2014 WCMC
Grain Elevator & Feed Mill Asset Valuations
– What is my Business Worth?

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Methodologies to Value the Company

- **Asset Based** – most appropriate for Holding entities
  - Real Estate/Securities
- **Income Based** – used for operating entities
  - Capitalized Earnings (historical earnings)
  - Discounted Cash Flow (DCF) Forward looking requiring forecasts
- **Market Based** – Used for Operating entities
  - Usually for larger companies
  - Requires enough COMPARABLE data to be relevant
    - Garbage in Garbage out
  - Probably most misused approach by casual valuators

Key Valuation Drivers

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  - Earnings
    - It is important to choose an earnings stream that is relevant to your Company/Industry. Heavy investments in hard assets; or very high or very low debt levels can dictate which earnings stream is appropriate.
      - Net Income (includes non-cash items such as depreciation)
      - EBITDA (Earnings Before Interest Taxes Depreciation and Amortization)
      - EBIT (Earnings Before Interest and Taxes)
      - Cash Flow (eliminates non-cash items such as Depreciation)
    - Whatever earnings stream is used, it must match the multiples applied to those earnings arrived at from market data.

Key Drivers, Cont.

- **Multiple**
  - Public Company/Transactional data
    - Need to be sure they are truly comparable
    - Must be applied correctly, each database has different items that need to be added to the calculated value (such as cash, fixed assets, etc.) **THIS IS OFTEN DONE INCORRECTLY AND CAN RESULT IN HUGE SWINGS/ ERRORS IN VALUE.**
    - Is a Company 50X larger than yours really comparable?
    - If the “comparable” Company is diversified into many areas and your company is in one niche, is that a comparable company?

BuM (Build up Method)

Risk Free Rate	4%	4% (Treasuries)
Equity Risk Premium	5%	5% (SBBI)
Size Premium	6%	6% (SBBI)
Specific Risk (JUDGMENT)	5%	5% (Valuator)
Discount Rate (for DCF)	20%	20%
LESS Growth Rate	(3%)	(8%) (Valuator/mgmt)
Capitalization Rate	17%	12%
Multiple (1/Cap. Rate)	5.9	8.3

Key Valuation Drivers

- **Growth – One of the biggest value drivers in a valuation**
  - Can dramatically impact value
  - Looking at LONG TERM –
    - Should it be at least equal to inflation?
    - Can it be double digit?
    - What happens if growth is not expected to be constant?
    - What is the impact on value?
  - Management provides significant input on this, Valuator must vet and determine its reasonableness.

Discount Rate (for DCF)	20%	20%
LESS Growth Rate	(3%)	(8%)
Capitalization Rate	17%	12%
Multiple (1/Cap. Rate)	5.9	8.3
Times Earnings	$100,000	$100,000
Calculated Value	$590,000	$830,000

In this case, a difference of 5% in growth resulted in a 30%-40% difference in value!!!

Key Valuation Drivers

- Specific Risk Rate (**Can have as big an impact as growth rate**)
  - Client Concentration
  - Volatile Niche
  - Poor Capitalization
  - Competition
  - Thin Management
- Level of Ownership
  - Control value: >50%
  - Blocking : = 50%
  - Minority: < 50% voting or any Non-voting/ limited partner block

Level of Ownership

- Control value: >50% of Voting shares
  - May require a small marketability discount
- Blocking : = 50%/50%
  - Is Non-controlling, so will have a discount for lack of control and lack of marketability, though less than straight minority ownership
- Minority: < 50% voting or any Non-voting/limited partner block
  - Full discounts for lack of control and lack of marketability, supported by empirical data

Fair Market Value Defined

The price at which 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 relevant facts.

Section 25.2512-1 of the estate tax regulations

What earnings stream should you use to value?

- What Income/revenue definition are you using for the valuation formula?
  - **Revenue Multiple?**
    - What if the Company is losing money? You get the same value for a profitable company as a Company losing money under this approach.
  - **Earnings?** – Does it use a predefined Multiple of Earnings?
    - Is the Earnings stream defined/detailed?
    - Are you using "Cash Flow"; "EBIT"; "EBITDA", each one requires a <u>different</u> multiple. For Example, applying the same multiple to EBIT and EBITDA will result in a much higher value under the EBITDA calculation than the EBIT calculation, due to the addback of depreciation and amortization, which is often significant.
    - Applying a net income multiple like P/E to an S-Corp should be reviewed carefully.

Earnings Issues

- Do you adjust for <u>market based expenses such as:</u>
  - Officer's Compensation – Is current compensation at market levels? If not, the earnings could be understated and the value of the company would be significantly understated.
  - Rent
    - If the company is leasing from a related party, this rent expense could be higher than market rates, thereby lowering the income, and thus the value.
  - Other
    - What do you do about non-operating assets? Is that cash in the business needed for operations, or can it be distributed without impacting earnings? This can have an impact on the value of the company under an earnings method. Non-operating assets are added to the value of the company calculated under the income methods.

Income Tax Issues

- Do you reduce earnings for <u>income taxes</u> (C-Corp or S-Corp)?
  - In valuing a pass through entity, we will typically impute taxes against the net income, even though the entity itself doesn't pay taxes. (a "premium" may be added to account for the tax benefits of a pass through entity).
  - This will lower the value of the company as compared to not tax imputing. If the agreement is silent on this issue, different appraisers may do this differently.

Weighting of Earnings

- Use most recent year?
  - What if that year is a mountain or a valley? In today's economy, the reliance on the most recent year or even the last 3 years will result in a lower value for the company than is likely warranted, due to lower earnings and often times lower multiples.
- 5 most recent years?
  - Weight them equally or other method?
  - How do you consider anomalies?
  - How do you consider cyclicality within the industry?
  - Does the formula require an adjustment for non-recurring items? For example, what if you have a capital gain in the most recent year of $500,000; do you remove that item from earnings? If not, and your multiple is 5, your value is $2,500,000 higher than it probably should be.

Invested Capital or Equity?

- Does your valuation require a reduction of the debt, or consideration of the equity of the company?
  - This goes to the issue of comparing apples to apples.
  - When valuing "invested capital" the value figure includes the debt.
  - When valuing equity, the debt is removed. Depending on the level and nature of the company's debt, this distinction can be dramatic.

Other Issues impacting value

- Is there excess cash or other non-operating assets that can be removed prior to transfer without impacting value?
  - Depending on the method utilized to value the company, the impact may be negligible
- Do your key people have non-compete agreements?
  - You must have these in place prior to marketing the business or risk losing value in the Company. You give the employees all the leverage if you ask them to sign these after marketing the business.

Tax Planning Issues

- Tax Planning
  - The gross sale price is not as relevant as the after-tax proceeds
  - Consult your tax advisor regarding:
    - Stock sale versus asset sale
      - Stock sale usually favors the Seller, all other things being equal (capital gains treatment)
      - Buyer may prefer asset purchase to allow for new basis in assets and resulting depreciation expense
    - Basis issues
  - Allocation of asset values – often a key area of disagreement
    - Need to match on the Tax Returns
  - Tax impact of non-competes; consulting agreements; etc.

Supporting the Transaction

- Highly advisable to get a formal appraisal, prepared by a “qualified appraiser” to support the transaction price, particularly for related party transfers
  - Set a fair market value for the stock to reduce risk of “implied gift” to related party if sale or part sale/part gift
  - Provides “adequate disclosure” compliance for gifts, if applicable (start statute of limitation tolling)
  - Need to substantiate the Business Enterprise Value, and specifically identify intangible assets acquired under FASB ASC 805 for GAAP purposes

COOP Specific Issues

- How do we value a COOP under ASC 805 for Business Combination purposes?
  - **Enterprise value** – the value of the COOP using FMV principles
    - DCF approach is the "preferred method" – Often times results in a value well BELOW net asset value – particularly if Patronage dividends are removed from cash flow.
    - Would a seller really take less than Net Asset Value?
  - Other Intangibles? (Must be separable and salable)
    - Trade Name
    - Formulae
    - Patents, etc.

COOP Specific Issues, cont.

- Cash Flow
  - Do you remove Patronage Dividends when developing a value under the Discounted Cash Flow Approach?
- Customer/Member Lists
  - Is there salable/transferable value capable of being calculated?
    - Why are they members – would they leave?
    - Are they members of multiple COOPs
- Will the COOP ever be sold or liquidated?
- Who is the likely buyer?
- Do you really need a Formal Business Appraisal?

CONCLUSION

- There are key valuation drivers that need to be focused on in order to increase value
- Pre-transfer planning can allow for the smooth transition at maximum tax benefit while addressing current owner's fears and needs
- COOPS have very unique issues that must be addressed and require valuator to have industry knowledge
- Adequately support your values

Questions?

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