MERCER CAPITAL
Business Valuation & Financial Advisory Services

IN THIS ISSUE

Value Matters™

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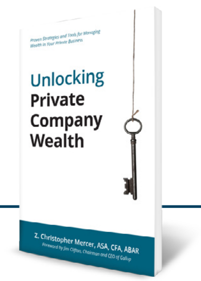
25 Questions for Business Owners

Perspective from Mercer Capital's publication *Unlocking Private Company Wealth*



The following is a list of 25 questions to think about in assessing whether you as an owner are treating your business as an investment. If you are a business adviser, you can ask the questions on your clients' behalf or, better still, in meetings with them.

1. **How much is your closely held or family business worth?**

   How much is your interest in the business worth if you own less than all of its shares (or other interests)? Having asked the question, the truth is that what you think doesn't matter. All that matters is: 1) what a buyer of capacity thinks if and when you are ready to sell your business; or, 2) what a qualified valuation professional thinks in the interim and will express in a valuation report for an ESOP, a buy-sell agreement, a gifting plan, for the estate of an owner, or whenever independent corroboration is needed for interim transactions.

2. **How do you know what your business is worth? Has it been independently valued in the last three years?**

   I recommend that every successful closely held and family business have an appraisal each year, or at least every other year. If you do this, you will have the best information available about the value for your private company.

3. **What portion of your personal net worth is represented by your business ownership interest?**

   If you will just make a calculation with whatever estimate you have of your company's worth in relationship to your other assets, you will likely be surprised at how concentrated your wealth is. Investment concentration is a red flag for investment advisors; it should be a concern for every business owner.

4. **What has been your shareholders' rate of return on their investment over the last one, two, three, four, or five years or more?**

   Return on investment (ROI) is not something that many private business owners talk about. Simply, an investment in a business provides returns in two forms, interim distributions (after taxes) and capital gains, or the appreciation in the value of the investment each year and over time. And don't forget, above-market owner compensation and other expensive perquisites are part of your return on investment.

5. **How does this rate of return performance compare with alternative investments, e.g., in the public securities markets?**

   You almost certainly know how your professionally managed liquid funds are performing. After all, you get a report from your manager at least quarterly, and perhaps more frequently. Have you ever compared your return on your business with that of your liquid wealth? You might be surprised, either pleasantly or not, if you have the information.

6. **Is your wealth adequately diversified to avoid the risk of major losses from adverse events with any of your assets, including your business?**

   Rephrasing the question, if your business suffered a major loss of value, do you have sufficient assets outside the business to sustain a reasonable lifestyle? For many business owners, the answer is no. And for owners who build lifestyles based on their returns to labor (salary and benefits) and the economic distributions of their businesses, the answer is likely no.

7. **Do you know how to increase your company's value over time?**

   You have been successful so far. Do you know and are you working on things to increase the value of your business over time? Even with large, highly successful businesses, significant enhancements in valuation can occur through efforts to reduce risk, to facilitate cash flow growth, and to use the balance sheet in a prudent manner.

8. **Are you working your way out of being a key person in your business?**

   What would happen if you went to the beach and didn't come back? Have you designated someone to run the business in your absence or if you are unavailable?

9. **How much money will you need to live the lifestyle you desire when you are no longer working and receiving a salary?**

   Pull out the calculator or have your financial adviser do it for you. What income will be required to support you when you are not working in the business? That's pretty easy to figure, probably based on your current lifestyle. How many dollars do you need invested at 4%, 5% or 6% such that you can generate that income from passive assets? Do you have other sources of income? These are important questions and they deserve your attention.

10. **Does your business make economic distributions (in excess of those necessary to pay taxes)?**

    If your business is profitable and achieves a reasonable return on equity and is not growing very fast, then you should be able to make economic distributions, or distributions after paying income taxes (assuming you have a pass-through entity). These economic distributions become an ongoing source for accumulating wealth outside your business.

11. **If you are not making economic distributions, is the return on your reinvestment of earnings into fixed assets or working capital or technology or whatever sufficient to warrant the investments?**

    If you have to reinvest all of the company's earnings and you are not growing steadily, something may be wrong and you are likely not achieving a reasonable return on your investment in the business.

12. **Are you reinvesting distributions in diversified assets as part of a plan to diversify your wealth? If not, why not?**

    This point follows up on the previous question about distributions. It can be a mistake to believe that distributions are a part of your earned income and fully available to support lifestyle. Your business provides you with three forms of return if you work there. First, you receive your salary, normal bonus and benefits. This is the return on your labor. Any distribution in excess of that, even if it comes in the form of additional bonus, is the income return from your investment in the business. The final form of return is the appreciation in the value of your investment from year to year. Too often, owners in even substantial businesses do not make this important distinction between returns to labor and returns on investment.

13. **What is the plan to obtain liquidity from your ownership of your business?**

    If your plan is to wait until some indefinite time in the future when you hope to sell the business, that may not be a plan but a wish. Begin to think about plans to generate liquid assets from your business. The interim, i.e., the time between now and that indefinite time when you wish to sell, can offer lots of surprises and lots of benefits.

14. **What is the plan for the other shareholders, if any, to obtain liquidity from their investments?**

    Many successful closely held and family businesses have multiple shareholders, often with owners in different generations. This is true whether the owners are all in one family or not. Assume you are in charge with a significant stake. The emphasis we place on distributions holds true here. Minority owners not working in the business do not receive a return on labor from the business. But they are entitled to distributions or opportunities for liquidity at appropriate times. Share repurchases along the way can provide significant return enhancements for longer-term owners. But you have to realize that the other owners are, well, owners, and are entitled to their returns on investment just like you.

15. **Are the plans for liquidity realistic and documented?**

    Do your other owners know about your plans? Does your family know about your plans? The Law of Unintended Consequences deals harshly with the unprepared.

16. **Is your business "ready for sale" whether or not you have any interest in selling today?**

    When we talk about having a business "ready for sale," we do not talk about necessarily preparing for an actual sale. Most business sales occur rather unexpectedly. So if you might sell your business unexpectedly this year, next year, or the next year, why not keep it in a position of readiness for sale? A business that is ready for sale has decent margins, is growing, lacks large customer or other concentration risks, and is focused on management and ownership transitions. Why not be "ready for sale" all the time. We guarantee that a business in that ongoing state is a lot more fun and profitable to run than otherwise.

17. **Are there things you know that need to be done and that take time to begin to get the business in a position to be "ready for sale"?**

This question could cause you to think about obvious concentrations in your business. If you have an overhang of stale inventory, get rid of it now so there will be no question later. If you need to train and appoint a successor CEO, then be in the process of doing so. It is so much easier to work on these and other issues on your own time. It is almost impossible when you are attempting to sell, and they will drag down value and proceeds.

18. **What are the plans to transfer ownership and/or management to other members of your family or to others not in your family or in the family of a co-owner?**

    Is there a plan for management transition? Is there a plan for ownership transition? Are these plans documented and do the right people know about them?

19. **Are the ownership and management transition plans realistic? Do those you are thinking about know about and agree with your plans?**

    You know what your stock ownership is currently. What do you and other key owners think that the ownership distribution should be in one year, two years, or five years. It won't change by chance. Regarding management transitions, it is far better to move them along sooner rather than later in most instances. The longer your business is highly dependent on you or you and a partner or two, the harder it will be to change as time progresses.

20. **Does your company have a buy-sell agreement? If so, how do you know that it will work if or when it is triggered?**

    If the buy-sell agreement has a fixed price, is it realistic and current? How do you know? If the plan depends on a formula to price agreement transactions, is the formula realistic in current market and financing conditions? Has anyone calculated it recently? What are the provisions for adjusting the formula for known issues like non-recurring costs or income items? If the plan calls for multiple appraisers, do you know what will happen when it is triggered? Most buy-sell agreements are ticking time bombs and will likely not provide reasonable resolutions. Our suggestion to the owners of successful closely held and family businesses is that they revise their buy-sell agreements such that they agree to the following. Select a single appraiser now. Have that appraiser provide a draft appraisal now. All parties review the draft now to be sure that the appraiser has interpreted the valuation language in the buy-sell agreement the way the owners are thinking, and then finalize the valuation. This becomes the price for the agreement until the next reappraisal, which establishes a new price. And so on. We recommend this because it works. It avoids confusion, litigation and angst when trigger events occur. It provides certainty as to the process.

21. **If there is life insurance associated with a buy-sell agreement, are the instructions within the buy-sell agreement and in any related documents clear as to how any proceeds of life insurance proceeds will be treated for valuation purposes?**

    Life insurance can be considered strictly as a funding vehicle. If so, the insurance proceeds are not considered part of company value and are used to acquire the stock of a deceased owner. Life insurance proceeds can also be considered to be a corporate asset. Under this treatment, the proceeds are added to value dollar-for-dollar before the per share price for the estate is determined. The choice of treatments can make a substantial difference in results for a selling shareholder, the company and the remaining shareholders. If there is life insurance associated with your agreement, be sure that the agreement specifies its use in unambiguous terms. If the treatment is ambiguous or not present in the agreement, there will almost certainly be disagreement between the estate and the company and other owners. It is easier to agree when all the parties are in the here and now. It is virtually impossible to agree when one of the parties is in the hereafter.

22. **Is your will current and does it reflect your current intentions for what happens in the event of your death?**

    I am not an estate planner, but this is a basic issue. The time of one's death is tough on the family. It is sad to compound their grief and angst with a will that does not represent your current desires or promises to your family. Not to mention, the state of your will and planning can have an enormous impact on your estate's tax liability.

23. **Do you know what you want to do the day after you sell the business or retire?**

    This is a bigger question than you might imagine. Many baby boomers will defer retirement or full retirement for a number of years. However, when owners sell, the likelihood of their being on for very long after the sale seems to be fairly low. Once your out, what will you do? Will you want to work for one or more nonprofits? Get attached now, while you are active and attractive. Want to do something for your church? Work with the pastor or administrator to get it defined before you are ready and you can work into it. Want to do something fun in a non-competing business? You might want to get something started now. Whatever it is you want to do, it is best to be thinking now about it and positioning yourself so that you can walk into that next phase of your life. If not you may find yourself bored and unemployed. That's not healthy.

24. **Who are your trusted advisers who are assisting you with your will, your gift and estate tax planning, your succession planning, retirement planning, your buy-sell agreement, and so on?**

    Do you have a team? Is there a quarterback for the team? Does your family know the team? Are you working with them on an ongoing basis to assure that your management and ownership transitions will go smoothly and that your estate tax planning and "life after work" plans are well underway? If not, it is probably time to get started.

25. **Are you comfortable with the state of your planning for your future and the future of your family? Or are you vaguely or specifically uncomfortable with the state of your affairs?**

    If you are vaguely or specifically uncomfortable, now is the time to take action. If you are comfortable, chances are that you are already working with a professional team – either that or you are oblivious to the issues or hoping they don't apply to you! They do.

The 26th question is a bonus:

How can anyone answer the first 25 questions or get others to help answer them? The answer lies in making one simple decision – treat your investments in closely held businesses as the important investments they are.

You will run your business. That is a fact. The question is whether you manage the private company wealth you are creating, or can potentially create, with the same concern and respect that you manage your liquid wealth?

The answer to this question will determine, in large measure, how much liquid wealth you and your fellow owners will ultimately have. Start the process of managing your private company wealth today.

Mercer Capital can assist you or your clients when thinking about ownership or management transition. Give us a call to discuss your situation in confidence.

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Valuation Discounts and Premiums in ESOP Valuation

Originally published as part of Appraisal Review Practice Aid for ESOP Trustees.

There is a protracted and clouded legacy of information and dogma surrounding the universe of discounts and premiums in business valuation. It seems logical enough that as elements of business valuation, the underlying quantification and development of discounts and premiums should be financial in basis, just as other valuation methods are founded on financial principles. Much of the original doctrine surrounding the determination of discounts and premiums was based on reference to varying default information sources, whose purveyors continue the ongoing compilation of transaction evidence (public company merger and acquisition activity, restricted stock transactions, pre-IPO studies, etc.). After begrudging bouts of evolution, there has been maturation toward more disciplined and methodical support for valuation discounts and premiums. Perhaps as the state of the profession concerning discounts and premiums has progressed, so, too, has the divide in skill and knowledge among valuation practitioners become wider. Certainly this seems to be the case regarding many users and reviewers of appraisal work (ostensibly the legal community, the DOL and the IRS).

There remains ample debate concerning numerous issues in the discount and premium domain. Unfortunately, in the quest for better clarification on the determination of discounts and premiums there has developed an arms' race of sorts. Despite the emergence of compelling tools and perspectives, no method or approach appears to have the preponderance of support in the financial valuation community. Nowhere is this truer than with the marketability discount (also known as discount for lack of marketability or DLOM). ***Within the ESOP community much of the confusion over DLOMs is mitigated due to the presence of put options designed to ensure reasonable liquidity for ESOP participants.*** However, ***in the ESOP community a legacy of concern over control premiums has now become an acute issue*** as stakeholders and fiduciaries have increasing concerns regarding flawed valuations and prohibited transactions.

The Levels of Value

Regarding the concept of control premiums and minority interest discounts (also known as "lack of control discounts"), there is less conflict and more uniformity on how and when these discounts are used in a business appraisal. That is not to say that differences among appraisers don't exist regarding certain issues. For purposes of establishing a platform to converse on valuation discounts and premiums, let us use the conventional levels of value framework to anchor the discussion. Figure 1 provides structure about where the traditional valuation discounts and premiums are applied in the continuum of value.

The integration of the basic income equation of value into the levels value chart results in the equations and relationships shown in Figure 2. It is here that we can begin to understand that ***valuation discounts and premiums are not a device in and of themselves. Each is the product*** (consequence) ***of the relationships among and between the underlying modeling elements that constitute financial***

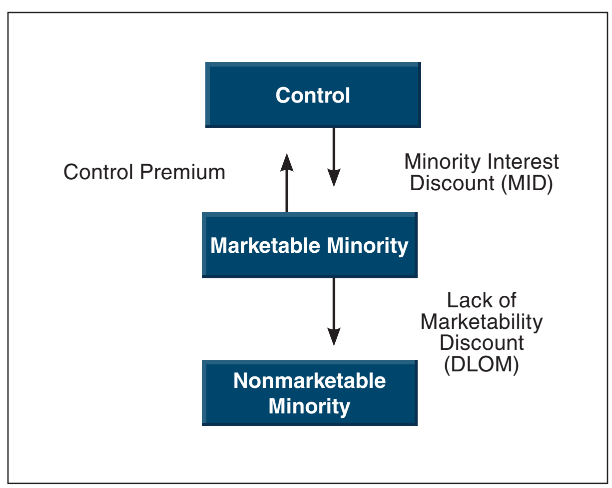


FIGURE 1

valuation (cash flow, risk and growth). We note that the conceptual core of the mathematical relationships is generally centered on the freely traded world of the public stock markets, which is characterized as the "marketable minority" level of value (enjoying readily achievable liquidity in a regulated, timely, and efficient market). Although other levels of value can be directly observed in various markets, the marketable minority interest level of value characterizes the empirical world from which most valuation data and observations are made (i.e., Ibbotson).

The take away from the relationships depicted in Figure 2 is that risk is negatively correlated to value (the universal reality of the time value of money) and that cash flow and the growth rate in cash flow are positively correlated to value. According to the preceding relationships, a control premium exists only to the degree that control investors reasonably expect some combination of enhanced cash flows, lower risk, or superior growth in cash flow, all as a result of better financial and operational capacity (financial control). ***Taking the financial control relationships one step higher via specific synergies results in a strategic control premium (which is not considered within the continuum of fair market value and generally exceeds adequate consideration for ESOP transaction purposes).***

Conversely, a marketability discount exists to the degree that investors anticipate subject returns (yield and capital appreciation) that are sub-optimal in comparison to the returns of a similar investment whose primary differentiating characteristic is that it is freely traded (also known as liquid). That is to say, minority investors (buyers and sellers) in closely held businesses that have investment-level considerations such as higher risks, lower yield, and/or lower value growth require some measure of compensation to compel a transaction in the subject interest. Otherwise, the investor would seek an alternative.

LEVELS OF (EQUITY) VALUE AND THE BASIC VALUATION EQUATION (GORDON GROWTH MODEL)

	Conceptual Math	Relationships	Value Implications
Strategic Control Value	$\frac{CF_{e(c,s)}}{R_s - [G_{mm} + G_s]}$	$CF_{e(c,s)} \geq CF_{e(c,f)}$ $G_s \geq 0$ $R_s \leq R_{mm}$	$V_{e(c,s)} \geq V_{e(c,f)}$
Financial Control Value	$\frac{CF_{e(c,f)}}{R_f - [G_{mm} + G_f]}$	$CF_{e(c,f)} \geq CF_{e(mm)}$ $G_f \geq 0$ $R_f = R_{mm}$ (+/- a little)	$V_{e(c,f)} \geq V_{mm}$
Marketable Minority Value	$\frac{CF_{e(mm)}}{R_{mm} - G_{mm}}$	$G_v = R_{mm}$ - Div Yld	V_{mm}
Nonmarketable Minority Value	$\frac{CF_{sh}}{R_{hp} - G_v}$	$CF_{sh} \leq CF_{e(mm)}$ $G_v \leq R_{mm}$ - Div Yld $R_{hp} \geq R_{mm}$	$V_{sh} \leq V_{mm}$

CF = cash flow; CF_e = cash flow to the business enterprise; CF_{sh} = cash flow to the shareholder; subscript "c,f" and c,s" denote, respectively, CF available to financial control investors and CF available to strategic control investors.

R = risk as expressed by the required rate of return on investment; R_{mm}, R_f and R_s denote risk as perceived through the eyes of marketable minority investors, financial control investors and strategic investors, respectively.

G = growth rate in cash flow or value (see notes above on "R"). G_{mm}, G_f and G_s denote growth as expected from the perspective of marketable minority investors, financial control investors and strategic investors, respectively. G_v differs from the other growth expressions in that it is an expression of the growth rate in value for the subject security in an appraisal exercise. All other expressions of "G" are growth rates in the cash flow of the business enterprise.

FIGURE 2

Perspective on the Control Premium

What is a control premium? The American Society of Appraisers (ASA) defines a control premium as *an amount or a percentage by which the pro rata value of a controlling interest exceeds the pro rata value of a non-controlling interest in a business enterprise, to reflect the power of control.* In practice, the control premium is often expressed as a percentage of the marketable minority value.

Based on this definition, it might seem that no controlling interest valuation can be developed without an explicit quantification to increase a value that is initially developed using a marketable marketable-minority interest level of value. This might be true in for circumstances in which the control value is not the direct result of the underlying methods. ***The fact is that most controlling interest appraisals are developed based on adjustments and methods that result directly in the controlling interest level of value. Therefore, no explicit control premium is required.*** Consequently, the appraiser cannot explicitly define the magnitude of the control premium in the appraisal.

In many cases, the appraiser may state that no control premium is added because all the features and benefits of control have been captured in the earnings adjustments and/or through other modeling assumptions in the underlying methods. We have seen numerous situations in which an appraiser was accused of failing to develop a control valuation because there is no explicit control premium applied to the correlated value or to the individual methods that are weighed in the correlation of value. Archaic though it may be in the context modern valuation practice, such accusations still exist even when the valuation features all the perfunctory control adjustments and treatments. For cases in which normalization and control adjustments were applied to cash flows and other elements, the additional application of a discrete control premium implies that there are further achievable control attributes. In such cases the control premium is likely quite small in comparison to typical published measures. If control adjustments are applied and a control premium is also applied, there is a potential overstatement in the valuation. This type of circumstance is a hot bed issue with the Department of Labor as such treatments could be the underpinning of a prohibited transaction. ***Appraisers and ESOP trustees are cautioned about the potential for double counting when applying an explicit control premium.***

The primary published source for control premium measurements is *Mergerstat Review*, published annually by Mergerstat FactSet. *Mergerstat Review* reports control premiums from actual transactions based on differences between public market prices of minority interests in the stock of subsequently acquired companies prior to buyout announcements and actual buyout prices. It is worth noting that Mergerstat's analysis indicates that higher premiums are paid for public companies than for private concerns because publicly traded companies tend to be larger, more sophisticated businesses with solid market shares and strong public identities. From a levels-of-value perspective, most of the transactions reported in *Mergerstat Review* are believed to contain elements of strategic value, which explains the relatively high level of control premiums cited therein. ***This strategic attribute of the data also makes it potentially troublesome when relied upon in ESOP appraisals.***

Noteworthy is the now widely accepted presumption that public stock pricing evidence is reflective of both the marketable marketable-minority and controlling financial interest levels of value. Referring to the expanded levels of value chart, ***minority interest discounts and financial control premiums are thought to be much lower in comparison to annually published data in*** **Mergerstat Review.** Thus, the two central boxes in the four-box vertical array of the expanded levels of value chart are essentially overlapping as in Figure 3.

The parity of value between financial control and marketable minority requires a few assumptions: normalized earnings adjustments are required, and these adjustments include some considerations that certain appraisers believe are not part of the minority interest equation (namely owners' and executive compensation). We believe that return on labor and return on capital are reasonable to segregate in valuations based on all levels of value. However, there may be differences between financial control and marketable minority valuations based on enterprise capital structure. There may be some consideration for the lack of liquidity to both control and minority investors when adjusted income streams overstate the real economic cash flows available for distribution or other shareholder-level benefits (including cash flows necessary to sustain an ESOP). There may be some justifiable difference in value for situations in which the

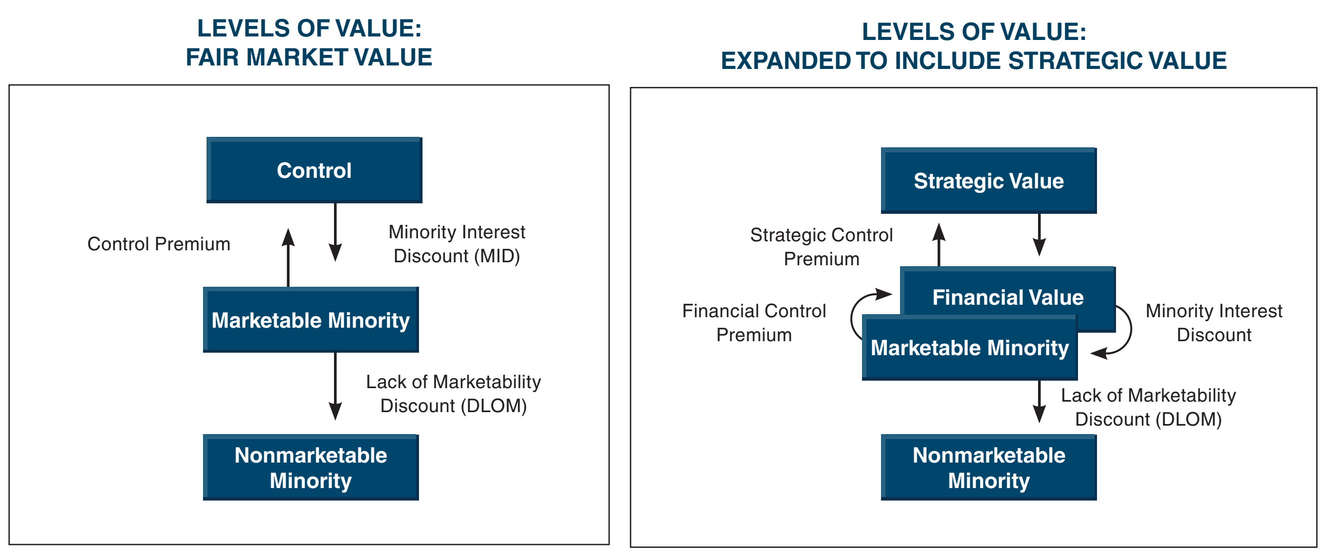


FIGURE 3

valuation subject's capital structure appears more conservative that than its peers. However, wanton manipulation of capital structures (for example, in the development of a weighted average cost of capital or WACC) in deriving the cost of capital is a frequent source of error in appraisals using a discounted future benefits (DFB) method. Such errors can lead to under- or over-valuation.

Control Premiums — Substance Over Form

Most appraisals that employ a controlling interest level of value definition do not (or should not) display a discrete or explicit control premium. That is because ***the adjustment processes underlying most individual valuation methods provide for the full consideration of control and thus do not require or justify further adjustment through the form of an explicitly shown control premium.*** So, despite the lack-of-control form that many control appraisals have, there is ample structure within the methodologies to capture the substance of a control premium. The following perspective plays off the basic equation to business valuation as well as the levels of value chart that depicts the relationships between risk, growth, and cash flow as one moves up and down the levels of value conceptual framework.

- ***Control premiums can be the result of earnings adjustments that eliminate discretionary expense, such as excess and non-operating compensation.*** Shareholder compensation paid to individuals who do not contribute to operations or management, directors' fees paid to family or others for non-vital roles, management fees paid to retired owners, loan guarantee fees paid to shareholders whose capital resources are not required, and other similar types of expenses are often the underlying control "pick-up" in an appraisal. Arguably, many of these adjustments should be part of the normalizing process for all appraisals so that returns on capital are clearly differentiated from returns on labor. ***When such adjustments are used to underpin an ESOP transaction, subsequent expenses and policies of the ESOP sponsor in future periods should confirm the credibility of the adjustments.***

- ***Control premiums can take the form of adjustments that place related party income and expense at arm's length pricing.*** Rents paid to related parties, management fees paid to affiliated entities, optimizing value or discretionary income from non-operating assets, and many similar adjustments that optimize the subject benefit stream are all part of the control mindset.

- ***Control premiums can be related to the optimization of capital structure.*** Many businesses enjoy the quality of having little to no interest interest-bearing debt. Perhaps in the paradigm of today's financial landscape, this is a better quality than previously appreciated. However, if a hypothetical investor can easily use debt in an efficient and responsible fashion to provide for the financial needs of the business, the subject's cost of capital may be reduced and correspondingly, the return on equity of the business can be enhanced. That is not to say that increased debt, as low cost as it may be, does not increase the potential risk profile of equity holders. All things equal, a reasonable blend of debt in the capital structure for a bankable group of assets and cash flow will provide a potential enhancement of return on equity. Many appraisals refer to public company debt ratios or to private peer balance sheet ratios to support an assumed capital structure that is different than actually employed at the subject entity. This can constitute a control premium. However, when taken too far or when assumed in a fashion that does not properly capture the incremental risk that higher levels of debt have on equity investors, ***the manipulation of capital structure can result in material valuation flaws.***

- ***Control premiums can emerge from weights applied in the correlation of value.*** In many cases, the valuation methods used to value a business result in similar value indications for both control and minority situations. However, a control valuation may include differing weights on the value indications such that the correlated value is higher than would result from the weighting scenario applied in a minority interest appraisal. Additionally, if a guideline transaction method is used in a control valuation and is weighed toward the correlation of value, the resulting value may represent a premium to the other indications of value developed in the appraisal.

- ***In tandem, capital structure efficiencies, income and expense efficiencies, and the consideration of peer transaction evidence are significant, albeit seemingly silent, control premiums.***

Perspective on the Minority Interest Discount

What is a minority interest (lack of control) discount? The ASA defines a minority interest discount as *the difference between the value of a subject interest that exercises control over the company and the value of that same interest lacking control (but enjoying marketability)*. In practice, the minority interest discount is expressed as a percentage of the controlling interest value. A minority interest is an ownership interest equal to or less than 50 percent of the voting interest in a business enterprise (or less than the percentage of ownership required to control the assets and/or the discretionary expense structure of a business).

As with the control premium, the minority interest discount is infrequently called upon in the valuation (as an explicit treatment) of most operating businesses because the majority of methodologies used to value nonmarketable minority interests results in an initial value at the marketable minority interest level of value. Accordingly, only a discount for marketability is required to derive the end nonmarketable minority valuation result.

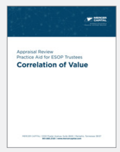
Minority interest discount discounts are a more common feature in the valuation of certain types of investment holding entities such as limited partnerships. This is because such entities have highly diverse purposes versus the relatively narrow operating focus of most operating business models. As such, the assets owned by the entity are generally best appraised by a specialty appraiser or from direct observation of market evidence concerning the asset. That being the case, most such entities are valued using an asset-based approach, which inherently captures the controlling interest level of value for the underlying assets. This makes it necessary for the business valuation to be adjusted first for lack of control considerations and second for lack of marketability concerns. Additionally, in cases involving operating business that hold operating and/or non-operating real property assets, such assets may need to be appraised by an appropriate expert and adjusted with a minority interest discount when integrated into the minority interest enterprise value of an operating business.

Appraisal Review Practice Aids for ESOP Trustees

By Timothy R. Lee, ASA, Managing Director of Corporate Valuation and Current Member of the ESOP Association Valuation Advisory Committee

ANALYZING FINANCIAL PROJECTIONS AS PART OF THE ESOP FIDUCIARY PROCESS

This whitepaper focuses on the use of financial projections in ESOP valuations. The use (or misuse) of financial projections is often the most direct cause of over- or under-valuation in ESOPs.

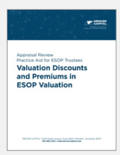


CORRELATION OF VALUE

In this whitepaper, we provide insight on the functional processes and analytical considerations underlying the determination of a correlated indication of value.

THE MARKET APPROACH

This whitepaper provides an overview of the primary elements of comparability and adjustments under the three primary categories of market methodology.



VALUATION DISCOUNTS AND PREMIUMS IN ESOP VALUATION

Debate over discounts and premiums in business valuation persists. Nowhere is this truer than with the marketability discount (or DLOM). Within the ESOP community, much of the confusion over DLOMs is mitigated due to the presence of put options. However, a legacy of concern over control premiums has now become an acute issue.

Although minority interest considerations are captured in the majority of appraisals by reference to returns on marketable investments in the public marketplace, there are techniques for developing the discount. One such method involves mathematically imputing the discount based on an assumed control premium. Other methods involve observations of securities trading values in the context of the valuation of the issuer's underlying assets, such as the case with closed-end funds and other securities in which underlying assets have an observable value that can be compared to the security's trading price.

The following formula provides an expression of the percentage minority interest discount as a function of an assumed percentage control premium. Although the expression is useful in identifying the minority interest discount as a percentage of an assumed or developed measure of control value, it is rarely used in a direct sense in the valuation of minority interests.

$$\text{Minority interest discount} = \left[1 - \left[\frac{1}{1 + \text{Control premium}}\right]\right]$$

In the valuation of minority interests in asset investment entities (limited partnerships et al.) that are invested in various classes of assets, many appraisers look to the observed discount to net asset value (NAV, the market value of a fund's asset holdings less its liabilities) that closed-end funds (CEF) typically trade at as evidence of an applicable minority interest discount for a subject partnership or similar ownership interest. As a general rule, CEFs report their net asset values, and the price-to-NAV relationship typically reflects a discount. Observed discounts to NAV reflect the consensus view of the marketplace toward minority investments in the underlying portfolios of securities. That is, the discounts are illustrative of the market's discounting of fractional interests in assets, making them somewhat comparable to a minority interest in an entity that is heavily invested in other assets (such as marketable securities, real estate, and other asset classes).

Discounts to net asset value for closed-end funds have been consistently observable for many years. The precise reasons for such discounts are subject to debate, but common attributes include the following factors:

- A lack of investor knowledge about the underlying portfolio;

- Absence of investor enthusiasm about the underlying portfolio;
- Enthusiasm, or lack thereof, about the fund's manager;
- Expense ratios;
- Tax liabilities associated with embedded gains;
- Lack of management accountability; and
- Lack of investment flexibility

Although closed-end funds may not be directly comparable to the subject interest in an appraisal, the discounts typically observed are evidence of the market's discounting of portfolios of generally liquid securities, and, therefore, offers valid indirect evidence of minority interest discounts applicable to asset-holding entities and operating businesses.

Marketability Discounts

The ASA defines a marketability discount as *an amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability.* Augmenting the consideration of marketability is the concept of liquidity, which the ASA defines as *the ability to readily convert an asset, business, business ownership interest, security, or intangible asset into cash without significant loss of principal*. Lack of marketability and lack of liquidity overlap in many practical regards. However, lack of liquidity is often attached to a controlling interest, while marketability discounts are used to describe minority interests.

Despite the proliferation of marketability discount studies and models, most models fall into one of three primary categories. These categories are based on the underlying nature of the analysis or evidence from which each model emanates. They include market-based perspectives (commonly referred to as benchmark analysis), options-based models, and income-based (rate of return) models. Although it is not our place to define a given model as the model, we do recognize that some models (or perspectives) provide general guidance for the appraiser regardless of the specific model employed. The following is a list of the so-called Mandelbaum factors, which are derived from the Tax Court's ruling in *Mandelbaum v. Commissioner* (T.C. Memo 1995-255, June 12, 1995). In essence, these factors serve a similar guidepost for the assessment of marketability, as does Revenue Ruling 59-60 for the valuation of closely held interests in general.

1. The value of the subject corporation's privately traded securities vis-à-vis its publicly traded securities (or, if the subject corporation does not have stock that is traded both publicly and privately, the cost of a similar corporation's public and private stock);
2. An analysis of the subject corporation's financial statements;
3. The corporation's dividend-paying capacity, its history of paying dividends, and the amount of its prior dividends;
4. The nature of the corporation, its history, its position in the industry, and its economic outlook;
5. The corporation's management;
6. The degree of control transferred with the block of stock to be valued;
7. Any restriction on the transferability of the corporation's stock;
8. The period of time for which an investor must hold the subject stock to realize a sufficient profit;
9. The corporation's redemption policy; and
10. The cost of effectuating a public offering of the stock to be valued, e.g., legal, accounting, and underwriting fees.

This list extends to considerations beyond the pure question of marketability. However, the ruling is instructive in its breadth. The Mandelbaum process is characterized by many appraisers as a qualitative or scoring procedure.

However, most of the parameters are mathematically represented by financial elements and assumptions under the income- and options-based models. Such parameters are also used, to the degree possible, in searching out market evidence from restricted stock transactions, which are documented in varying degrees by numerous studies over several decades.

Benchmarking analysis relies primarily on pre-IPO studies and restricted stock transactions. In essence, benchmarking calls for the use of market-based evidence to determine a lack of marketability discount. Some appraisers have pointed out the oxymoron of benchmarking (market transactions) analysis for use in determining lack of marketability discounts.

On the same note, other appraisers cite the restricted stock studies for capturing market evidence that at its core demonstrates the diminution to value associated with illiquidity. Imputed evidence concerning the implied rates of return for restricted stock lends support for more specific analyses within certain marketability models.

Options-based models, most of which are derivations and evolutions of the Black Scholes Option Model, are based on assessing the cost to insure future liquidity in the subject interest. Rate of return models are based on modeling the expected returns to the investors as a means for determining a valuation that results in an adequate rate of return given the investment attributes of the subject interest.

There is no one method that is acknowledged as superior to all others. Indeed, virtually every method employed in the valuation universe has been challenged or debated in the courts as well as by and among the professional ranks of appraisers.

Perhaps the best approach, stemming from a review of the IRS's *DLOM Job Aid*, which was discovered and published several years ago, is the use of multiple disciplines in a fashion consistent with the breadth of valuation approaches called for in business valuation (principally the income and market approaches).

DLOMs in ESOP Valuation

Notwithstanding the previous perspectives on DLOMs and the methods and processes for developing them, most ESOP appraisals that involve a minority interest definition of value reflect a relatively minimal DLOM of 5-10%. This is due to the obligatory put option feature required for qualified retirement plans holding closely held employer stock.

The virtual guarantee of a market for the ESOP participants' interests is believed to all but eliminate the DLOM. The consensus treatment from most appraisers is that a DLOM applies and is relatively small (say 5-10%) but not 0%.

Some appraisers use the DLOM as a proxy for concerns about future liquidity as it relates to the sponsor company's ESOP repurchase obligation. If a business is floundering, has a significant bubble of participants requesting near-term liquidity, has weak cash flow, has limited financial resources or financing options, and/or any other underlying fundamental challenge, some appraisers will use a DLOM to reflect this concern.

DLOMs quantified in the correct fashion may indeed be a viable approach to capturing the cash flow needed to service repurchase obligations and the associated effect on the sustainable ESOP benefit (the stock value). However, many appraisers use a more direct and explicit approach to studying and treating the repurchase obligation by iterating the associated expense into the valuation modeling (generally using an income method).

The expense is determined through a repurchase obligation study which informs trustees, sponsors, and plan administrators what measure of cash flow will service the foreseeable needs of the plan. To the degree that the assumed ongoing retirement plan funding is insufficient to service the obligation, an additional expense may be applied or a single present-value adjustment may be quantified to adjust the total equity value of the business.

Conclusion

The application of a discount or premium to an initial indication of value is an often controversial and necessary input to the valuation process. Fortunately, appraisers are equipped with numerous income and market methodologies to derive reasonable estimates of the appropriate discount or premium for the subject interest.

As with the determination of the initial indication of value, it is ultimately up to the valuation analyst to choose the appropriate methodology based on the facts and circumstances of the subject interest.

None of the available methodologies are perfect, and all of them are subject to varying degrees of criticism from the courts and members of the appraisal community. Critics of the various market approaches often cite the lack of contemporaneous transaction data that are rarely comparable or applicable to the subject interest.

Arguments against the income methodologies often focus on the model's inputs, particularly the holding period assumption, which is typically uncertain for most private equity investments.

The number of discount methodologies and their respective criticisms will, in all likelihood, continue to expand into the foreseeable future. It is ultimately up to the appraiser to consider the various options and determine the appropriate model or study applicable to the subject interest.

There are no hard-and-fast rules or universal truths that are applicable to all appraisals when it comes to the selection of an appropriate discount methodology. Appraiser judgment is ultimately the most critical input to any valuation, particularly in regard to the application of an appropriate discount methodology or control premium.

Admittedly, the number of discount methodologies and their corresponding criticisms can be a bit overwhelming to anyone unaccustomed to reviewing or writing business valuation reports.

At the end of the day, the most important thing to keep in mind is how reasonable the discount (or premium) is in light of the liquidity and/or ownership characteristics of the interest being appraised.

An appraisal may have carefully considered all the pertinent discount methodologies and their criticisms, but if the ultimate conclusion is not reasonable or appropriate for the subject interest, it will probably not hold up in court or communicate meaningful information for the end user of the report. Appraisers should investigate the reasonableness of their conclusions when preparing valuation reports and related analyses.

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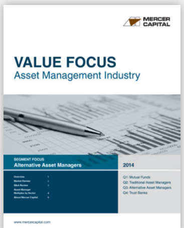

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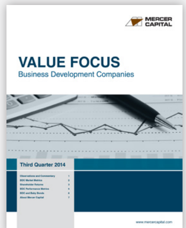

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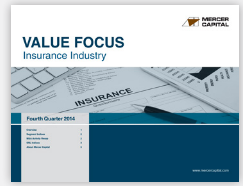

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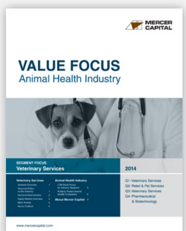

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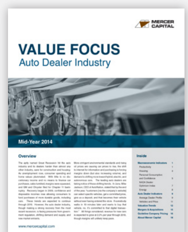

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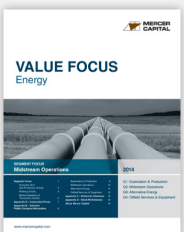

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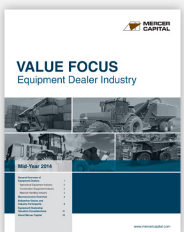

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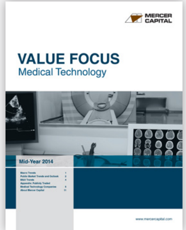

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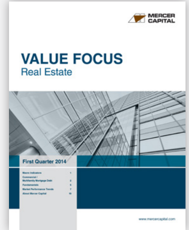

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