Business Valuation Fundamentals

Estate Planning Council of Stanislaus County, CA.

OCTOBER 25, 2024

MARINER

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A Multidisciplinary Financial Services Firm

At Mariner's inception, there was only one goal. The co-founders simply wanted to build a company they could be proud of while **always putting the client first.** Years later, we have experienced significant growth, but our driving force remains unchanged.

Knowledge & Advice

In today's rapidly changing environment, clients are asking for more. We recognize that an advisor is only as successful as the team and resources they have supporting them. At Mariner, we provide advisors with extensive resources to help them retain their current clients and assist them in growing their business.

Customized Solutions

Mariner has purposefully broadened the menu of services it offers to clients through the addition of professionals who provide:

- Estate planning and trust services
- Tax planning and preparation
- Retirement plan/401(k) services
- Investment banking and valuation advisory
- Insurance solutions

We live by our purpose: Positively impact the lives of many.

Mariner Valuation

- Our professionals are senior members of the American Society of Appraisers and have valued over 800 companies across a wide range of industries and growth stages.
- We seek to deliver the same high-quality work as larger valuation firms while providing a level of personal service.
- We believe our valuations are enhanced by our group's M&A transaction advisory experience, to provide "real world" knowledge on how buyers and sellers assess key value drivers and risks.

John Stevenson, ASA

Valuation Director

Role at Mariner

John leads our valuation advisory practice and is primarily responsible for overseeing and assisting in the preparation of valuation reports for a variety of purposes.

Advisory Experience

John has overseen and completed more than 800 valuation engagements regarding mergers and acquisitions, gift and estate tax planning, equity incentives, strategic planning, buy-sell agreements and financial reporting. Prior to joining Mariner, John served as valuation director for BDO. Prior to that, John held the same position at RSM McGladrey. He also has experience with two investment banks focused on business valuation, fairness opinions and M&A transactions.

Education and Credentials

- Bachelor's degree in business administration (finance concentration) and economics from Iowa State University
- Senior Accredited Appraiser in Business Enterprise Valuation with the American Society of Appraisers

Jason O'Bryon, ASA

Vice President

Role at Mariner

Jason is a lead analyst on valuation engagements, providing oversight of our valuation practice. This includes client onboarding, project management, financial modeling strategy, and review of valuation deliverables.

Advisory Experience

Jason has more than 100 valuation engagements regarding mergers and acquisitions, gift and estate tax planning, charitable giving, strategic planning, buy-sell agreements and financial reporting. Prior to joining Mariner, Jason obtained experience in the mutual fund industry in operations and project planning roles.

Education and Credentials

- Senior Accredited Appraiser in Business Enterprise Valuation with the American Society of Appraisers
- Master's degree in finance from the University of Missouri – Kansas City
- Bachelor's degrees in finance and management & leadership
- Minor in economics and concentrations in human resources as well as international business from the University of Kansas

Key Elements of the Process

- Understand the business, industry, and the economic environment
  - An objective assessment of the company's prospects and risks is critical
- Forecast company performance
  - Need to develop the expected case projection
- Select and implement the appropriate approaches
  - Need to use at least two methods
- Determine the final value
  - Perform a reasonableness test
- Apply minority and marketability discounts as may be required
  - Avoid double counting for risks that are already reflected in the pre-discounted value

Reasons for a Private Company Valuation

Transactions

- Sale/merger of a business
- Acquisition of a business
- Minority shareholder buyout
- ESOP
- Equity financing

Tax Reporting

- Gift and estate tax
- Charitable donations
- Employee stock options and equity awards (IRC Section 409A)
- Holding company discount studies

Financial Reporting

- Purchase price allocations
- Goodwill impairment testing
- Private equity investments

Litigation Support

- Shareholder disputes
- Marital dissolution
- Lost profits

Standards of Value

- Most valuations use fair market value (IRS Revenue Ruling 59-60) as the standard of value:
  - The amount at which the property would change hands between a willing buyer and 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.
  - Assumes a hypothetical willing buyer and willing seller, rather than any particular buyer and seller
  - Assumes an arm’s length transaction
- Investment Value
  - The value to a specific investor, based on their particular investment requirements. This differs from Fair Market Value due to differences in estimates of future earnings power, perceptions of risk, and synergies available to a particular buyer
- Fair value
  - GAAP definition for financial reporting is virtually identical to fair market value
    - The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
  - Dissenting Shareholder Appraisal Rights

Valuation Methods

Income Approach

- The value of a business is equal to the sum of the present value of its future benefits
- Valuation methodologies are Discounted Cash Flow and Capitalization of Earnings

Market Approach

- The value of a business interest is equal to the value of a similar business or security
- Valuation methodologies are Guideline Public Companies and Guideline M&A Transactions
- Recent transactions in the company's securities may also provide a reliable value indication

Cost Approach

- The value of a business equals the fair market value (FMV) of its assets, less the FMV of its liabilities including contingent liabilities
- This approach is normally used for holding companies or to value non-operating assets

Income Approach

Discounted Cash Flow

- Equals the present value of cash flow during the forecast period plus the present value of the terminal value
- Requires financial projections to the point when the company is expected to reach a steady state (maturity)
  - The period could be as short as a few years or up to 10 years (emerging tech company)
  - Management normally only prepares a one-year budget, although projections covering several years will be available if required by a lender or if management undertakes a strategic planning review
  - Management will need to extrapolate projection assumptions to maturity
    - Revenue growth
    - Operating profit margin
    - Capital expenditures

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Income Approach

Discounted Cash Flow

- The terminal value is based on the perpetuity growth rate method or exit multiple method
    - The perpetuity growth rate method assumes annual cash flow grows at a constant rate and is the more common method.
    - The exit multiple method relies on multiples of similar public companies or M&A transactions and is applied to the final forecast year (typically, to EBITDA) and assumes a sale of the entity
- Debt-free cash flow is defined as:
    - Net operating profit after-tax (NOPAT – removes interest expense)
    - Less capital expenditures
    - Plus deprecation & amortization expense
    - Less net working capital increases (plus decreases)
- Produces enterprise value:
    - Enterprise value is the value of the entity on a debt-free and cash-free basis
    - Debt is subtracted and cash is added to derive equity value

Income Approach

Capitalized Cash Flow

- Used for mature companies and when current results represent sustainable profits
- No extraordinary capital expenditures are required
- Divide a single year's debt-free cash flow by the capitalization rate which equals the discount rate minus the long-term perpetuity growth rate of free cash flow
- Produces enterprise value:
    - Enterprise value is the value of the entity on a debt-free and cash-free basis
    - Debt is subtracted and cash is added to derive equity value

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Income Approach

- The discount rate used to present value the cash flow equals the risks inherent in the business and is measured by the weighted average cost of capital (WACC)

- WACC equals the cost of equity and cost of debt weighted in proportion to their use in the capital structure

- Several methods are available for the cost of equity
    - Capital asset pricing model
    - Build-up method
    - VC target rates of return for start-up and early-stage companies (~25% -50%)

- The cost of debt is contractual based on the company's current interest rate for loans.
    - Can check against rates for bonds with various credit ratings by S&P or Moody's

Market Approach

- Common valuation methodologies:
  - Guideline Public Companies
  - Guideline M&A Transactions
  - Prior transactions in the company stock (if recent and arm’s length)
  - Bona fide (formal) offers to purchase the company
- Normalize/recast earnings before interest, taxes, depreciation and amortization (EBITDA)
  - Adjust owner compensation to market value
  - Adjust rent to market value in cases where the business rents property from the owner
  - Non-discretionary, one-time expenses such as legal costs from the settlement of a lawsuit
  - Discretionary, a large special bonus to shareholders over and above the normal bonus payouts

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Market Approach

- Determine a valuation multiple by reviewing multiples paid in transactions of similar companies and/or comparable publicly traded companies
- Multiple selection is supported with financial and qualitative comparisons to similar companies. Key factors include:
  - Revenue size
  - Growth rates
  - Profit margins
  - Variability of earnings
  - Liquidity
  - Financial leverage
  - Customer, product and/or geographic diversification
  - Intellectual property rights
  - Management depth

Market Approach

- Multiple can be on an enterprise value (invested capital) or equity value basis
- Enterprise value basis
  - Revenue
  - EBITDA
  - EBIT
    - Enterprise value is the value of the entity on a debt-free and cash-free basis
    - Debt is subtracted and cash is added to derive equity value
- Equity value basis
  - Pretax or after-tax income
  - Cash flow
  - Net book value (relevant for banks and insurance companies)
- Multiples can be applied to historical averages, current (LFY or TTM) results, and/or forecasts (one year or two years out)
  - For highly cyclical companies, examine long-term averages to gauge mid-cycle revenue and earnings

Market Approach

Differences between publicly traded companies and M&A transactions

- Public companies produce a minority interest value, and M&A transactions produce a control value
    - Examine the specific circumstances surrounding each M&A transaction for comparability/uniqueness
- Public company values are always contemporaneous with the valuation date, but M&A transactions are often dated
    - For mature and stable industries, dated M&A transactions are less of a concern (e.g., food manufacturers)
- Public company data is more transparent than M&A transaction data which is usually limited to historical data
    - In an M&A transaction, the buyer and seller rely, to some degree, on projected information which is often undisclosed

Cost Approach

- The value of a business is worth the fair market value of its assets less the fair market value of its liabilities
- Ignores inseparable intangible assets such as goodwill
- Common valuation methodologies:
    - Net Asset Value
    - Liquidation Value
- Applicable for asset intensive firms with low profits or firms with losses
- Applicable for companies holding real estate or investments

Discounts

Minority and Non-Marketable Interests

- Discount for Lack of Control (DLOC)
  - Minority interests are inherently worth less than an interest representing corporate control
  - The DLOC typically ranges from 5%-15%
- Discount for Lack of Marketability (DLOM)
  - Minority investors in closely-held companies do not have a market to easily sell their interests, as do public company shareholders, which creates higher risk
  - The DLOM range can be wide depending on the specific characteristics of the company and the interest being valued but is commonly 15%-35% (a put option will lower the DLOM significantly)
- Establish the level of value before applying a DLOC or DLOM
  - The DLOC and DLOM are applied to the control level of value assuming marketability
  - Control value reflects maximum cash flows including add-backs of discretionary expenses and the optimal capital structure (produces the lowest WACC)

Discounts - DLOC

- Price discounts from net asset value (NAV) for closed-end funds serve as a proxy for minority discounts and may be adjusted up or down depending on the circumstances of the company
    - Long-term average is around 10%
    - Consider the distribution of ownership; is there a single control owner (over 50.01% or over 67.0%)?
- The inverse of public company control premiums provides a DLOC but includes synergy values which are difficult to back out
    - Financial buyer (PE) transactions include a control premium but may not have a premium for synergy values (unlike strategic buyers)
- Consider whether the majority shareholder is benefiting from control at the expense of minority holders
    - Level of discretionary expenses, if any
    - What has been the level of distributions?
    - Is the firm well managed?
- In PE-financed companies, SEC and IRS feedback states that minority discounts should be quantified based on any divergence in cash flows between controlling (PE) and minority (management) holders
    - May not be justified if all shareholders are aligned (maximizing profits), thus minority shareholders would operate the company in a similar manner

Restricted Stock Discount Studies - DLOM

- Public company-restricted stock transactions are prohibited from trading for a period of time, although in some cases, registration rights are attached
  - As the SEC restriction period declined; average discounts decreased
  - Transactions without registration rights tend to have higher discounts
- This lack of marketability detracts from value relative to the freely traded stock
  - Inability to control the timing of potential gains and to avoid losses (noted in Revenue Ruling 77-287)
  - Creates higher risk over the restriction period
- Requires specific comparative analysis with the subject company rather than the use of averages or medians from the studies
  - Block size and volatility are key correlative measures
  - Privately held company stock often has a holding period longer than the restriction period for companies in the studies (> two years)

Pre-IPO Discount Studies - DLOM

- Discount of the stock price from the IPO price 12 months (or less) before the IPO
  - Most transactions are in preferred stock or common stock options (with strike price set to appraised FMV) rather than direct purchases of common stock
  - The IPO price is not known at the time of the transaction
  - It may be difficult to isolate the value of marketability from other factors that increase a company's value during the period leading to the IPO
    - Milestones achieved and the likelihood of the cash infusion from the IPO
- Some tax court cases have been critical of the method

Put Option Method - DLOM

- A put option provides a hedge against stock price declines in underlying equities (cost of insurance). This cost of insurance is used as a proxy for the DLOM
- Chaffe European Put Option Model uses Black Sholes to calculate a theoretical put option price for a closely held stock
- The Finnerty Average-Strike Put Option Model assumes the investor would, in the absence of any transfer restrictions, be equally likely to sell the shares any time during the restriction period
- Commonly used under Fair Value (GAAP) in allocating the equity value among differing classes of ownership (PE-backed firm)

Qualified Appraisal

IRS Appraisal Requirements

- Valuation by a qualified appraiser is required for closely-held gifts over $10,000
- Penalty for noncompliance with rules is complete disallowance of charitable deduction
  - Appraisal must be no earlier than 60 days before the gift date and completed by tax return filing
  - Should follow Uniform Standards of Professional Appraisal Practice (USPAP)
  - Adhere to the Business Valuation Standards of the American Society of Appraisers (ASA) or the AICPA Statements on Standards for Valuation Services
- Qualified appraiser
  - Appraisal designation (ASA or ABV) or minimum education standard
  - Regularly performs appraisals for which the individual receives compensation

The Appraisal Process

Mariner Responsibility | Client Responsibility

Pre-Engagement

AS REQUIRED

Pre-Engagement

Mariner and Client identify the purpose, valuation date, level of ownership, etc.

Mariner Responsibility:
- Provide fixed fee quote and engagement letter
- Provide document request list

Client Responsibility:
- Sign Engagement Letter
- Provide requested documents

Analysis and Application of Methods

2 WEEKS

Diligence

Mariner Responsibility:
- Prepare valuation model and report
- Organize and review documents
- Enter financial data into valuation model
- Conduct preliminary financial analysis
- Prepare and send the management discussion agenda

Client Responsibility:
- Participate in management discussion

Valuation Modeling

Mariner Responsibility:
- Company analysis
- Financial analysis
- Valuation analysis
- Industry analysis
- Discount analysis
- Peer review and senior review of inputs and assumptions

Deliverable Reviews and Completion

4 WEEKS

Present Exhibits

Mariner Responsibility:
- Prepare draft exhibits and send to Client
- Discuss valuation results with Client including key assumptions and value drivers

Client Responsibility:
- Review draft exhibits
- Participate in valuation review discussion

Deliver Report

Mariner Responsibility:
- Prepare draft valuation report
- Peer review and senior review of draft report
- Deliver draft report to Client for review
- Finalize report

Client Responsibility:
- Review draft report and provide comments

For illustrative purposes only, the actual timeline and process may vary.

Closing Thoughts

- Valuation conclusions rely on many assumptions and parameters, some of which are subjective and can be a source of variations in value, especially for high-growth companies

- The challenge for valuation professionals is to establish assumptions that are supported by market data, company-specific information, industry information, and assertions of company management

- Valuations may rely on many different pieces of information, some of which may be inconsistent with each other – valuation professionals need to carefully mine through the information, documenting what was relied upon and why

Questions

Disclosures

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