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Value Matters™

Corporate Valuation » Transaction Advisory » Financial Reporting Valuation » Litigation Support

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What is the Fair Market Value of Your Promissory Note?

The Internal Revenue Service's Revenue Ruling 59-60, which provides guidelines for valuation of closely held companies, presents a working definition of fair market value:

> 2.2 Section 20.2031-1(b) of the Estate Tax Regulations (section 81.10 of the Estate Tax Regulations 105) and section 25.2512-1 of the Gift Tax Regulations (section 86.19 of Gift Tax Regulations 108) define fair market value, in effect, as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.

Promissory notes are written promises to repay a debt under specific terms. These notes (sometimes called "notes payable") allow companies to borrow money from sources other than public debt markets or commercial lenders. Typical promissory note lenders are individuals connected to the company or other companies who are willing to lend the money for various reasons.

A promissory note consists of a contract which details the terms of the promise of the borrower ("maker," "issuer," "obligor") to pay an amount to the lender ("payee," "holder," "obligee"). The contract usually identifies the parties, the amount of the obligation (principal), the date of issue, the interest rate charged, the payment amounts and payment dates, prepayment privileges or penalties, any security for the loan, what constitutes default, and default remedies. If the note is secured a security agreement or deed of trust will also be issued.

Companies generally carry promissory notes on their balance sheets at the amount of the debt yet to be repaid. Fair market value for a promissory note is determined by calculating the present value of the expected payments on the note. In a world of alternative investments, a hypothetical investor considers the current situation of the borrower and the default remedies

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available under the terms of the note in developing a return requirement (discount rate) sufficient to induce investment. If that return requirement is different than the interest rate stated on the note, the fair market value of the note is not the principal balance, but rather the present value of expected future payments, which will be higher if the discount rate is lower, and vice versa. The fair market value of the note is sensitive to the contractual timing of the scheduled payments as well as the required return.

Repayment Schedules

There are several ways to schedule repayment of the principal amount. As with all financial instruments, the sooner cash is received, the more valuable the financial instrument. The most common payment schedules include:

1. *Amortized payments* where the same amount is repaid periodically and part of each payment is applied to interest while the remaining payment is used to reduce principal.

2. *Equal periodic payments* and a final balloon payment, where the periodic amount has lower monthly payments than an amortizing loan, but the final payment is much larger as the principal has not been reduced as quickly as in a fully amortizing loan.

3. *Interest only periodic payments* and a final balloon payment, where the principal does not decrease during the life of the note, but is repaid in its entirety at maturity.

4. *A single payment of principal and interest*, in which all interest and principal is paid off at the end of the term. Most likely this type of loan could only be acquired from friends or family, not a commercial lender.

Fair market value for a promissory note is determined by calculating the present value of the expected payments on the note

Determining an Appropriate Discount Rate

The value of a fixed income security is sensitive to the discount rate used. The appropriate interest rate will recognize the time value of money, the risk inherent in the investment and the relative liquidity of the investment. In order to derive an appropriate interest rate for the note, one must examine the interest rate environment at the valuation date.

The time value of money represents the return available from an investment with no risk. U.S. Treasury debt securities are considered risk free investments as they are backed by the U.S. Government.

Corporations raise capital by issuing bonds and notes and these instruments are often evaluated by various rating agencies to provide a current opinion of the creditworthiness of a maker with respect to a specific financial obligation. Corporate debt securities rated AAA to BBB are considered investment grade and most regulated institutions are allowed to invest in these instruments. Obligations rated below BBB are considered to have significant speculative characteristics.

Financial institutions lend money to individuals through secured and unsecured loans. Mortgages and home equity loans are the most common types of secured loans offered. These loans are secured by the underlying property making them less risky to the institution than an unsecured loan. While financial institutions often make short-term business loans at or near the prime rate, short-term unsecured personal loans are generally considered riskier and carry higher rates.

Depending upon the terms of the promissory note and the strength of the borrower, a base discount rate is chosen based on the interest rate environment at the valuation date. To this base rate various premiums would be added to capture risks not pertaining to the instruments used to derive the base rate. Several characteristics of a particular promissory that might give rise to a premium to the base rate include:

1. *Premium for lack of protection* and/or collateral might be appropriate for debt issued with no collateral backing the instrument and/or no recourse other than a court proceeding in the event of default.

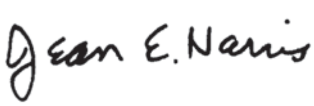
2. *Premium for lack of underlying financial information about the borrower* may be a source of significant uncertainty regarding the ability to collect on the note.

3. *Premium for note structure* may be warranted for long term notes with no paydown of principal scheduled as the borrower's circumstances could change unfavorably over time.

4. *Private placement premium* is warranted as a differential between privately placed debt and similar SEC registered debt. Academic researchers have provided empirical evidence regarding the potential magnitude of this premium.

Once the appropriate discount rate is determined, it is used to calculate the present value of the promised cash flows over the life of the note, which is the fair market value of the note. This article has outlined a few of the important considerations in determining the fair market value of promissory notes.

At Mercer Capital, we have extensive experience valuing promissory notes. Please give me or one of our professionals a call at 901.685.2120 to discuss valuation issues in confidence.



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What's New on Mercer Capital's Web Site

Mercer Capital's website is updated frequently and contains information of interest to attorneys, business owners, bankers, and other professional advisors to business. Please visit often at www.mercercapital.com.

ANNOUNCEMENT

Patton Retires After 25 Years, Crow Named President of Mercer Capital

After a 25 year career with the firm, Kenneth W. Patton retired as President of Mercer Capital, effective August 14, 2009. A former co-owner, Ken was instrumental in helping to build Mercer Capital into one of the largest and most successful independent business valuation firms in the nation. His retirement, and the subsequent leadership transition, had been planned for as part of the firm's strategic plan and leadership transition process which began with the installation of the firm's employee stock ownership plan in 2006. Chris Mercer remains as CEO. Matthew R. Crow, formerly a senior vice president who has been with the firm for 15 years, assumes the office of President.

Matt noted that he is "humbled that the Board and the professionals of Mercer Capital have placed their confidence in me. Stepping into Ken's shoes will not be easy. However, in planning for this transition, Ken made certain that the foundations of Mercer Capital were strong. We are all excited about the future and, as always, ready to serve the needs of our clients."

INDUSTRY FOCUS

Beverage & Construction Industry Publications Launched

For over 25 years, Mercer Capital has performed thousands of engagements across a wide array of industries. This broad base of experience has resulted in the development of specialized expertise in various industry sectors. We follow certain of these industries through our *Value Focus* industry publication. Joining the asset management, insurance, and medical devices industry coverage is the beverage and construction industries. Visit our website for details.

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SELECTED LIST OF RECENT & UPCOMING SPEAKING ENGAGEMENTS

September 3, 2009
"Buy-Sell Agreements"
Birmingham Estate Planning Council
Birmingham, Alabama
Timothy R. Lee, ASA

September 15, 2009
"Understanding, Measuring, and Managing Value"
America's Bank Board Symposium
presented by American Banker and Bank Director Magazine
Austin, Texas
Andrew K. Gibbs, CPA/ABV, CFA

September 16, 2009
"Valuation Issues Important to Your Clients"
Memphis Bar Association
Memphis, Tennessee
Timothy R. Lee, ASA & Nicholas J. Heinz, ASA

September 24, 2009
"An Alternative Approach to Determining Active/Passive Appreciation in Divorce"
Business Valuation Resources Divorce Summit
Chicago, Illinois
Z. Christopher Mercer, ASA, CFA

September 24, 2009
"Marketing a Valuation Practice"
Virginia Society of CPAs 10th Annual Business Valuation Conference
Glen Allen, Virginia
Barbara Walters Price

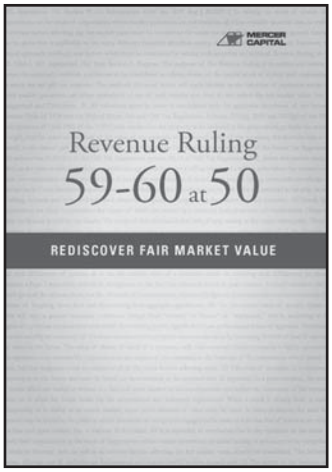
October 19, 2009
"So You Want to Be An Expert?"
Southern Federal Tax Institute
Atlanta, Georgia
Z. Christopher Mercer, ASA, CFA

November 10, 2009
"Fair Value in Today's World"
Birmingham FEI Chapter
Birmingham, Alabama
Travis W. Harms, CFA, CPA/ABV

November 16, 3009
"Buy-Sell Agreements"
AICPA's Annual Business Valuation Conference
San Francisco, California
Z. Christopher Mercer, ASA, CFA

To see a complete list, visit the Speaker's Bureau section of our website at www.mercercapital.com. To inquire about engaging a professional from Mercer Capital to speak to your group, contact Barbara Walters Price at priceb@mercercapital.com, or by calling 901.322.9724.

The Mercer Capital Library



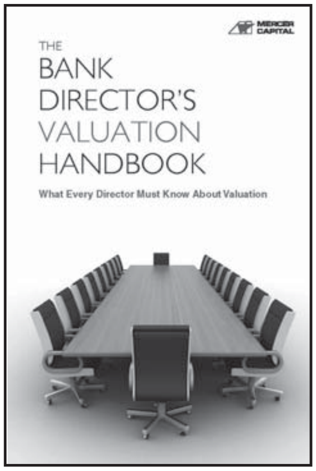
Revenue Ruling 59-60 at 50

Rediscover Fair Market Value

January 2009

Sale Price: $45 (plus s/h)

Revenue Ruling 59-60 is a compact storehouse of enduring practical wisdom for business appraisers and the users of appraisal reports. To celebrate the 50th anniversary of its publication, we summarize the Ruling and provide a non-technical view of how appraisers attempt to translate its guidance into actual valuation engagements. This 120+ page book is written for attorneys and other users of business appraisal reports.



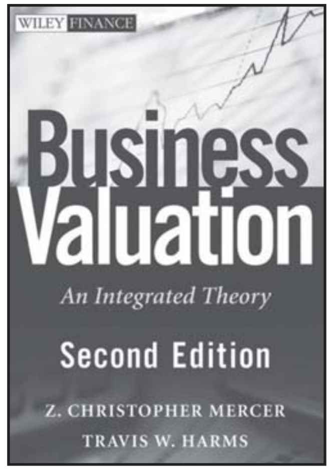
The Bank Director's Valuation Handbook

What Every Director Must Know About Valuation

January 2009

Sale Price: $45 (plus s/h)

Mercer Capital has been working with financial institutions for over 25 years and has provided valuation and other financial consulting services to thousands of clients. We find that most of our clients have the same basic questions about important valuation issues. This handbook addresses many of these questions and provides useful information for bank directors and managers when valuation needs emerge.



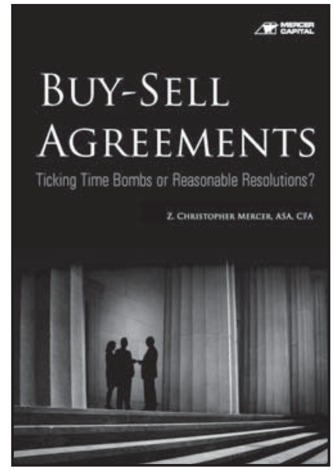
Business Valuation, An Integrated Theory

Second Edition

January 2008

Reg. Price: $95 (plus s/h)

Whether you are a business appraiser, auditor, financial planner, or attorney, *Business Valuation: An Integrated Theory, Second Edition* enables you to understand and correctly apply fundamental valuation concepts. Thoroughly revised and expanded, the Second Edition demystifies modern valuation theory, bringing together various valuation concepts to reveal a comprehensive picture of business valuation.



Buy-Sell Agreements

Ticking Time Bombs or Reasonable Resolutions?

January 2007

Reg. Price: $79 (plus s/h)

Does your or your clients' buy-sell agreement say what you think it says? You might be surprised. Written for business owners, attorneys, CPAs, business appraisers, and other professional advisors to business, this book provides a road map for you (or your clients) to develop or improve your buy-sell agreement.

Coming in Fall 2009 - Valuation for Impairment Testing, Second Edition

A GENTLE PLUG FOR OUR FIRM

MERCER CAPITAL is a business valuation and investment banking firm serving a national and international clientele. Our reputation for excellence is based on an ability to solve complex financial problems expeditiously. We convert over 25 years of experience, including thousands of assignments, into solutions for the issues of today.

Mercer Capital provides a broad range of independent valuation and financial advisory services, including:

- Dispute Analysis Services and Expert Testimony
- Valuation for Corporate Tax Matters
- Valuation for Corporate Income Tax Issues
- Valuation for ESOPs
- Purchase Price Allocations
- Goodwill Impairment Testing
- Valuation of Employee Options
- Portfolio Valuation Services
- Valuation of Intangible Assets
- Fairness Opinions

Mercer Capital's investment banking professionals specialize in providing merger and acquisition services to sellers or buyers of private businesses or public companies divesting divisions and subsidiaries. In addition, we assist clients in industry consolidations, roll ups, and refinancings.

INTERNET COMMERCE: OBTAIN PROPOSALS TO VALUE YOUR COMPANY, BANK, FLP OR LLC VIA OUR WEBSITE

The cost of your time and delays in obtaining proposals has just gone down. Use one of the PROPOSAL REQUEST FORMS on our website.

Many of your colleagues have already used our PROPOSAL REQUEST FORMS and are impressed by the decrease in transactional overhead and the increased ease in obtaining actionable proposals for their clients. We are pleased to be doing business with them. Try it yourself! Visit our website and provide us with the pertinent information via this form, and we'll prepare a proposal and deliver it to you via e-mail, fax or USPS. Complete confidentiality is assured.

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