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Business Valuation: Essential Approaches & Current Perspectives – Cost/Asset Approach

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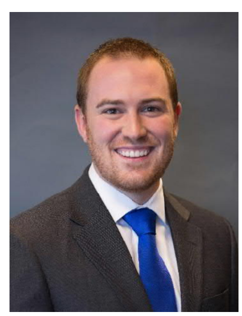

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INTRODUCTION

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Basics of the Cost/Asset Approach & Current Perspectives

INTRODUCTION

- ***Fundamental Precept*:**
  - An astute investor will not pay more for a collection of assets, net of liabilities, than the price for which those same assets could be purchased or constructed
- ***Determination of value predicated upon assessment of each of a company's assets and liabilities on its historical financial statements***
  - Tangible and intangible assets
  - Recorded and unrecorded assets and liabilities

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- ***Process converts GAAP-prepared historical balance sheet to an economic balance sheet***
  - Reflects assets/liabilities on a fair market value basis (or some other applicable standard of value)
- ***Subtracting economic balance sheet liabilities from assets yields economic value of the equity of the company***
  - Additional discounts and adjustments may be required
- ***Result of the process should be accurate indication of value***

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Basics of the Cost/Asset Approach & Current Perspectives

INTRODUCTION

- ***Primary Methodologies under the Asset Approach***
  - Asset Accumulation Method
  - Excess Earnings Method

Basics of the Cost/Asset Approach & Current Perspectives

INTRODUCTION

- ***Popularity of approach due to simplicity of the methods available and familiarity of most users with balance sheet formats***
- ***Due care is required in proper application and interpretation to avoid erroneous conclusions***
- ***Approach not as useful for companies that have significant unrecorded intangible value***
- ***Approach used most often as primary approach only where value of equity is based on value of underlying assets***

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Basics of the Cost/Asset Approach & Current Perspectives

TODAY WE WILL DISCUSS

- ***Methodologies***
- ***Tangible Asset Appraisals***
- ***Built-In Gains Tax***
- ***Propriety of Discounts***
- ***Current Issues***

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METHODOLOGIES

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COST/ASSET APPROACH METHODOLOGIES

- ***Asset Accumulation Method***
  - Most common method
  - Also referred to as “Net Asset Method”
  - Encompasses fundamental concepts of the approach most directly

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COST/ASSET APPROACH METHODOLOGIES

- ***Application of the Asset Accumulation Method***
  - Obtain balance sheet with information on or near the date of valuation
  - Adjust the balance sheet for GAAP basis
  - Adjust the assets and liabilities to reflect their current appraised values
  - Identify and quantify unrecorded assets and liabilities

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COST/ASSET APPROACH METHODOLOGIES

- ***Application of the Asset Accumulation Method***
  - Assess/quantify goodwill or other intangible value (if applicable)
  - Make necessary adjustments to reflect deferred income tax effect on any gains or losses
  - Adjust value for control and marketability discounts, if any are applied

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COST/ASSET APPROACH METHODOLOGIES

- ***Asset Accumulation Method Example***

Economic Fair Market Value Balance Sheet

Assets		Liabilities	
Cash	$ 5,000	Accounts Payable	$ 15,000
Accounts Receivable	20,000	Other Current Liabilities	10,000
Inventory	10,000	Taxes Payable	6,000
Building	15,000	Long Term Debt	20,000
Other Assets	20,000	Equity	19,000
Total	$ 70,000		$ 70,000

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COST/ASSET APPROACH METHODOLOGIES

- ***Excess Earnings Method***
  - Hybrid of Asset Approach and Income Approach promulgated by the IRS
  - Also referred to as "Treasury Method," "Formula Method," or "Excess Cash Flow Method"

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COST/ASSET APPROACH METHODOLOGIES

- ***Application of the Excess Earnings Method***
  - Determine fair market value of each tangible asset, then add values of assets and "net" against liabilities
  - Determine total normalized earnings applicable to all invested capital
  - Determine rate of return required for investment in tangible assets, and apply appropriate portion of normalized earnings to net tangible asset value

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COST/ASSET APPROACH METHODOLOGIES

- ***Application of the Excess Earnings Method***
  - Determine the portion of total normalized earnings in excess of earnings serving as return on tangible assets; "excess" earnings are attributed to intangible assets
  - Capitalize excess earnings under a normal capitalized earnings method to produce fair market value of the intangible assets
  - Add fair market value of intangible assets to the fair market value of tangible assets resulting in fair market value of all invested capital

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COST/ASSET APPROACH METHODOLOGIES

- ***Application of the Excess Earnings Method***
  - Subtract long-term debt from the fair market value of all invested capital to provide fair market value of equity capital
  - Adjust value for control and marketability discounts, if any are applied

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COST/ASSET APPROACH METHODOLOGIES

- ***Excess Earnings Method Example***

Net tangible asset value (fair market value less operating liabilities)	$ 10,000,000	
Total normalized earnings	3,000,000	
Rate of return – tangible assets – 12%		
Normalized earnings to tangible assets (12% x $10,000,000)	(1,200,000)	
Excess normalized earnings		
Attributable to intangible assets	1,800,000	
Capitalization rate for intangible assets	30%	
Fair market value of intangible assets	6,000,000	
Fair market value of tangible assets (from above)	10,000,000	
Fair market value of invested capital	16,000,000	
Less: Long-term debt (assumed)	(12,000,000)	
Fair market value of equity capital	$ 4,000,000	*on a control, marketable basis

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TANGIBLE ASSET APPRAISALS

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TANGIBLE ASSET APPRAISALS

- ***Typically, separate appraisers are used to determine value of real property and personal property***
- ***Business valuator assembles the value of tangible assets and adds them to the value he/she determines for intangible assets to conclude on the overall business value***
  - Tangible Assets + Intangible Assets = Overall Business Value

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TANGIBLE ASSET APPRAISALS – REAL ESTATE

- ***Types of Interests***
  - Fee simple estate
  - Leased fee estate
  - Leasehold estate

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TANGIBLE ASSET APPRAISALS – REAL ESTATE

- ***Standard of Value***
  - Market value
  - Value-in-use
  - Investment value
  - Going concern value
  - Insurable value
  - Liquidation value

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TANGIBLE ASSET APPRAISALS – REAL ESTATE

- ***Highest and Best Use***
  - Determine all legally-permissible uses
  - Determine which of these are physically possible
  - Determine which of these are financially feasible
  - Determine which of these produces the maximum profits for the site

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TANGIBLE ASSET APPRAISALS – REAL ESTATE

- ***Approaches to Value***
  - <u>Cost approach</u> – sum of land value at its highest and best use and value of improvements, less depreciation
  - <u>Market (sales comparison) approach</u> – assumes that a prudent buyer will pay no more than the cost to purchase a comparable property
  - <u>Income (income capitalization) approach</u> – capitalizes or discounts an income stream to produce a value

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TANGIBLE ASSET APPRAISALS – M&E

- ***Not as location-specific as real estate***
- ***Appraisers frequently have niche expertise***
- ***Performed for a number of purposes***

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TANGIBLE ASSET APPRAISALS – M&E

- ***Standard of Value***
  - Fair market value
  - Fair market value – removal
  - Fair market value in continued use
  - Fair market value – installed

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TANGIBLE ASSET APPRAISALS – M&E

- ***Premise of Value***
  - Orderly liquidation value
  - Forced liquidation value

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TANGIBLE ASSET APPRAISALS – M&E

- ***Approaches to Value***
  - Cost approach – appraiser computes "reproduction cost new" or "replacement cost new"
  - Market (sales comparison) approach – appraiser analyzes recent sales and current offerings, and considers depreciation and other allowances
  - Income approach – appraiser uses direct capitalization and discounted future cash flow methods

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TANGIBLE ASSET APPRAISALS

- ***Concluding Thoughts***
  - Credentialed appraisers are important
  - Appraisers will adhere to standards related to due care, development and reporting

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BUILT-IN-GAINS TAX

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BUILT-IN-GAINS TAX

- ***Problem for C corporations***
- ***Willing buyer likely to alter offer price due to tax liability associated with appreciated assets***
- ***Issue was historically debated in the courts in estate and gift tax cases***
- ***General Utilities Doctrine revoked – tax liability upon liquidation is not necessarily speculative***
- ***Most valuators consider the impact of capital gains tax as a dollar-for-dollar reduction in value or incorporated in a discount***

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Basics of the Cost/Asset Approach & Current Perspectives

BUILT-IN-GAINS TAX

- ***Relevant Cases***
  - Estate of Jelke v. Commissioner (2005)
  - Estate of Dunn v. Commissioner (2002)
  - Eisenberg v. Commissioner (1998)
  - Dawkins v. Hickman Family Corp. (2011)
  - Estate of Jones v. Commissioner (2001)
  - Estate of Welch v. Commissioner (1998)
  - Estate of Davis v. Commissioner (1998)
  - Estate of Borgatello v. Commissioner (2000)
  - Estate of Richmond v. Commissioner (2014)
  - Estate of Dailey v. Commissioner (2001)

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PROPRIETY OF DISCOUNTS

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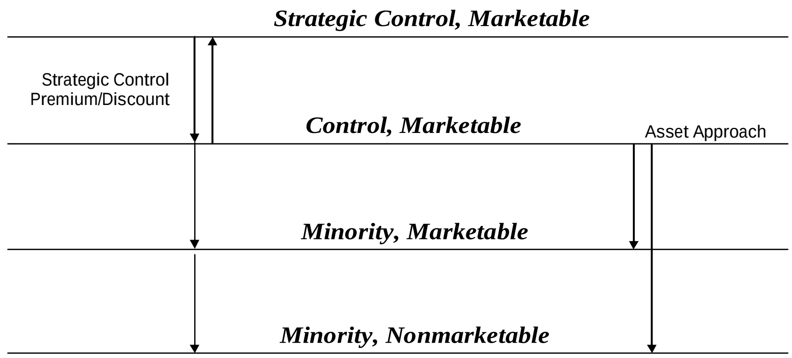
PROPRIETY OF DISCOUNTS

- ***Values obtained under the Asset Approach generally held to be control interest values***
- ***Is it appropriate to use the approach to value a non-controlling or minority interest?***
  - Professional standards require consideration
  - Often no better alternative is available

Basics of the Cost/Asset Approach & Current Perspectives

PROPRIETY OF DISCOUNTS

- ***Levels of Value***



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PROPRIETY OF DISCOUNTS

- ***Values obtained under the Asset Approach generally deemed to be marketable values***
  - Appropriate discounts must be considered and applied
  - Be careful not to “double dip”
  - Specific data source used to determine discounts is dictated by underlying class of assets held by entity

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PROPRIETY OF DISCOUNTS

- ***Closed-end fund data***
  - Used for entities holding marketable securities
  - Ownership interests in closed-end funds have control restrictions similar to fractional interests in FLPs
  - Databases allow valuator to search using various criteria to closely match comparables
  - Provides discounts for lack of control only

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PROPRIETY OF DISCOUNTS

- ***RELP transaction data***
  - Used for holders of fractional interests in FLPs holding real estate
  - Most widely-used source is annual study published by Partnership Profiles, Inc.

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PROPRIETY OF DISCOUNTS

- ***RELP transaction data***
  - For discount to be relevant, two elements must apply:
    - Interest being valued is non-controlling
    - Interest being valued must have marketability issues
  - Data can be searched using various criteria
  - Provides discounts for both lack of control and lack of marketability

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PROPRIETY OF DISCOUNTS

- ***Example – FLP Reconciliation of Discounts***
  - Valuation of a fractional interest in an FLP
  - Underlying assets include marketable securities and real estate

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PROPRIETY OF DISCOUNTS

- ***Example – FLP Reconciliation of Discounts***

Asset	Minority	Marketability	Combined	% of Total Assets	Weighted Discount
	----------- DISCOUNTS ------------				
Investments					
Domestic Stock	4.1%	23%	26%	20.0%	5.2%
International Stock	8.2%	23%	29%	10.0%	2.9%
Bonds	3.8%	23%	26%	10.0%	2.6%
Real Estate	*	*	31%	60.0%	18.6%
TOTAL					29.3%

* Partnership Profiles database produces a combined discount

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CURRENT ISSUES

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CURRENT ISSUES

- ***Businesses are succumbing to economic effects of COVID***
  - Businesses closing
    - Liquidation or abandoning assets
  - Temporarily shut down
  - Reduction in capacity
  - Inventory issues

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CURRENT ISSUES

- ***Political Landscape***
  - Election year and changes may impact estate planning
  - Valuations of holding companies and family limited partnerships in particular will be prevalent
    - Asset appraisals and valuation discounts will come into play

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CONCLUSION AND PRACTICAL CONSIDERATIONS

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CONCLUSION AND PRACTICAL CONSIDERATIONS

- ***Key is understanding the basis for setting historical assets and liabilities at their respective fair market values***
- ***Appraisals of tangible assets must match the assignment requirements set by legal counsel***
- ***Engaging outside appraisers involves additional cost, which should be communicated to the client as soon as possible***
- ***If any abuse of assets is suspected, forensic procedures may be necessary, but can be time-consuming and costly***

Basics of the Cost/Asset Approach & Current Perspectives

THANK YOU!