Business Valuation Overview

PRESENTED BY

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ABOUT

Cogent Valuation

Independent valuation opinions

Thousands of engagements completed since our founding in 1991.

California offices

Los Angeles, San Francisco and Orange County, serving clients nationwide.

Senior-led execution

Managing Directors (ex-Houlihan Lokey) average more than 40 years of valuation experience.

AGENDA

What We'll Cover

01 Reasons for Business Valuation

02 What We Appraise

03 Valuation Considerations

04 Valuation Approaches

05 Tax Valuation Issues

SECTION 01

Reasons for Business Valuation

Corporate Transaction Opinions

Tax & Estate Planning

Fair Value Reporting

ESOP Opinions

Dispute Resolution

REASONS FOR BUSINESS VALUATION

Transactions, Tax and Reporting

Corporate Transaction Opinions

- Valuation Advisory
- Fairness opinions
- Solvency opinions

Tax & Estate Planning

- Estate & gift taxes
- Management stock options (IRC 409A)
- S-corporation conversion (built-in gain)
- Charitable contributions
- Corporate recapitalizations

Fair Value Reporting

- Common stock valuations for option pricing (FASB 718)
- Portfolio valuation (FASB 820)
- Purchase price allocation (FASB 805)
- Goodwill impairment testing

REASONS FOR BUSINESS VALUATION

ESOPs and Dispute Resolution

Employee Stock Ownership Plan (ESOP) Opinions

- Initial ESOP purchase transaction (leveraged or unleveraged)
- Annual updates for plan administration
- Subsequent transactions where the ESOP buys from or sells to third parties
- Phantom stock plans

Dispute Resolution

- Shareholder buyouts pursuant to buy-sell
- Expert Testimony
    - Corporate dissolution (Section 2000)
    - Shareholder disputes
    - Lost profits / economic damages
    - Family law

SECTION 02

What We Appraise

Entity Interests

Intellectual Property

Other Assets

WHAT WE APPRAISE

From Entity Interests to Intangibles

Entity Interests

- Common stock
- Preferred stock
- Partnership interests (general & limited)
- LLC membership interests
- Options and warrants
- Carried interests
- Non-US entities

Intellectual Property

- Patents
- Trademarks
- Film rights
- Publishing rights
- Recording rights
- Software

Other Assets

- Promissory notes
- Contractual rights
- Legal claims
- Contingent consideration (earn-outs)
- Tenancy-in-common interests
- Loan guarantees

SECTION 03

Valuation Considerations

Framing the Assignment

Standards of Value

Fair Market Value

Revenue Ruling 59-60

VALUATION CONSIDERATIONS

Framing the Assignment

1. Description of asset to be valued
2. Identify the valuation date(s)
3. Identify the valuation purpose
4. Identify and define the standard of value
5. Clarify the premise of value

WHY IT MATTERS

The same asset can have materially different values under different standards, premises and dates.

BT1

Standards of Value

Fair Market Value	The standard most often used; governs tax appraisals and many other valuation situations
Fair Value	Two contexts: 1) State laws governing corporate transactions, and 2) financial-reporting under FASB, with different definitions and parameters
Investment Value	Value to a specific investor, reflecting that buyer's synergies
Adequate Consideration	ERISA standard applicable to ESOP transactions

Slide 11

BT1 Add CR to each bock

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Fair Market Value, Defined

"The price at which an asset 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."

— REVENUE RULING 59-60

Key attributes:

-both the buyer and the seller are hypothetical, not specific parties.
-interest viewed in isolation, not combined with other holdings (Revenue Ruling 93-12)
-disregard synergies with potential acquirors

Revenue Ruling 59-60, Factors to Consider

01 History and nature of the business

02 Economic outlook

03 Industry outlook

04 Financial condition (and book value)

05 Earnings and dividend-paying capacity

06 Intangible values (goodwill)

07 Comparable sales

SECTION 04

Valuation Approaches

Market Approach

Income Approach

Asset Approach

BT1

VALUATION APPROACHES

Three Recognized Approaches

EARNINGS-BASED

Market Approach

Value indicated by prices of guideline public companies and acquisition transactions.

EARNINGS-BASED

Income Approach

Value as the present value of expected future investment returns.

ASSET-BASED

Asset Approach

Value built up from the fair market value of the underlying assets less liabilities.

Inadequate benchmarks of value: book value, industry rules of thumb, and the excess earnings method.

Slide 15

BT1 CR for each block

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Step 1: Identify the Value Drivers

- Proprietary product / technology
- Brand
- Sales force / distribution network
- Exclusive rights
- Human capital
- Customer / supplier relationships
- Physical assets

VALUATION APPROACHES

Market Approach

GUIDELINE COMPANIES

- Public companies
- Acquisition transactions

MOST COMMON METHODS

- Price / Earnings (P/E)
- Multiple of EBITDA
- Multiple of revenue
- Industry-specific metrics

IN PRACTICE

Multiples observed in the market are adjusted for differences in size, growth and risk before being applied to the subject company.

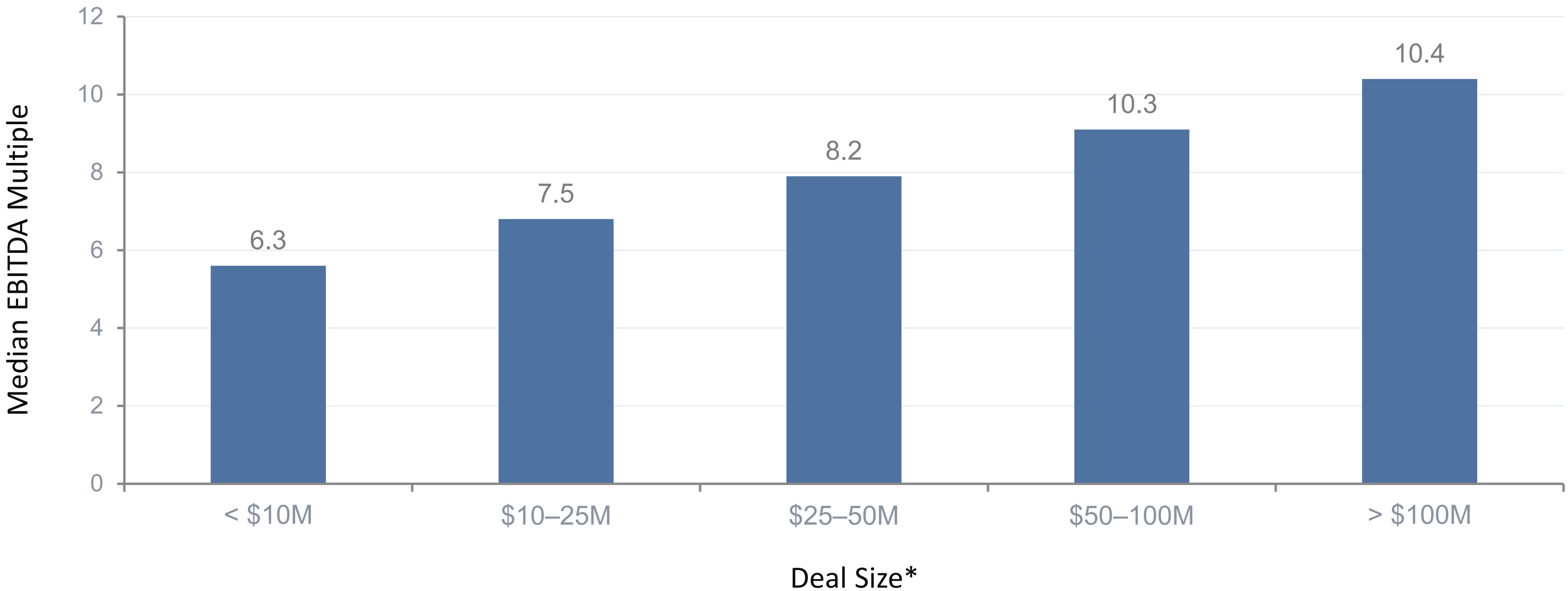
The EBITDA Multiple

- The EBITDA multiple is the most often used valuation benchmark
- Reported EBITDA is adjusted for (1) nonrecurring items and (2) discretionary expenses, including owners' compensation
- The multiple is most often applied to the latest normalized EBITDA, but can also be applied to a historical average or next fiscal year’s projected EBITDA
- Factors such as size, growth, key-person risk and key-customer concentration affect the EBITDA multiple

WHY EBITDA

A capital-structure-neutral measure of operating cash flow, comparable across companies.

EBITDA Multiples Increase with Size



*measured by total consideration paid plus debt assumed

Market Approach Summary

Approach	Rep. Level		Market Multiple	Total Capital	Less: Debt	Equity Value		Weight	Weighted Equity Value
Price / Earnings	320	x	11.0	—	—	3,520	x	25%	**880**
Multiple of EBITDA	700	x	6.0	4,200	(774)	3,426	x	50%	**1,713**
Multiple of Revenue	8,430	x	0.5	4,215	(774)	3,441	x	25%	**860**
Market Value of Equity									**3,453**

$ thousands. Illustrative. The P/E multiple applies directly to equity, so no debt is deducted; EBITDA and revenue multiples are applied to total capital, less debt.

Income Approach

CONCEPT

- Calculate the net present value (NPV) of expected future investment returns

METHODS

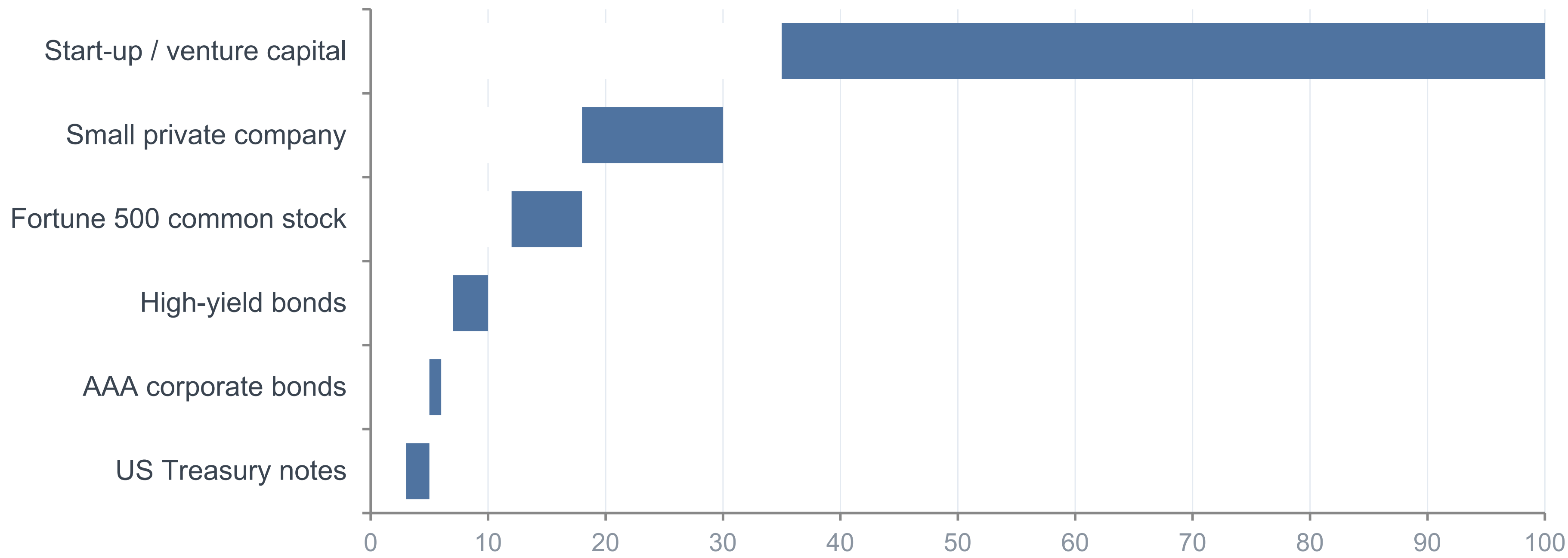
- Multi-period discounted cash flow (DCF)
- Single-period perpetual growth model

STEPS

- Determine net cash flow (NCF)
- Determine the required rate of return
- Calculate NPV of expected NCF at required rate of return

Business Value = Income ÷ (Required Rate of Return − Growth)

Market Rates of Return (%)



Approximate required rates of return (%) — riskier assets demand higher returns and lower values per dollar of income.

Net Asset Value

CONSIDERATIONS

- Adjust individual assets and liabilities to fair market value
- Determine whether liquidation or going-concern value applies
- Use appraisals for real estate and equipment when possible

APPLICATIONS

- Real estate companies
- Natural resources (oil & gas) companies
- Investment companies
- Other asset holding companies
- Liquidation of a company

SECTION 05

Tax Valuation Issues

IRS Requirements

Fractional Interest Discounts

How Taxes Affect Business Valuation Conclusions

Other Issues

Common Issues in Tax Valuations

01 IRS requirements

02 Fractional interest discounts

03 How taxes affect valuation conclusions

04 Other issues

IRS Requirements

QUALIFIED APPRAISAL

- Compliance with appraisal standards (USPAP)
- Fee cannot be % of appraised value
- Narrative report requirements:
    - Detailed description of asset, including relevant restrictions
    - Valuation date
    - Valuation methods used
    - Appraiser qualifications, declaration and signature

QUALIFIED APPRAISER

- 1) Appraisal designation or 2) relevant coursework PLUS two years experience valuing similar assets
- No conflict of interest
- In good standing

Appraisal Requirements

Charitable Gifts	Statutory requirement for charitable gifts of non-cash property with FMV > $5,000 (must be signed by appraiser-Form 8283)
Gift Tax	No statutory requirement but starting the three-year statute of limitations requires adequate disclosure, which a qualified appraisal helps to satisfy
Estate Tax	No statutory requirement but helps establish FMV

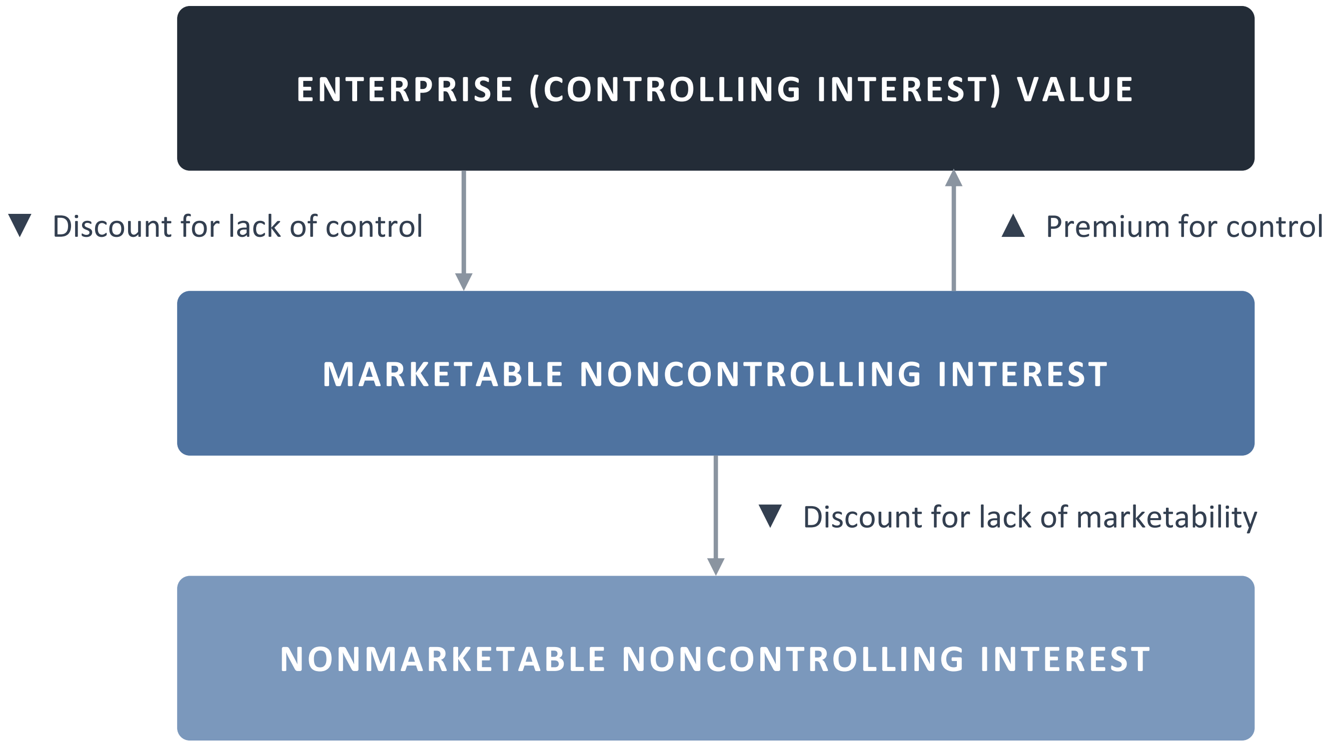
Fractional Interest Discounts

- A fractional interest in an entity is generally worth less than its pro rata share of the 100% value, due to:
  - Lack of control
  - Lack of marketability
- Taking advantage of this fact is the cornerstone of much estate and gift tax planning
- Fractional interest discounts are supported by numerous Tax Court cases…the issue is not whether discounts are valid but, rather, the magnitude of the discounts

PLANNING NOTE

Value-mitigating estate tax planning should occur well before a death event.

Levels of Value



Reasons for the Discount for Lack of Control

NONCONTROLLING INTERESTS ARE UNABLE TO

- Change corporate (partnership) bylaws
- Determine dividend (distribution) policies
- Determine salaries
- Redeploy corporate (partnership) assets
- Change the capital structure
- Effect a sale, dissolution or other change in ownership structure
- Make personnel changes
- Otherwise influence the operations and financial structure of the company

EMPIRICAL EVIDENCE OF THE DISCOUNT

- **Operating company**
  - Control premium studies (inverse)
- **Real estate holding company**
  - REITs
  - Secondary real estate LP market
  - Closed-end mutual funds
- **Marketable securities**
  - Closed-end mutual funds

Reasons for the Discount for Lack of Marketability

CLOSELY-HELD INTERESTS

- Lack an active market
- Cannot be converted into cash quickly and at minimal expense
- Have a limited number of potential buyers
- May be subject to transfer restrictions under shareholder, partnership or operating agreements

EMPIRICAL EVIDENCE OF THE DISCOUNT

- **All companies**
  - Restricted stock (Rule 144)
  - Private placements prior to IPO
  - Quantitative models
    - Time to liquidity
    - Volatility

Factors Influencing Discounts Cont'd

Type of Business

- Operating company
- Real estate
- Securities
- Other / combination

Form of Ownership

- Corporate
- General partnership
- Limited partnership
- Limited liability company
- Tenancy-in-common

Rights & Privileges

- Restrictions on control
- Restrictions on transfer
- Distribution of income
- Formula (buy-sell) prices
- Ability to compel liquidation

Financial Characteristics

- Size
- Leverage
- Dividend / distribution yield
- Volatility
- Excess Comp

General Range of Discounts (Operating Company)

Discount	Low	High
Lack of control	0%	35%
Lack of marketability	20%	40%
Combined discount*	**20%**	**61%**

* *Discounts are applied sequentially; the combined discount is not the sum of the discounts for lack of control and lack of marketability.*

General Range of Discounts (Real Estate Company)

Discount	Low	High
Lack of control	10%	25%
Lack of marketability	20%	30%
Combined discount*	**28%**	**48%**

* *Discounts are applied sequentially; the combined discount is not the sum of the discounts for lack of control and lack of marketability.*

General Range of Discounts (Securities)

Discount	Low	High
Lack of control	5%	10%
Lack of marketability	20%	25%
Combined discount*	**24%**	**33%**

** Discounts are applied sequentially; the combined discount is not the sum of the discounts for lack of control and lack of marketability.*

Tiered Discounts

- Tiered discounts may apply when valuing a fractional interest in a company that itself owns fractional interests in another entity
- After a primary layer of discounts, the second layer should reflect only the incremental lack of control and marketability relative to the first
- The magnitude of tiered discounts can be mitigated by a high distribution yield

KEY PRINCIPLE

Each additional layer captures only incremental impairment. Not a full second discount.

Treatment of Unrealized Gain

- As a general rule, a taxpayer's low basis in an asset is not grounds for discounting the value of the asset for unrealized gains
- The FMV of a share of Apple stock is the same regardless of the taxpayer's basis. The same holds for directly owned real estate
- This is because the FMV standard is premised upon a hypothetical willing buyer and seller
- Appropriateness of discount for unrealized gain in assets if held by:
  - C Corp – yes
  - S Corp – probably
  - Partnership/LLC – probably not

GENERAL RULE

Low basis alone does not justify a discount under the FMV standard.

C Corp Trapped-In Gain

- In the asset approach, appreciated assets in a C corp warrant a discount for the unrealized tax liability, even though the timing of realization is uncertain
- A hypothetical buyer of the stock would recognize this potential liability and demand a discount relative to a like bundle of assets without the unrealized gain
- While historically the Tax Court was reluctant to allow such discounts, it has been accepting dollar-for-dollar reduction for the tax liability on unrealized gain in the asset approach

CURRENT PRACTICE

A dollar-for-dollar reduction for the embedded tax liability is appropriate.

Unrealized Gain in S Corps

- S corp interests may also warrant a discount for unrealized gain in the asset approach because a hypothetical buyer steps into a disadvantageous tax position where they could have a significant tax liability upon the sale of low-basis assets
- However, unlike the trapped-in gain in C corps, consensus for modeling the valuation impact is lacking and is complicated by several factors, including the assumed timing of the sale of assets and disposition of stock
- There is also little case law to provide guidance

CURRENT PRACTICE

Treatment varies by appraiser.

The S Corp Premium Issue

- Pre-2001, when using an income approach, S corps and other pass-through entities were valued by applying a C corp tax rate (as instructed in the IRS training manual)
- Then, a string of Tax Court cases (*Gross, Heck, Adams*) suggested that S corps had to be valued without tax affecting income, leading to the illogical conclusion that an S corp could be worth 60%+ more than an otherwise equivalent C corp
- The valuation community responded with a number of (generally very complex) methods for capturing the true benefits of pass-through status at the shareholder level which usually result in premiums from 10% to 20%

TODAY

Treatment varies by appraiser, ranging from no S corp premium to a 10–20% premium based on the models.

Secondary Market Transactions

- Timely transactions in the subject company's stock, including rounds of financing, tender offers and secondary market sales, are highly relevant and must be “considered”
- If these transactions are in a different class of stock than common, adjustments should be made for differences in rights and privileges
- The weight given to such transactions depends on:
  - Proximity to the valuation date
  - Size of the transaction
  - Frequency of transactions
  - Presence or absence of other considerations / motivations

TODAY

Most often arises when valuing common stock for option pricing (IRC 409A/ASC 718).

Publicly Traded Stock

- Generally, publicly traded stock is valued for tax purposes as the average of the high and low stock price on the valuation date (Treasury Regulation Section 20.2031-2(b))
- However, certain situations warrant a premium or a discount to the market price
- A premium (relatively rare) would be warranted for a block of shares that represents actual or effective control
- A discount (relatively common) would be warranted if the block cannot be sold in the market quickly, for a variety of reasons
- In rare cases, when trading is too sporadic (pink sheets), market price may be not be used as starting point

BASELINE

High / low average on the valuation date, then adjust for block-specific facts.

Blockage Discounts

WHAT THEY COVER

- Discounts to the publicly traded price are appropriate for the following reasons:
  - Securities law restrictions (Rule 144)
  - Contractual restrictions (lock-ups)
  - Trading volume limitations
- A block can face more than one limitation. They can run consecutively

SIZING THE DISCOUNT

- Most often, option pricing is used to determine the blockage discount
  - Estimated time to liquidate at the market price - the longer the time, the higher the discount
  - Stock price volatility - the higher the volatility, the higher the discount

Multiple Related Businesses

- Unified operations are often carved up into multiple (seemingly arbitrary) entities for myriad legal and tax reasons
- Quality of financial statements is key:
  - Are related-party leases at market rates?
  - Are intercompany service charges at market?
  - Are all costs allocated?
  - Do related-party due to/due from balance? Are there terms? Are they documented?

WATCH FOR

Intercompany arrangements that shift value between entities and distort stand-alone earnings.

Thank You.

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