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What Attorneys Should Know About Valuations of Closely Held Businesses

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Karolina Calhoun, Vice President at Mercer Capital, has been involved with hundreds of valuation and litigation support engagements in a diverse range of industries on local, national and international levels. Prior to joining Mercer Capital, Karolina was a Senior Auditor at EY (Ernst & Young) in their Audit and Assurance Services practice.

As a member of Mercer Capital's Litigation Group, she provides valuation and forensics services for family law, gift & estate planning, commercial litigation, transactions (M&A), and further matters related to privately held businesses, dissenting shareholders, intellectual property, personal goodwill, etc. With her forensics accreditation, she provides economic and financial damages studies, asset tracing, lost profits, and lifestyle analyses.

Karolina also provides financial reporting and valuation analyses related to mergers & acquisitions, intangible assets, private equity portfolio companies, contractual agreements, and complex capital structures. She has experience in valuing a wide variety of intangible assets such as patents, customer lists, trademarks, and contracts. These engagements have been conducted for the purposes of mergers & acquisitions, buyouts, financial reporting, estate and gift taxes, allocation of purchase price, litigation support, shareholder dissent, buy-sell agreements, dissolutions, financing, and business planning.

Karolina is the Valuation Chair of the AICPA's Forensic and Valuation Services Conference Committee and a member of the AICPA's CFF Task Force. In 2018, she received the Forensic and Valuation Services (FVS) Standing Ovation award, presented by the AICPA to professionals for significant contributions in their specialty areas and in their communities. Karolina served as the President of the Memphis Chapter of TSCPAs (2019-2020). Karolina is also a presenter of various valuation and forensic topics to attorneys, accountants, and business professionals for the purpose of educating the public.

What Is a Business Valuation?





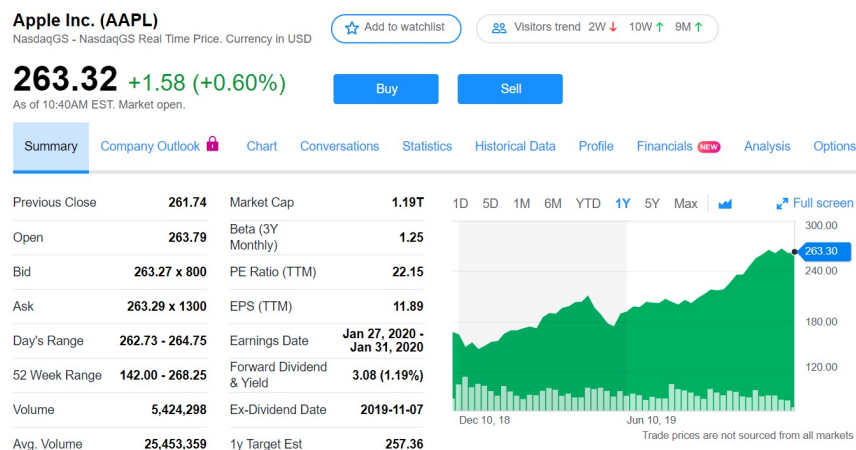
Business valuation is the process of determining the value indication of a business, business ownership interest, security, or intangible asset. The process is similar to the valuation of public interests, and the work product resembles a real estate appraisal.

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



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"

Critical Issues & Terms to Know

Planning/Initial Phase

- Date(s) of Valuation
- Standard of Value
- Level of Value
 - Ownership %
- Type of Report (deliverable)
 - Ex: Calculations for mediation vs. report for trial
- State statute

Unique to the Underlying Matter/Subject Company and Family Law

- Valuation Adjustments & Impact on Income Determination
- Marital vs. Separate
- Personal vs. Enterprise Goodwill
- “Discount”
 - Discount rate vs. Discount for lack of marketability and/or discount for lack of control
- Discount Rate vs. Capitalization Rate

There Are Three Valuation **Approaches**

Asset-Based Approach

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

Income Approach

Utilizes expected future earnings, discounted back to the present at a rate commensurate with the risk and growth characteristics of those cash flows or a single period capitalization of one or more earnings measures

Market Approach

Utilizes pricing metrics from public companies or from transactions in other private companies (or the entity itself) relative to company performance characteristics

Asset-Based Approach

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



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

When May an Asset-Based Approach be Appropriate?

- Asset-intensive businesses
- Asset holding entities

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

There Are Multiple **Methods** Within the Income **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
- Etc.

Multi-Period Capitalization Method

- Discounted Cash Flow Method

Theoretical Basis – Single Period Method

**The Gordon
Growth Model**

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

$$\text{Value} = \text{Earnings} \times \text{Multiple}$$

?



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
Value = Earnings x Multiple (\$1,000 x 10.0x)	\$10,000

So, How Does One Determine the Inputs?



Earnings

- Trends in historical performance
 - \$ and % levels
 - Margin & growth trends
 - How do historical trends support future potential performance?
 - Weighted average, simple average, or recent period?
- Expectations into the future



Growth (“g”)

- Unique to Company
 - Historical growth trends (top & bottom line)
 - Stage of growth cycle
 - Management expectations/plans
- Industry trends
- Inflation
- The economy in general



Discount Rate (“r”)

- Required rate of return
- Required return
- Cost of capital
- Cost of equity (“k”)
- Cost of debt
- Weighted average cost of capital (“WACC”)
- **Risk**
- **Unique to Company**



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
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	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
Capitalization Factor	9.65

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

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

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

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

Determination of Value	
Ongoing Earning Power	\$500,000
Capitalization Factor	6.95
Capitalized Earnings Value	\$3,475,000
Indicated Value: Capitalization of Earnings Method	<u>\$3,475,000</u>

There Are Multiple **Methods** Within the Market **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.

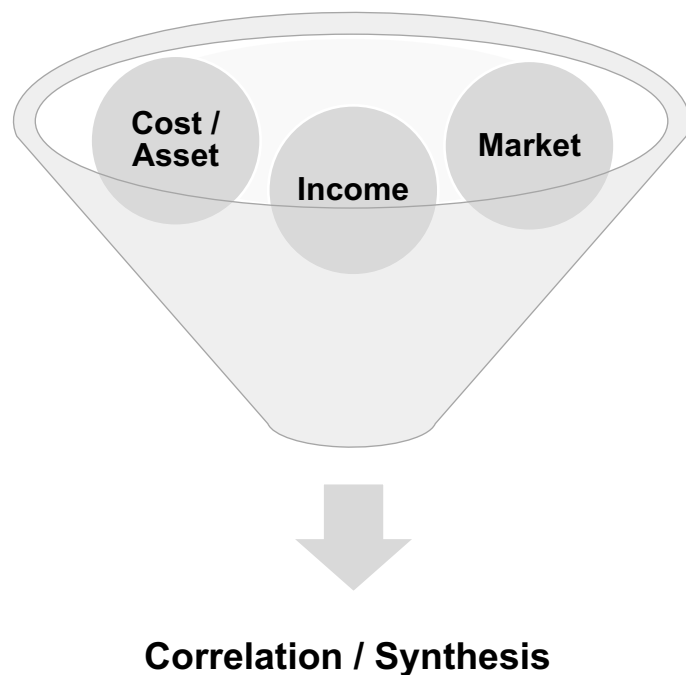
Guideline Company Transactions Method

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

Transaction Method

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

Synthesis of Valuation Approaches



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.

About Mercer Capital

Mercer Capital is a national business valuation and financial advisory firm.

We offer a broad range of services, including corporate valuation, financial institution valuation, financial reporting valuation, gift and estate tax valuation, M&A advisory, fairness opinions, ESOP and ERISA valuation services, and litigation and expert testimony consulting.

We have provided thousands of valuation opinions for corporations of all sizes in a wide variety of industries. Our valuation opinions are well-reasoned and thoroughly documented, providing critical support for any potential engagement.

Our work has been reviewed and accepted by the major agencies of the federal government charged with regulating business transactions, as well as the largest accounting and law firms in the nation in connection with engagements involving their clients.

For over 35 years, Mercer Capital has been bringing uncommon professionalism, intellectual rigor, technical expertise, and superior client service to a broad range of public and private companies and financial institutions located throughout the world. Feel confident in our experience and expertise.

Mercer Capital's Core Services

Valuation & Financial Opinions

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- 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

Financial Reporting Valuation Services

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

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