our opinion, an average multiple would significantly undervalue the subject team.

Applying This Lesson to the NBA

We have attached a summary on the following page of all NBA teams with their associated 2020 *Forbes* estimate of enterprise value and revenue. We have also calculated each team's EV/Revenue multiple to demonstrate the wide range of value and multiples between the averages calculated, as well as the top-tier and bottom-tier teams. In our experience, this type of range is consistent across all major leagues.

As you can see from the *Forbes* NBA estimates the enterprise values in 2020 range from $1.3 billion for the Memphis Grizzlies, to $4.6 billion for the New York Knicks, and annual revenues range from $224 million for the Grizzlies to $472 million for the Knicks. Not surprisingly, the larger markets generate much higher revenues than the smaller markets. Also note that the valuation multiples have a broad range, with the Lakers estimate at a 10.1x revenue multiple, and the Grizzlies at a 5.8x revenue multiple. The average revenue multiple for the NBA is 7.0x. Therefore, if you were valuing the Lakers and applied a league average multiple to the team's revenue as an indication of value, the valuation could be understated by over 30%.

In summary, every valuation situation has its own facts and circumstances. Make sure your "expert" knows the industry and its unique valuation drivers, and does not simply apply averages because it will lead to answers that are far from reality.

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Team	2020 Enterprise Value ($mm)*	2020 Revenue Estimate ($mm)*	Implied EV / Revenue
Atlanta Hawks	$1,520	$251	6.1x
Boston Celtics	$3,100	$304	10.2x
Brooklyn Nets	$2,500	$304	8.2x
Charlotte Hornets	$1,500	$240	6.3x
Chicago Bulls	$3,200	$301	10.6x
Cleveland Cavaliers	$1,510	$300	5.0x
Dallas Mavericks	$2,400	$307	7.8x
Denver Nuggets	$1,600	$252	6.3x
Detroit Pistons	$1,450	$255	5.7x
Golden State Warriors	$4,300	$440	9.8x
Houston Rockets	$2,475	$348	7.1x
Indiana Pacers	$1,525	$243	6.3x
Los Angeles Clippers	$2,600	$282	9.2x
Los Angeles Lakers	$4,400	$434	10.1x
Memphis Grizzlies	$1,300	$224	5.8x
Miami Heat	$1,950	$294	6.6x
Milwaukee Bucks	$1,580	$283	5.6x
Minnesota Timberwolves	$1,375	$234	5.9x
New Orleans Pelicans	$1,350	$224	6.0x
New York Knicks	$4,600	$472	9.7x
Oklahoma City Thunder	$1,575	$258	6.1x
Orlando Magic	$1,430	$244	5.9x
Philadelphia 76ers	$2,000	$300	6.7x
Phoenix Suns	$1,625	$246	6.6x
Portland Trail Blazers	$1,850	$287	6.4x
Sacramento Kings	$1,775	$286	6.2x
San Antonio Spurs	$1,800	$285	6.3x
Toronto Raptors	$2,100	$334	6.3x
Utah Jazz	$1,550	$258	6.0x
Washington Wizards	$1,750	$269	6.5x
Average	**$2,123**	**$292**	**7.0x**

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