



The Income Approach to Business Valuation

INTRODUCTION

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The Income Approach to Business Valuation

INTRODUCTION

- Privately-held equity ownership interests are first and foremost, an investment
- Foregone consumption in the hope of getting back principal plus an investment return commensurate with risk principles

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INTRODUCTION

- All value is “forward-looking”
- Value = all future economic benefits set forth in “today’s dollars”
- Past performance, per se, is not relevant

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The Income Approach to Business Valuation

INTRODUCTION

- Future economic returns: 2 broad categories
 - *Income distributions*
 - *Capital appreciation*
- Value considers both returns

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The Income Approach to Business Valuation

INTRODUCTION

- **Income Approach**
 - *Incorporates both categories of economic returns*

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The Income Approach to Business Valuation

INTRODUCTION

- **Economic benefit stream**
 - *After-tax income*
 - *Pre-tax income*
 - *Operating income*
 - *Net free cash flow (most commonly used)*

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The Income Approach to Business Valuation

INTRODUCTION

- **Income Approach**
 - *Requires financial modeling*
 - Use of present value concepts



The Income Approach to Business Valuation

BASICS OF THE INCOME APPROACH



The Income Approach to Business Valuation

BASICS OF THE INCOME APPROACH

- **Income Approach**

- *Most commonly used approach to value privately-held business ownership interests*

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BASICS OF THE INCOME APPROACH

- **Income Approach**

- *Directly aligns with concept of forward-looking economic benefits*
 - Principle of “anticipation”
 - Why would any investor be concerned with what his investment did before he owned it?

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BASICS OF THE INCOME APPROACH

- **Income Approach**

- *Numerator = future expected economic benefit stream*
- *Denominator = risk associated with amounts and timing of benefit stream*

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BASICS OF THE INCOME APPROACH

- **Income Approach – Example**

Economic benefit \$ 1,000

Risk rate 20%

Value \$ 5,000

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BASICS OF THE INCOME APPROACH

- **Future economic benefits = expected future cash flow**
 - *Cash flow is used due to empirical source data*
 - *Can be something other than cash flow, but using another proxy for future economic benefits requires risk rate modification*
 - *Critical error often made is “mismatching” risk rates to benefit streams*

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BASICS OF THE INCOME APPROACH

- **Income Approach**
 - *Denominator is an indicator of opportunity cost or risk*
 - *Denominator is the “cost of capital”*
 - The amount of return required to draw investors to the investment

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BASICS OF THE INCOME APPROACH

- **Discount rate**
 - *“Real” rate of return*
 - *Expected inflation*
 - *Risk*

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BASICS OF THE INCOME APPROACH

- **Income Approach – 3 methods**
 - *Capitalized cash flow (CCF) method*
 - *Discounted cash flow (DCF) method*
 - *Excess cash flow (ECF) method*

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NORMALIZATION & DETERMINATION OF FUTURE EXPECTED CASH FLOWS

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FUTURE EXPECTED CASH FLOWS

- **Income Approach Methods** rely on present value of enterprise's future cash flows
 - *Often based on historical financial data*
 - *Must attempt adjustments to normalize financials*
 - *Results in an economically “normal” basis – not GAAP or tax-basis*

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FUTURE EXPECTED CASH FLOWS

- **Common normalization adjustments for:**
 - *Ownership characteristics (control v. minority)*
 - *GAAP departures, extraordinary, nonrecurring and/or unusual items*
 - *Nonoperating assets and liabilities and related income and expenses*
 - *Taxes*
 - *Synergies from mergers and acquisitions*

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FUTURE EXPECTED CASH FLOWS

- **Adjustments for ownership characteristics**
 - *Intercompany fees/payments*
 - *Related party transactions*
 - *Sales/purchases to/from related entities*
 - *Nonbusiness travel and entertainment*
 - *Excess fringe benefits*

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FUTURE EXPECTED CASH FLOWS

- **Control vs. minority**
 - *Content of numerator drives the type of value*
 - Adjustments made related to control – control value
 - Adjustments related to control are excluded – minority value
 - No control adjustments – minority and control value are the same (might still apply a minority discount)

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FUTURE EXPECTED CASH FLOWS

EXAMPLE: CONTROL VS. MINORITY

Assume an entity with \$700 in cash flow is paying \$300 in excess compensation to the control shareholder.

	<u>Control</u>	<u>Minority</u>
Cash Flow	\$ 1,000	\$ 700
Rate	<u>20%</u>	<u>20%</u>
Value	<u>\$ 5,000</u>	<u>\$ 3,500</u>
Difference	<u>\$ 1,500</u>	Minority Discount
Percentage Discount	<u>30%</u>	

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FUTURE EXPECTED CASH FLOWS

- **Debate over making control adjustments**

- *Make adjustments*

- Otherwise value is understated, minority discount is overstated, potential to “double count” minority discount

- *Don’t make adjustments*

- Minority interests have no say in compensation or perquisites
- Amount of adjustments is difficult to verify/justify

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FUTURE EXPECTED CASH FLOWS

- **Adjustments for GAAP departures, extraordinary, nonrecurring and/or unusual items (examples)**

- *One-time advertising expenditures*

- *Unusually high equipment repairs*

- *Catastrophic events*

- *Labor strikes*

- *Insurance premium collections*

- *Large fixed asset purchases*

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FUTURE EXPECTED CASH FLOWS

- **Adjustments for nonoperating assets and liabilities and related income and expenses**
 - *Airplanes*
 - *Unsold plant facilities that have been replaced*
 - *Significant investments in unrelated companies*
 - *Equity investments*
 - *Excess cash/working capital*

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FUTURE EXPECTED CASH FLOWS

- **Adjustments for nonoperating assets and liabilities and related income and expenses**
 - *Remove interest, dividends, rental income, and expenses related to nonoperating assets*
 - *Valuation of these assets/liabilities varies depending on the nature*
 - Appraised, separate entity valuation, determine any tax implications of gains associated with appreciation

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FUTURE EXPECTED CASH FLOWS

- **Adjustments for taxes**
 - *Whether to tax-affect or not tax-affect the income in pass-through entities*
 - *Selection of tax rate*
 - Actual, average, or highest marginal tax rate

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FUTURE EXPECTED CASH FLOWS

EXAMPLE: TAXES AND VALUE

	<u>Actual Tax Liability</u>	<u>Average Tax Rate (35%)</u>	<u>Highest Marginal Rate (39%)</u>
Pre-tax income	\$ 1,000,000	\$ 1,000,000	\$ 1,000,000
Tax on the taxable income	222,500	350,000	390,000
After-tax cash flows	777,500	650,000	610,000
Capitalized value at 20%	\$ 3,887,500	\$ 3,250,000	\$ 3,050,000

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FUTURE EXPECTED CASH FLOWS

EXAMPLE: APPLYING AFTER-TAX CAP RATE TO PRE-TAX CASH FLOW

	Pass-Through Entity	"C" Corporation
Pre-tax cash flow	\$ 1,000,000	\$ 1,000,000
Tax on the taxable income	0	\$ 350,000
After-tax cash flows	\$ 1,000,000	\$ 650,000
Capitalized value at 20%	\$ 5,000,000	\$ 3,250,000

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FUTURE EXPECTED CASH FLOWS

- **Adjustments for synergies from mergers and acquisitions**
 - *Savings in rent due to consolidating office facilities*
 - *Increased/decreased sales*
 - *Decreased production costs*
 - *Decreased sales and marketing costs*
 - *Improvements from anticipated economies of scale*

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FUTURE EXPECTED CASH FLOWS

- **Determination of future benefits stream (cash flows)**
 - ***CCF***: single measure of the “expected” annual future economic benefit
 - ***DCF***: discrete “expected” future economic benefits projected for a set number of years, single measure for use into perpetuity after specified period

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FUTURE EXPECTED CASH FLOWS

Direct to equity

Net income after tax
Plus: Depreciation/amortization,
other non-cash changes
Less: Incremental working capital
Plus: New debt principal
Less: Repayment of debt principal
Equals: Net cash flow to direct equity

Invested capital

Net income after tax
Plus: Interest expense (tax-affected)
Plus: Depreciation/amortization,
other non-cash changes
Less: Incremental “debt-free”
working capital
Less: Incremental capital expenditures
Equals: Net cash flow to invested capital

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COST OF CAPITAL

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COST OF CAPITAL

- **Value under the income approach includes consideration of three elements**
 - *Economic benefit stream*
 - *Risk rate determination*
 - *Growth*

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COST OF CAPITAL

- Higher risk – lower value
- Higher growth – higher value



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COST OF CAPITAL

- Economic cost of attracting and retaining capital investors
 - *Efficient markets theory*



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COST OF CAPITAL

- **Basic concepts**
 - *Expected rate of return to attract investors*
 - *Focus on investor – not investment*
 - *Opportunity cost*
 - *Principle of substitution*
 - *Market driven*
 - *Encompasses risk*
 - *Each component of capital has a cost of capital*

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COST OF CAPITAL

- **Three components of cost of capital**
 - *“Real” rate of return*
 - *Expected inflation*
 - *Risk*
- **Cost of capital is a “discount rate”**

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COST OF CAPITAL

- **Methods**

- *Buildup method (BUM)*
- *Capital asset pricing model (CAPM)*
- *Modified capital asset pricing model (MCAPM)*
- *Weighted average cost of capital (WACC)*
- *Price/earnings method*

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COST OF CAPITAL

- **Understanding growth and cost of capital**

- *Capitalization rate = discount rate – growth*

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COST OF CAPITAL

- Note that a capitalization rate is the inverse of price/earnings or a price/cash flow multiple
- **Example:** Assume a P/E ratio of 10
Price = 10 x earnings
Capitalization rate is 1/10 or 10%

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COST OF CAPITAL

- Growth rates
 - *Short-term and long-term must be considered*
 - *Long-term is most important*

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COST OF CAPITAL

- **Gross Domestic Product (GDP)**
 - *Since 1926, grew 6.0% to 6.3%*
- **Long-term growth rates**
 - *3% to 5%*

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COST OF CAPITAL

- **Three types of risk**
 - *Maturity risk*
 - *Systematic risk*
 - *Unsystematic risk*

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COST OF CAPITAL

- **Unsystematic risk – four sources**
 - *Size*
 - *Macroenvironment*
 - *Industry*
 - *Specific-company attributes*

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COST OF CAPITAL

- **Buildup model (BUM)**
 - *An equity discount rate model*

Formula:

$$K_e = R_f + R_{pm} + R_{ps} + R_{pu}$$

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COST OF CAPITAL

- **BUM – developing the discount rate**

Risk-free rate

Risk premium of the market over risk-free rate

Risk premium for size

Risk premium specific to company

Total risk rate (discount rate)

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COST OF CAPITAL

- **Risk-free rate**
 - *20-year U.S. Treasury Bond rate at date of valuation*
- **Equity risk premium of market over the risk-free rate and risk-free premium for size**
 - *CRSP Deciles Size Premia Study, Duff & Phelps*
- **Risk premium specific to company**
 - *Judgmental*

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COST OF CAPITAL

EXAMPLE: CALCULATING DISCOUNT RATE USING THE BUILDUP MODEL

Valuation date (June 30, 2014) long-term U.S. Treasury Bond Yield	3.08%
+ Equity risk premium-stocks over bonds	<u>6.18%</u>
Valuation date average company return	9.26%
+ Risk adjustment for size in relation to comparative companies	5.99%
+ Other risk factors specific to the company	<u>4.00%</u>
= CASH FLOW DISCOUNT RATE – EQUITY	<u>19.25%</u>

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COST OF CAPITAL

- **Weighted average cost of capital**

– *Balance sheet*

Assets	Debt	} Invested Capital
	Equity	
<u>Assets</u>	<u>Debt plus Equity</u>	

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COST OF CAPITAL

- **Cost of equity**
 - *Computed under the buildup approach*
- **Cost of debt**
 - *After-tax borrowing rate*

$$K_d (1 - t)$$

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COST OF CAPITAL

$$\begin{aligned} \text{After tax borrowing rate} &= k_d (1 - t) \\ &= 3.25\% (1 - 35\%) \\ &= 3.25\% (65\%) \\ &= \underline{2.11\%} \end{aligned}$$

$$\begin{aligned} \text{Where: } k_d &= \text{Cost of debt} \\ t &= \text{Tax rate} \end{aligned}$$

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COST OF CAPITAL

$$\begin{aligned}\text{WACC} &= (K_e * W_e) + [(K_{dpt} (1-t)) * W_d] \\ &= (19.25\% * 49\%) + [(3.25\% * (1-35\%)) * 51\%] \\ &= 9.43\% + [(3.25\% * 65\%) * 51\%] \\ &= 9.43\% + (2.11\% * 51\%) \\ &= 9.43\% + 1.08\% \\ &= \underline{10.51\%}\end{aligned}$$

Where:

k_e = Cost of equity
 W_e = Weight of equity
 K_{dpt} = Pre-tax cost of debt
 t = Tax rate
 W_d = Weight of debt

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COST OF CAPITAL

- To derive a value for equity under a WACC model, the market value of debt must be subtracted

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COST OF CAPITAL

- **Comparison to market multiples**
 - *Free cash flow*
 - *EBITDA*
 - *EBIT*

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APPLICATION OF INCOME APPROACH METHODS

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The Income Approach to Business Valuation

APPLICATION OF INCOME APPROACH METHODS

- **Three methods of the income approach**
 - *Capitalized cash flow (CCF) method*
 - *Discounted cash flow (DCF) method*
 - *Excess cash flow (ECF) method*

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The Income Approach to Business Valuation

APPLICATION OF INCOME APPROACH METHODS

- **Steps utilized by the CCF**
 - *Historical financial information is analyzed as of the date of valuation*
 - *Extraordinary, nonrecurring and nonoperating items of income and expense are removed*
 - *Benefit stream is selected*

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The Income Approach to Business Valuation

APPLICATION OF INCOME APPROACH METHODS

- **Steps utilized by the CCF**
 - *Period of review is determined and selected benefit stream is constructed on a year-by-year basis*
 - *A weighting of each period's benefit stream is considered*
 - *Selected weighted economic benefit stream chosen as base*

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APPLICATION OF INCOME APPROACH METHODS

- **Steps utilized by the CCF**
 - *Discount rate is calculated and converted to a cap rate*
 - *Economic benefit stream divided by cap rate to produce value of the operating enterprise*
 - *Nonoperating assets and liabilities are added or subtracted*

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APPLICATION OF INCOME APPROACH METHODS

$$PV = \frac{NCF_1}{k - g}$$

Where: *PV* = Present value

NCF₁ = Expected income in the full period
immediately following the effective
valuation date

k = Present-value discount rate

g = Expected long-term growth rate in NCF

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APPLICATION OF INCOME APPROACH METHODS

EXAMPLE: CALCULATION USING THE CCF METHOD

Assumptions:

Discount rate (k)	24%
Long-term growth rate (g)	4%
Year 0 cash flow	\$1,000

Capitalized Cash Flow Method:

Year 0 cash flow	\$ 1,000
One year growth factor	<u>1.04</u>
Year 1 cash flow	1,040
Capitalization rate	<u>.20</u>
Value Result	<u>\$ 5,200</u>

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APPLICATION OF INCOME APPROACH METHODS

- **The cash flow benefit stream can either be available to all invested capital (debt and equity holder) or equity capital**
- **The CCF method can be applied an end-of-year convention or a midyear convention**

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APPLICATION OF INCOME APPROACH METHODS

- **The DCF method is comprised of two components:**
 - *Discrete period projection, and*
 - *Terminal period*
 - Terminal value is extremely important as it typically represents a substantial portion of total value of an entity

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APPLICATION OF INCOME APPROACH METHODS

- **Steps utilized by the DCF**
 - *Benefit stream is selected*
 - *Discrete period projection of the selected benefit stream is constructed on year-by-year basis to a point of stabilization*
 - *Terminal value is determined*

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APPLICATION OF INCOME APPROACH METHODS

- **Steps utilized by the DCF**
 - *Discount rate is calculated to match the selected benefit stream*
 - *Discrete period economic benefit streams and terminal year are discounted to present value*
 - *Nonoperating assets and liabilities added/subtracted*

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APPLICATION OF INCOME APPROACH METHODS

$$PV = \sum_{i=1}^n \frac{E_i}{(1+k)^i}$$

- Where: PV = Present value
 Σ = Sum of
 n = Last period for which economic income is expected
 E_i = Expected future economic income in the i^{th} period in the future
 k = Discount rate
 i = Period in the future over which the prospective economic income is expected to be received

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APPLICATION OF INCOME APPROACH METHODS

- The formula can be expanded as follows:

$$PV = \frac{E_1}{(1+k)^1} + \frac{E_2}{(1+k)^2} + \dots + \frac{E_n}{(1+k)^n}$$

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The Income Approach to Business Valuation

APPLICATION OF INCOME APPROACH METHODS

EXAMPLE: CALCULATION USING THE DCF METHOD

Assumptions:

Discount rate (k) 24% Long-term growth rate (g) 4% Year 0 cash flow \$1,000

Discounted Cash Flow Method:

Projected year	1	2	3	4	5	Terminal yr*
Cash flow (CF)	1,040	1,082	1,125	1,170	1,217	6,327
Present value factor	.8065	.6504	.5245	.4230	.3411	.3411
Discounted cash flow	839	704	590	495	415	2,158
Value Result (rounded)	\$ 5,200					

*Terminal Year: $CF_n \cdot (1+g)/k-g = \$ 6,327$

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APPLICATION OF INCOME APPROACH METHODS

- **Excess cash flow method**

- *Also known as the “excess earnings method”*
- *Blend of asset and income approaches*
- *First introduced in the 1920s by “Treasury Department, Appeals and Review Memorandum (ARM) No. 34”*
- *Later updated in Revenue Ruling 68-609*

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APPLICATION OF INCOME APPROACH METHODS

- **Steps utilized by the ECF**
 - *Fair market value of entity's net tangible assets determined*
 - *Normalized economic benefit stream (typically, cash flow) is developed*
 - *Appropriate rate of return for net tangible assets selected*

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APPLICATION OF INCOME APPROACH METHODS

- **Steps utilized by the ECF**
 - *Normalized cash flows attributed to net tangible assets is calculated using appropriate rate of return*
 - *Cash flows attributable to net tangible assets subtracted from total normalized cash flows to determine cash flows attributable to intangible assets*
 - *Appropriate return for intangible assets is selected*

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APPLICATION OF INCOME APPROACH METHODS

- **Steps utilized by the ECF**
 - *Fair market value of intangible assets is calculated by capitalizing cash flows attributable to the intangible assets by an appropriate cap rate as determined in prior step*
 - *Fair market value of net tangible assets is added to fair market value of intangible asset*

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APPLICATION OF INCOME APPROACH METHODS

- **Steps utilized by the ECF**
 - *Interest-bearing debt subtracted to provide value of equity*
 - *Rate reconciliation prepared to determine reasonableness*

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APPLICATION OF INCOME APPROACH METHODS

EXAMPLE: CALCULATION USING THE ECF METHOD

<i>Assumptions:</i>	Normalized cash flow	\$ 100
Value of net tangible assets	Less cash flow attributable to tangible assets	<u>50</u>
Return on net tangible assets	Cash flow attributable to intangible assets	50
Return on intangible assets	Intangible asset rate of return	<u>20%</u>
	Value of intangible assets *	<u>\$ 250</u>
	Value of net tangible assets	\$ 500
	Value of intangible assets	<u>250</u>
	Value of invested capital	\$ 750
	Less: Interest-bearing debt	<u>(100)</u>
	Value of equity	<u>\$ 650</u>

* Uses CCF method

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COMMON MISUSES AND MISTAKES

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COMMON MISUSES AND MISTAKES

- Failure to normalize earnings
- Mismatching the discount rate with the economic income measure
- Interchanging discount and capitalization rates
- Inappropriately relying on the recent past to provide the best estimate of future results

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The Income Approach to Business Valuation

COMMON MISUSES AND MISTAKES

- Projecting growth beyond what can be supported
- Discounting future economic benefits using a year-end convention when a midyear is more appropriate
- Failure to identify control versus noncontrol cash values

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COMMON MISUSES AND MISTAKES

- **Sampling of cases involving mistakes and misuses of the income approach**
 - *Wall v. Comm.*
 - *Estate of Adams v. Comm.*
 - *Re Nellson Nutraceutical*
 - *Re Lear Corp.*

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CONCLUSION AND PRACTICAL CONSIDERATIONS

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CONCLUSION & PRACTICAL CONSIDERATIONS

- Complexities in models can influence conclusions if analyst assumes advocacy rather than objectivity
- Modifying expected benefit stream or increasing or decreasing company-specific risk or growth rates can have profound effect on conclusion
- When used properly, the income approach can provide a more accurate reflection of value

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THANK YOU!

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