



MERCER CAPITAL

# The Art and Science of Business Valuations

A Guide for Attorneys and Advisors

Scott A. Womack

(615) 345-0234

womacks@mercercapital.com



BUSINESS VALUATION &  
FINANCIAL ADVISORY SERVICES

[WWW.MERCERCAPITAL.COM](http://WWW.MERCERCAPITAL.COM)

# Scott A. Womack, ASA, MAFF



## Scott A. Womack, ASA, MAFF

Senior Vice President

Mercer Capital

615.345.0234

womacks@mercercapital.com

[www.linkedin.com/in/scott-womack/](http://www.linkedin.com/in/scott-womack/)

Scott A. Womack, Senior Vice President, has over 20 years of experience in business valuation. During his valuation career, Scott has worked with clients in a wide variety of industries and for purposes including, gift and estate tax valuation, litigation support, corporate valuation, ESOPs, and financial reporting.

As part of his corporate litigation practice, Scott has deep experience in family law litigation (traditional litigated divorce and collaborative divorce). He assists family law attorneys in divorce matters including business valuation, forensic accounting, and division of the marital estate, among others. Scott has testified in several jurisdictions involving family law matters. Scott is a regular contributor to Mercer Capital's Family Law Valuation and Forensic Insights monthly newsletter.

Scott also assists estate planning attorneys throughout the nation in federal and state gift and estate tax valuation matters. In addition, he has testified in Tax Court.

While Scott has provided valuation services for clients in a wide variety of industries, he has significant experience in the auto dealership industry. As the leader of Mercer Capital's Auto Dealership Industry team, Scott provides valuation services to dealerships throughout the U.S. related to corporate planning and reorganization, transactions, employee stock ownership plans, litigation support, and tax issues as well as valuations of intangible assets, and assets subject to specific contractual restrictions. Scott and his team also consult with auto dealer clients in the process of selling or buying. Additionally, Scott publishes research related to the auto dealership industry and is a regular contributor to Mercer Capital's weekly blog, Auto Dealer Valuation Insights.

Other notable industry experience includes heavy equipment dealerships, healthcare, general & specialty contracting, construction, income-producing real estate, distribution, food services, hospitality, manufacturing, retail, technology, and transportation.

Scott is often a featured speaker for auto dealer industry groups, family law associations, attorneys, accountants, business appraisers, and business professionals on various valuation and financial advisory topics.

# Why Are Valuations Different?

Art vs. Science



# Business Valuation: Both Art and Science

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Those knowledgeable about valuation recognize that the field is as much art as science.

Business valuation is often described as part art and part science because many of the techniques used by business appraisers require the use of subjective assumptions.

The practice of valuation is an inexact art, not a precise science.

***Athlon Sports Communications, Inc. v. Duggan, 549 S.W.3d 107, 123 (Tenn. 2018)***

# What Is the Purpose of a Business Valuation?

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“

**To protect the  
integrity of the  
transaction or event**

# When & Why a Valuation is Needed?

## Valuation Triggers: 4 Basic Quadrants

(Generally) Not  
Regulatory  
Driven

### Litigation

- Buy/Sell Disputes
- Family Law
- Contract Disputes
- Business Torts
- Tax Disputes
- Dissenting Shareholder Disputes
- ESOP/ERISA Disputes
- Bankruptcy
- Economic Damages

### Transactional

- Sale of Business (Pricing / Negotiations)
- Buy/Sell Agreements
- Stock Exchange / Public Co. / IPO
- Installment Sale
- ESOP's
- Fairness Opinions
- Incentive / Corporate Planning

Regulatory  
Driven

### GAAP / Financial Reporting

- ASC 805 - Allocation of Purchase Price
- ASC 350 & 360 Impairment
- ASC 718 - Equity Based Compensation
- ASC 820 - Portfolio Valuation

### Tax

- Estate & Gift Taxes
- Charitable Gifting
- 409(a) Transactions
- IRC 367(d) "Toll Charge"
- Transfer Pricing
- IRC 197 – Allocation of Purchase Price
- Corporate Reorganizations & Basis Step Ups
- IRC 280G "Golden Parachute"



# What to Look for in a BV Expert

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1. Excellent reputation
2. A “professional witness?”
3. Ability to provide insights from business and valuation perspectives
4. Valuation experience and credentials
5. Publications and speaking background
6. Testimony experience (plaintiffs, defendants, or both)
7. Communications skills (need to explain complex financial issues in layman’s terms)
8. “Grace under pressure”
9. Does the expert have the time and support to handle the matter under consideration
10. Independence
11. Industry experience?

# Credentials/Licenses

## YES

ASA  
CVA  
ABV  
CFA

## MAYBE

CPA  
CFE  
Economist  
Professor  
Ph.D.

## NO

Business Broker  
CFP



# Assignment Definition

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Business Name	ABC Company
Business Interest Under Consideration	100%, XX%, or TBD Non-Controlling Interest
Standard of Value	Fair Market Value
Level of Value	Non-marketable, minority interest
Effective Date	December 31, 2020
Type of Engagement	Appraisal Report

# Ownership Interest Under Consideration

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- Confirm in planning phase
- Level of Value
- DLOC and DLOM
  - Confirm with state statutes or standard of value



# Standards of Value

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**Fair Market Value**

**Fair Value**

**Strategic/Investment Value**

# 8 factors of Revenue Ruling 59-60

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- 1 The nature of the business and the history of the enterprise from its inception
- 2 The economic outlook in general and the condition and outlook of the specific industry in particular
- 3 The book value of the stock and the financial condition of the business
- 4 The earning capacity of the company

# 8 factors of Revenue Ruling 59-60

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- 5 The Dividend-paying capacity
- 6 Whether or not the enterprise has goodwill or other intangible value
- 7 Sales of the stock and the size of the block to be valued
- 8 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

# Premise of Value

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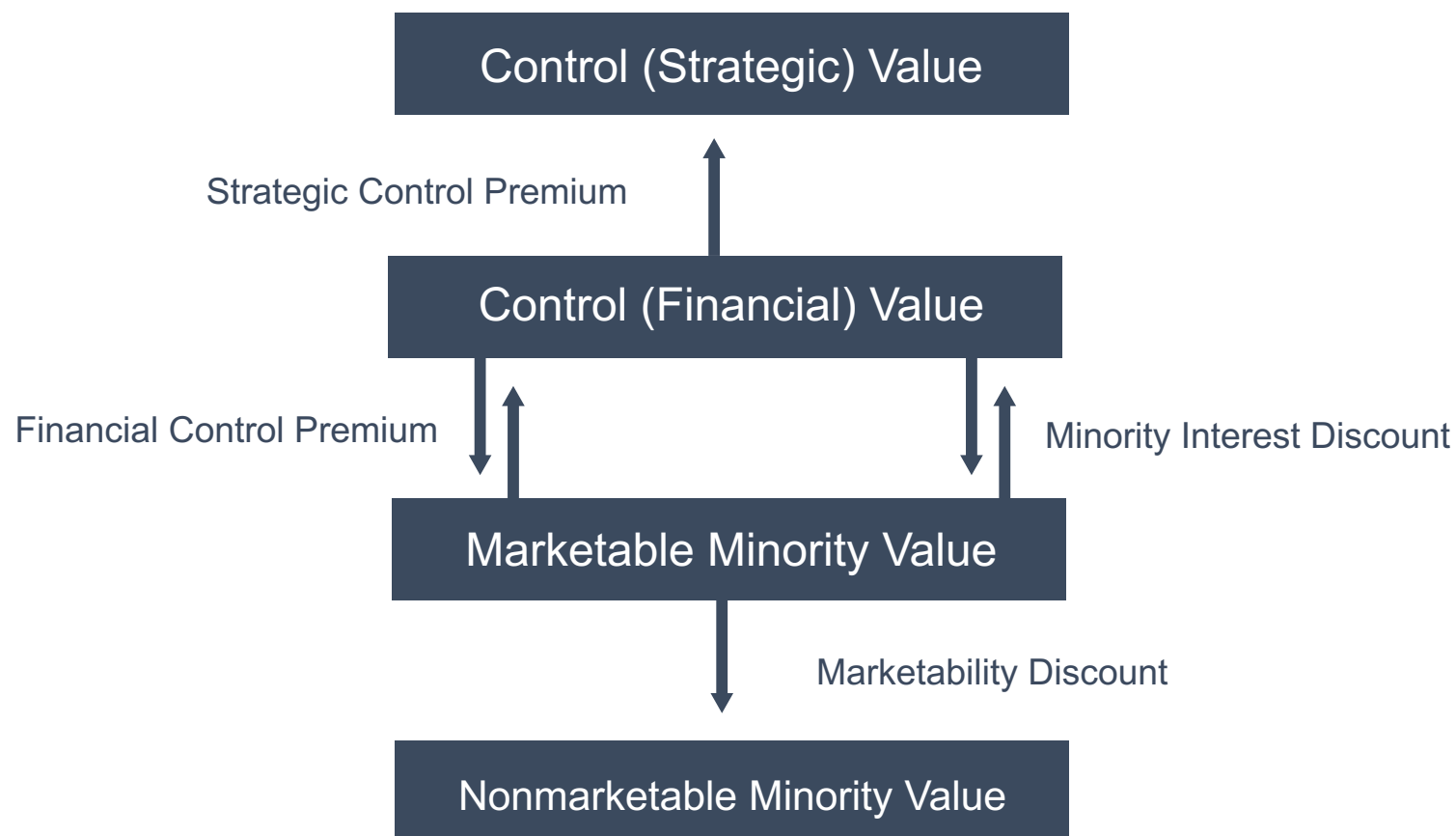
## Going Concern

Assumes the business will continue operations as an ongoing business enterprise

## Liquidation

Assumes the business will be sold either in an orderly or forced liquidation

# Levels of Value





# Date(s) of Valuation

## Why is this possibly ‘tricky?’

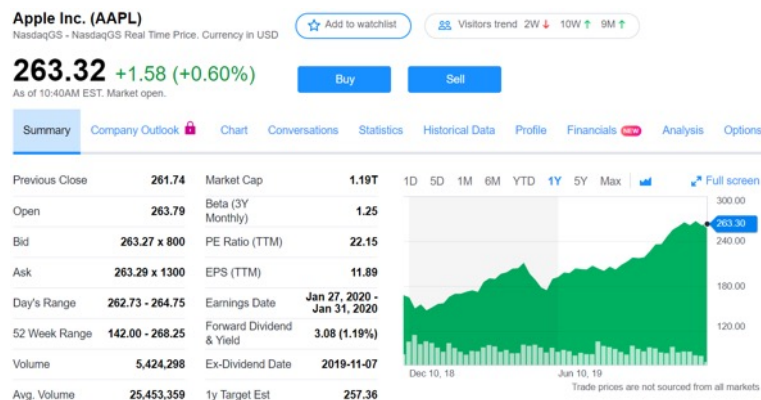
- Known or Knowable Concept
- Litigation Impacts
  - Marital/Separate
  - Current/Date of Trial
- Passing of time – lengthy processes
  - Report date > Trial/Event date
  - Update or new valuation necessary?



# Business Valuation

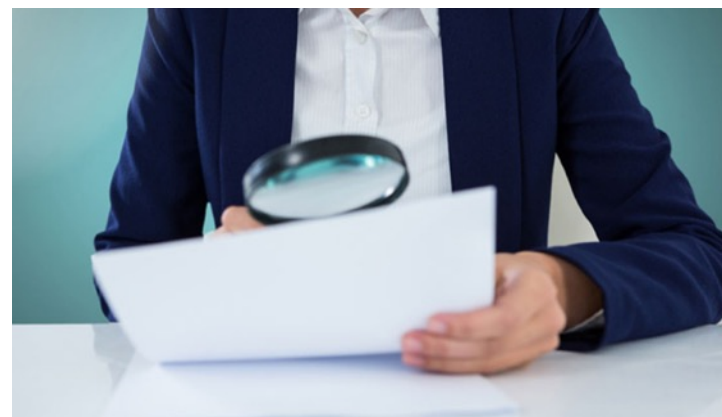
Business valuation is the process of determining the value indication of a business, business ownership interest, security, or intangible asset. The process is similar to the valuation of public interests, and the work product resembles a real estate appraisal.

## Public Company



Traded on an exchange like NYSE or NASDAQ;  
Price of shares readily available

## Private Company



There is no public market with frequent buyers and sellers;  
Hypothetical Buyer and Seller

# Valuation Approaches

Real Estate vs. Business/Company

# Valuation Approaches

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## Asset-Based Approach

Considers cost or market values of the Company's tangible assets and liabilities

## Income Approach

Utilizes expected future earnings, discounted back to present or a single capitalization of one or more earnings measures

## Market Approach

Utilizes pricing metrics from public companies, private company transactions, or transactions within the entity itself

# Asset-Based Approach

The fundamental accounting equation expresses the relationship between the company's assets, liabilities, and equity



## When May an Asset-Based Approach be Appropriate?

- Asset-intensive businesses
- Asset holding entities
- Recession/Economic Downturns

**Adjusted Book Value** : A method within the asset approach whereby all assets and liabilities (including off-balance sheet, intangible, and contingent) are adjusted to their fair market values. Common terms referring to this approach:

- Cost approach
- Replacement approach
- Liquidation value

Note: Further appraisals may be necessary – examples: property appraisal, equipment or inventory appraisal.

# Asset Approach

## STRENGTHS

1. Accounting formula that is easy to follow
2. Good indicator of value for a liquidating company or a Company in a declining industry
3. Can establish the minimum value of a company

## WEAKNESSES

1. Ignores a Company's earnings
2. Doesn't consider the intangible or goodwill value of a Company
3. May ignore the fair market value of some underlying assets

# Income Approach

\* There are **MULTIPLE** methods in this approach

*No matter the specific approach taken, an income approach is a general way of determining the value of a business by converting anticipated future economic benefits into a single present amount.*

## Single Period Capitalization Methods

Capitalization of Earnings Method

Capitalization of Cash Flow Method

## Multi-Period Capitalization Method

Discounted Cash Flow Method



# Theoretical Basis – Single Period Method

**The Gordon  
Growth Model**

$$\text{Value} = \frac{\text{CF}}{(r - g)}$$

**Value = Earnings x Multiple**

?



**Value increases when:**

- Cash flow increases;
- Growth increases; and
- Risk decreases

# Simple Example & Terms to Know

## Application of the Gordon Model Value Indication

Expected Cash Flow (CF)	\$1,000
Constant Growth Rate of CF (g)	10%
Discount Rate (r)	20%
Capitalization Rate (r-g) (20%-10%)	10%
Capitalization Factor/ Multiple (1/r-g) (1/10%)	10.0x
<b>Value = Earnings x Multiple (\$1,000 x 10.0x)</b>	<b>\$10,000</b>

# Valuation Adjustments in Valuations

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- **Importance of Adjustments**
- **Importance of Adjustments in Litigation**
  - Potential for altering the financial position of the business and/or compensation of divorcing party in anticipation of litigation
- **Specifically,**
  - Owner Compensation
    - How is the owner is paid over a period of time not just at the current day?
    - Possible pay-out arrangements?
  - Perquisites
    - Support marital/family lifestyle?
  - Non-Recurring Items: Litigation, Insurance, Hail/Tornadoes
  - Others, ex: rent expense if related-party entities

# Discount Rate Components

- Risk-Free Rate
- Equity Risk Premium
- Market Beta
- Size Premium
- Specific Company Risk

Derivation of Capitalization Factor		
Risk-Free Rate		2.15%
Equity Risk Premium	5.50%	
Guideline Beta	1.00	
Beta Adjusted Common Stock Premium		5.50%
Size Premium		5.22%
Specific Company Risk Premium		6.00%
Equity Discount Rate (Required Rate of Return)		18.87%
- Sustainable/Perpetual Growth Rate in Earning Power		-4.50%
Capitalization Rate		14.37%
Capitalization Factor		6.96
<b>Capitalization Factor</b>		<b><u>6.95</u></b>

# Specific Company Risk

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- Economic (National, Local, Regional)
- SWOT Analysis
- Management Depth
- Dependence on Key Man/Relationships
- Customer Concentration
- Supplier Constraints
- Competition
- Labor

# Income Approach

## STRENGTHS

1. Flexibility in valuing Companies at different stages in their life cycle
2. Reflects value of a Company based upon its earnings and growth potential

## WEAKNESSES

1. Reliance on Company/Management produced projections
2. Number of assumptions
3. Sensitivity and reliance on assumptions

# Change in “r”

## Derivation of Capitalization Factor

Risk-Free Rate	2.15%
Equity Risk Premium	5.50%
x Market Beta	1.00
Beta Adjusted Common Stock Premium	5.50%
Size Premium	5.22%
Specific Company Risk Premium	6.00%
Equity Discount Rate (Required Rate of Return)	18.87%
- Sustainable/Perpetual Growth Rate in Earning Power	-4.50%
Capitalization Rate	14.37%
Capitalization Factor	6.96
<b>Capitalization Factor</b>	<b>6.95</b>

## Determination of Value

Ongoing Earning Power	\$750,000
Capitalization Factor	6.95
Capitalized Earnings Value	\$5,212,500
<b>Indicated Value: Capitalization of Earnings Method</b>	<b>\$5,213,000</b>

## Derivation of Capitalization Factor

Risk-Free Rate	2.15%
Equity Risk Premium	5.50%
x Market Beta	1.00
Beta Adjusted Common Stock Premium	5.50%
Size Premium	5.22%
Specific Company Risk Premium	2.00%
Equity Discount Rate (Required Rate of Return)	14.87%
- Sustainable/Perpetual Growth Rate in Earning Power	-4.50%
Capitalization Rate	10.37%
Capitalization Factor	9.64
<b>Capitalization Factor</b>	<b>9.65</b>

## Determination of Value

Ongoing Earning Power	\$750,000
Capitalization Factor	9.65
Capitalized Earnings Value	\$7,237,500
<b>Indicated Value: Capitalization of Earnings Method</b>	<b>\$7,238,000</b>



# Change in “g”

## Derivation of Capitalization Factor

Risk-Free Rate	2.15%
Equity Risk Premium	5.50%
x Market Beta	1.00
Beta Adjusted Common Stock Premium	5.50%
Size Premium	5.22%
Specific Company Risk Premium	6.00%
Equity Discount Rate (Required Rate of Return)	18.87%
- Sustainable/Perpetual Growth Rate in Earning Power	-4.50%
Capitalization Rate	14.37%
Capitalization Factor	6.96

**Capitalization Factor** 6.95

## Determination of Value

Ongoing Earning Power	\$750,000
Capitalization Factor	6.95
Capitalized Earnings Value	\$5,212,500

**Indicated Value: Capitalization of Earnings Method** \$5,213,000

## Derivation of Capitalization Factor

Risk-Free Rate	2.15%
Equity Risk Premium	5.50%
x Market Beta	1.00
Beta Adjusted Common Stock Premium	5.50%
Size Premium	5.22%
Specific Company Risk Premium	6.00%
Equity Discount Rate (Required Rate of Return)	18.87%
- Sustainable/Perpetual Growth Rate in Earning Power	-2.00%
Capitalization Rate	16.87%
Capitalization Factor	5.93

**Capitalization Factor** 5.95

## Determination of Value

Ongoing Earning Power	\$750,000
Capitalization Factor	5.95
Capitalized Earnings Value	\$4,462,500

**Indicated Value: Capitalization of Earnings Method** \$4,463,000

# Change in “Earning Power”

## Derivation of Capitalization Factor

Risk-Free Rate	2.15%
Equity Risk Premium	5.50%
x Market Beta	1.00
Beta Adjusted Common Stock Premium	5.50%
Size Premium	5.22%
Specific Company Risk Premium	6.00%
Equity Discount Rate (Required Rate of Return)	18.87%
- Sustainable/Perpetual Growth Rate in Earning Power	-4.50%
Capitalization Rate	14.37%
Capitalization Factor	6.96

**Capitalization Factor** 6.95

## Determination of Value

Ongoing Earning Power	\$750,000
Capitalization Factor	6.95
Capitalized Earnings Value	\$5,212,500

**Indicated Value: Capitalization of Earnings Method** \$5,213,000

## Derivation of Capitalization Factor

Risk-Free Rate	2.15%
Equity Risk Premium	5.50%
x Market Beta	1.00
Beta Adjusted Common Stock Premium	5.50%
Size Premium	5.22%
Specific Company Risk Premium	6.00%
Equity Discount Rate (Required Rate of Return)	18.87%
- Sustainable/Perpetual Growth Rate in Earning Power	-4.50%
Capitalization Rate	14.37%
Capitalization Factor	6.96

**Capitalization Factor** 6.95

## Determination of Value

Ongoing Earning Power	\$500,000
Capitalization Factor	6.95
Capitalized Earnings Value	\$3,475,000

**Indicated Value: Capitalization of Earnings Method** \$3,475,000

# Market Approach

\* There are **MULTIPLE** methods in this approach

## Guideline Public Company Method

A method within the market approach whereby market multiples are derived from market prices of stocks of companies that are engaged in the same or similar lines of business, and that are actively traded on a free and open market.

## Guideline Company Transactions Method

Pricing multiples are derived from transactions of significant interests in companies engaged in the same or similar lines of business.

## Transactions Method

Develops an indication of value based upon consideration of actual transactions of the subject company.

# Market Approach

## STRENGTHS

1. Straightforward calculation
2. Value indications on various metrics – Revenue, EBITDA, Net Income, SDE, etc.
3. Value reflected in the market

## WEAKNESSES

1. Sources of data (private or internal transactions)
2. Comparability of market comparable to subject company
3. Sample size

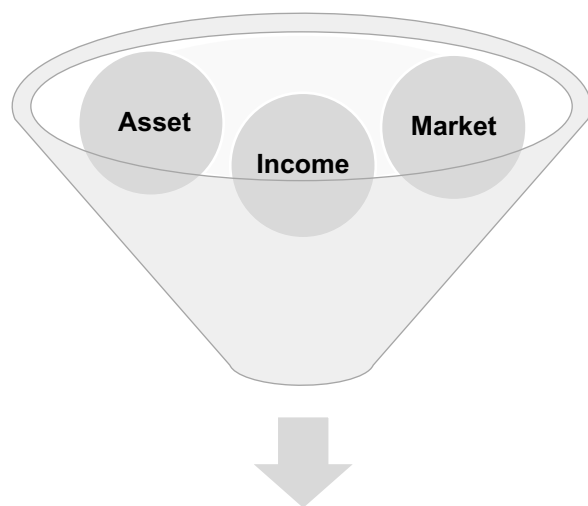
# Market Approach

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## WEAKNESSES

- 4. Time/Relevance of Transactions
- 5. Arm's length transaction vs. motivation of buyer/seller
- 6. Not as flexible on inputs

# Synthesis of Valuation Approaches



**Correlation / Synthesis**

A proper valuation will factor, to varying degrees, the indications of value developed utilizing the three approaches outlined.

A valuation is much more than the calculations that result in the final answer.

**It is the underlying analysis of a business and its unique characteristics that provide relevance and credibility to these calculations.**

# **What are some common flaws to look for in Valuation Reports?**



# Common Flaws

1. Not using acceptable methodology or ignoring relevant methodology
2. Using flawed projections
3. Too much precision in assumptions/conclusions – DLOM, Specific Company Adj.
4. Overreliance on Rules of Thumb
5. Blindly Using Comparable Transactions



# Common Flaws

6. Mismatching Discount Rates with Measures of Economic Income
7. Mismatching Interest-Bearing Debt with Measures of Economic Income
8. Not listing or relying on source documents
9. Inability to defend assumptions and link to source documents
10. Double counting/biased assumptions



# Double/Triple Counting Example

	1	2	3
	Judgmental Key Person Discount	Incremental Company Specific Risk	Lower Expected Cash Flows and Lower Growth
Long-Term Treasuries	1.80%	1.80%	1.80%
Equity Risk Premium	5.50%	5.50%	5.50%
Beta	1.25	1.25	1.25
Beta-Adjusted ERP	6.88%	6.88%	6.88%
Size Premium	5.50%	5.50%	5.50%
Company-Specific Risk	1.00%	1.00%	1.00%
Key-Person Risk Premium	0.00%	3.07%	0.00%
Equity Discount Rate	15.18%	18.24%	15.18%
Expected Long-Term Growth	-3.00%	-3.00%	
Expected Growth w/o Key Person			-2.50%
Equity Cap Rate	12.18%	15.24%	12.68%
Multiple (1 / Cap Rate)	8.20	6.56	7.89
Net Cash Flow to Equity	\$1,000,000	\$1,000,000	\$831,480
Expected Cash Flow w/o key Person			
Multiple (per above)	8.20	6.56	7.89
Initial Edquity Estimate	\$8,200,000	\$6,560,000	\$6,560,000
Key Person Discount	-20% (\$1,640,000)	\$0	\$0
Marketable Minority/Financial Control Value	\$6,560,000	\$6,560,000	\$6,560,000

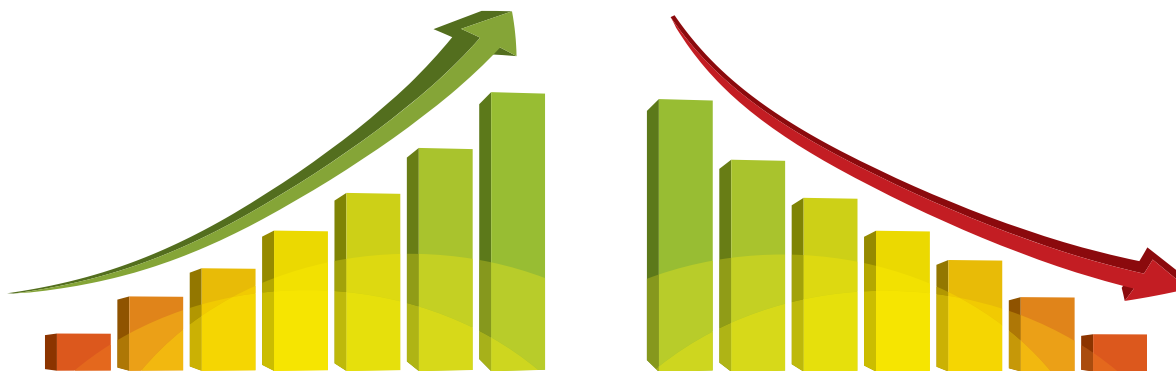
# Special Topics

# Covid Impact vs. Litigation Recession

- Covid winners vs. Covid losers
- Litigation/Divorce Recession
- Industry/Economic Factors

## WHAT is the goal?

To determine the ongoing, sustainable earnings or cash flow of the business



# Marketability Discounts

## Methodologies

### Empirical Studies

Restricted Stock Studies

Pre-IPO Studies

### Qualitative Analysis

Prospects for Liquidity, Events to Purchase/Sell Interest, Restrictions on Transfer, Pool of Potential Buyers, Risk or Volatility, Size and Timing of Distributions, Concentrations of Ownership

### Quantitative Models

Quantitative Marketability Discount Model (QMDM), Finnerty Model, etc.

# Price vs. Value

- “Value” and “Price” are often used interchangeably
- Much of what passes as valuation is really pricing

**Appraisers are often asked to estimate what someone else will pay for a business/asset right now – which is a pricing imperative**



# Value of an Asset

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**The value of an asset is based on its fundamentals.**

- Business – cash flow, growth, and risk
- Asset – condition, age and creator



# Price of an Asset

- Price of an asset is based on supply and demand – nothing more, nothing less
- Price can be affected by mood, momentum and even irrational forces
- The collection of these factors is what is referred to as Behavioral Economics

**Question: Are you appraising for a transaction (price) or a legal proceeding (value)?**



# Valuation Report Checklist

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Is there a signed certification or transmittal letter from the appraiser?



Is the Standard of Value stated and defined?



Are the Scope and Assignment of the subject property stated and defined?



Does the report state that is prepared in accordance with appropriate professional standards (USPAP, SSVS 1, AICPA, NACVA, etc.)



Does the report contain sections of the Company background indicating the appraiser has an understanding of the Company's history, operations and risk factors?

# Valuation Report Checklist

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Does the report contain a section indicating the appraiser's understanding of the industry and economic conditions?



Does the report contain a section analyzing the Company's historical operating performance?



Does the report include a benchmarking analysis?



Does the report consider all three approaches to value and give an explanation if one or more approaches was excluded or not relied upon?



Does the report give and provide support for the key assumptions including ongoing cash flow, normalization adjustments to earnings, growth, discount rate, etc.?

# Valuation Report Checklist

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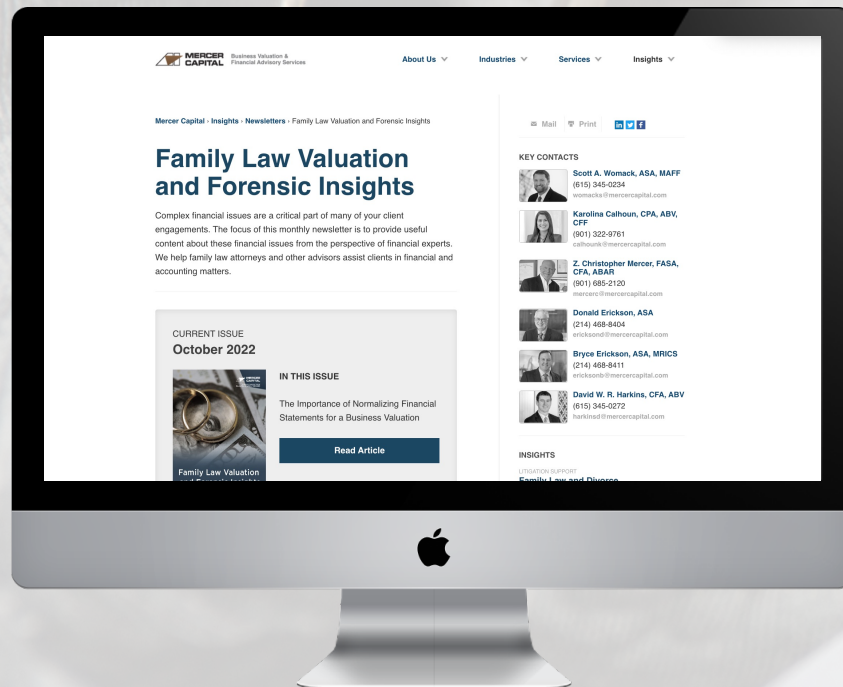
Are the value indications obtained from various methods reconciled and explained appropriately?



Does the final conclusion seem reasonable and supported?

MERCER CAPITAL'S MONTHLY NEWSLETTER

# Family Law Valuation and Forensic Insights



Complex financial issues are a critical part of many divorces. The focus of this monthly newsletter is to provide useful content about these financial issues from the perspective of financial experts.

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*We help family law attorneys and other advisors assist clients in financial and accounting matters.*

# Mercer Capital's Family Law Services

Mercer Capital is a national business valuation and financial advisory firm. We are frequently engaged to provide support in family law and divorce disputes. We bring a team of experienced and credentialed experts and over 35 years of experience to the field of valuations, forensic analysis, and litigation support. Assisting our clients through the entire dispute process, we provide initial consultation and analysis, as well as testimony and trial support. We provide services to litigated divorces, as well as collaborative/mediated divorces.

## Valuation Services

- Valuations of Businesses, Interests in Business Professional Practices, and Sports Teams
- Valuations of Intellectual Property, Tradename, and Other Intangible Assets
- Valuations and Determination of Personal vs. Enterprise Goodwill and Active vs. Passive Appreciation
- Valuations of Stock Options, Restricted Stock, Pensions, Notes, and Other Investment Assets
- Valuations of Compensation Agreements
- Business Damages
- Lost Profits Analysis
- Assist with Depositions, Mediations and Trial Preparation
- Expert Testimony

## Forensic Services

- Assistance with Financial Affidavits
- Equitable Distribution Analysis
- Lifestyle Analysis / Pay and Need Analysis
- Income Determination
- Alimony Scenario Analyses
- Classification of Assets and Liabilities
- Tracing Services
- Dissipation Analysis
- Business Disruption Analysis
- Damages Analysis
- Lost Profits Analysis
- Assist with Depositions, Mediations and Trial Preparation
- Expert Testimony

## Advisory Services

- Expert Witness Testimony
- Serving in Arbitration as Court-Appointed and/or Mutually Agreed-Upon Experts
- Serving as the Financial Neutral in a Collaborative Divorce
- Assistance with Discovery
- Critique of Opposing Expert Reports
- Impact of Transactions on Valuation
- Economic Research
- Public Securities, Market, and Industry Research
- Assistance with Depositions and Cross-Examination
- Preparation of Demonstrative Exhibits for Trial
- Other Consulting Services

# Mercer Capital's Core Services

Mercer Capital is a national business valuation and financial advisory firm

## Valuation & Financial Opinions

- Litigation-Related Expert Witness Opinions
- Succession & Shareholder Planning
- Valuations for Corporate Tax Planning
- Valuations for Gift & Estate Tax Planning
- Fairness Opinions
- ESOP & ERISA Advisory Services
- Bankruptcy-Related Valuation Services
- Valuations for Buy-Sell Agreements

## Transaction Advisory Services

- M&A and Investment Banking Services
- Bankruptcy/Restructuring Advisory
- Fairness Opinions
- Solvency Opinions
- Quality of Earnings

## Litigation Support Services

- Business Damages & Lost Profits
- Corporate Restructuring & Dissolution
- Statutory Fair Value
- Valuation, Labor & Contract Disputes
- Family Law & Divorce
- Tax-Related Controversies
- Initial Consultation & Analysis
- Testimony & Trial Support

## Family Business Advisory Services

- Customized Board Advisory Services
- Management Consulting
- Independent Valuation Opinions
- Transaction Advisory Services
- Confidential Shareholder Surveys
- Benchmarking/Business Intelligence
- Shareholder Engagement
- Shareholder Communication Support

## Financial Reporting Valuation Services

- Purchase Price Allocation Services
- Impairment Testing Services
- Portfolio Valuation Services
- Equity-Based Compensation Valuation





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