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Private Business Appraisal as Viewed through *Value Worlds*

Rob Slee, CBA, CPIM, MA, MBA

Professional business appraisers spend most of their time deriving fair market values of private business interests. This is understandable since fair market value is the most developed standard of value in the literature, the tax code and the courts. Fair market value is often the default standard, and is routinely employed for deriving value in a variety of scenarios, such as the value of a company to be sold, or the value of a business interest in an insurable setting. It is surprising to many business owners and others outside of the appraisal community that a notional, hypothetical standard such as fair market value is so widely used to value actual interests. Rather than proposing to further stretch fair market value into a one-size-fits-all standard, this article shows that the universe of private business appraisal is quite large and can be structured in a useful manner.

Private securities do not enjoy access to an active trading market and, therefore, must rely on point-in-time appraisal or transactional pricing for value to be determined. This means that either a private valuation must be undertaken, or a transaction must occur to determine the value of a private security *for some purpose at some point-in-time*. Purpose is defined as the intention of the involved party as to why a valuation is needed. Purpose leads to the function of an appraisal. Function is described as the specific use of an appraisal. The function of a valuation requires the use of specific methods or processes, each of which can derive dramatically different value conclusions. As a helpful construct, the purposes for undertaking an appraisal are referred to herein as giving rise to *Value Worlds*. Thus, the Value Worlds Theory of Private Business Appraisal is:

A Private Business Value is Relative to the Value World in which it is Viewed

Every private company, therefore, has a number of different values at the same time, depending on the purpose *and* function of the valuation. The purpose of the appraisal governs the selection of a Value World. Each Value World follows a defined process to determine value under specific rules, based on the function of the appraisal. Each Value World may have multiple functions. Each world also has an Authority, which is the agent or agents that govern the world. The Authority decides whether the intentions of the involved party are acceptable for use in that world, as well as prescribes the methods used in that world.

Sanctioning is the gatekeeping power of the Authority to regulate access to the world. If the intention of the involved party, which leads to a purpose, does not meet the access criteria of an Authority, the purpose will not be accepted. For example, an owner who pursues value in the Owner Value World may not access the World of Collateral Value. The latter world operates under a different set of valuation rules and will not recognize the owner's treatment of value.

Examples of Authority are found in each appraisal world. For instance, the Financial Accounting Standards Board is the Authority in the World of Impaired Goodwill. The FASB is responsible for developing the criteria, and administering methodology used to derive value and

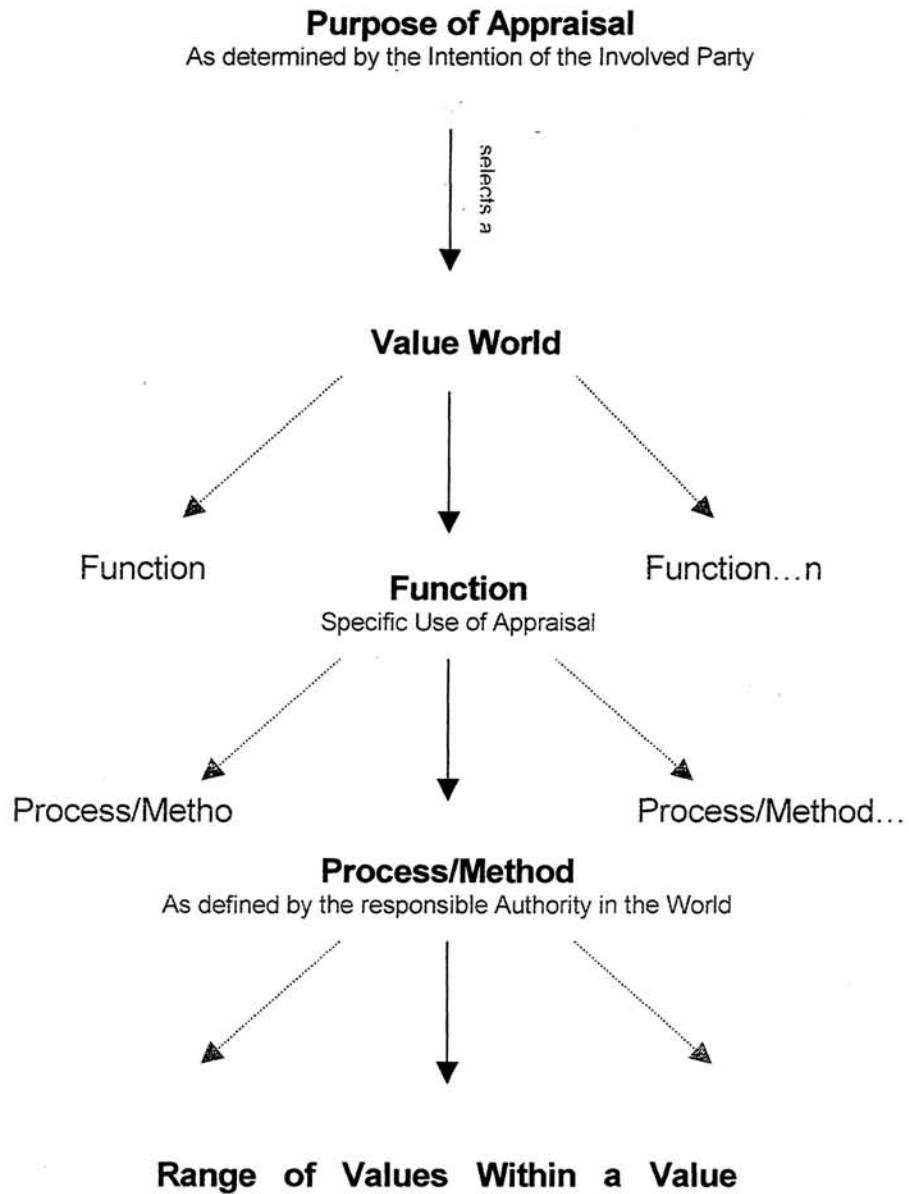
sanctioning non-compliance.

Another example involves the World of Owner Value. The owner of the subject company is the Authority in this world since he/she governs both the rules within the world and methodology used to derive value. However, for these to have meaning outside the owner's view they must be expressed in communally shared methods and standards. The Owner can sanction non-compliant behavior by not selling, not allowing investment in the business or not accepting an outsider's view of value. However, for an Authority to be effective, it must be widely recognized and accepted.

By understanding the logic, the definitions of process, and the treatment of fact within each world, it becomes clear that private valuation is only possible within a set of parameters - a Value World.

The conceptual hierarchy, graphically depicted in the Private Valuation Conceptual Linkage chart below, demonstrates the logical flow of decision making for an appraiser as the thought process moves from the more general to the specific.

Private Valuation Conceptual Linkage



Value Worlds as Possible Worlds

To understand the concept of Value Worlds it may be instructive to consider the discussion of “Possible Worlds” that philosophers have been engaged in for decades. The discussion can be traced back to Bertrand Russell and Alfred North Whitehead in their “*Principia Mathematica*,” where they argued that all of mathematics could be reduced to the logic of set theory.¹ Set theory is a way of organizing the primary concepts of a discipline. A similar concept was developed by Thomas Kuhn in his landmark book ‘*The Structure of Scientific Revolutions*.’² He is the fellow who coined the overused phrase “paradigm shift.” Broadly speaking, it is the notion that the world can be seen through a structured prism of preconceived ideas, language and logic. A paradigm is a set of embodied experiences. A possible world then is a logically consistent way of viewing and explaining the world.

More recently the philosophical discussion centers around “Structured Propositions” which encapsulate a set of complex entities bound together in identifiable ways. Structured propositions perform a number of functions in addition to being the primary bearers of truth, falsity and meaning. They are coherent arguments, expressed in a consistent language that excludes non-conforming language, logic and fact. A primary goal of each of these arguments is to root out the fallacy of including language, factual interpretations or conclusions from one world in another, without careful thought as whether they are mutually exclusive.

The concept of “Value Worlds” used here has the earmarks of what philosophers call a “Possible World.” Each Value World is a coherent construct that purports to describe a possible world. Possible Worlds are not metaphysical speculations of little green men; rather, they are discussions of the language, truth and logic of explanations. Here are a few questions to guide the discussion of Value Worlds taken loosely from discussions of Possible Worlds.

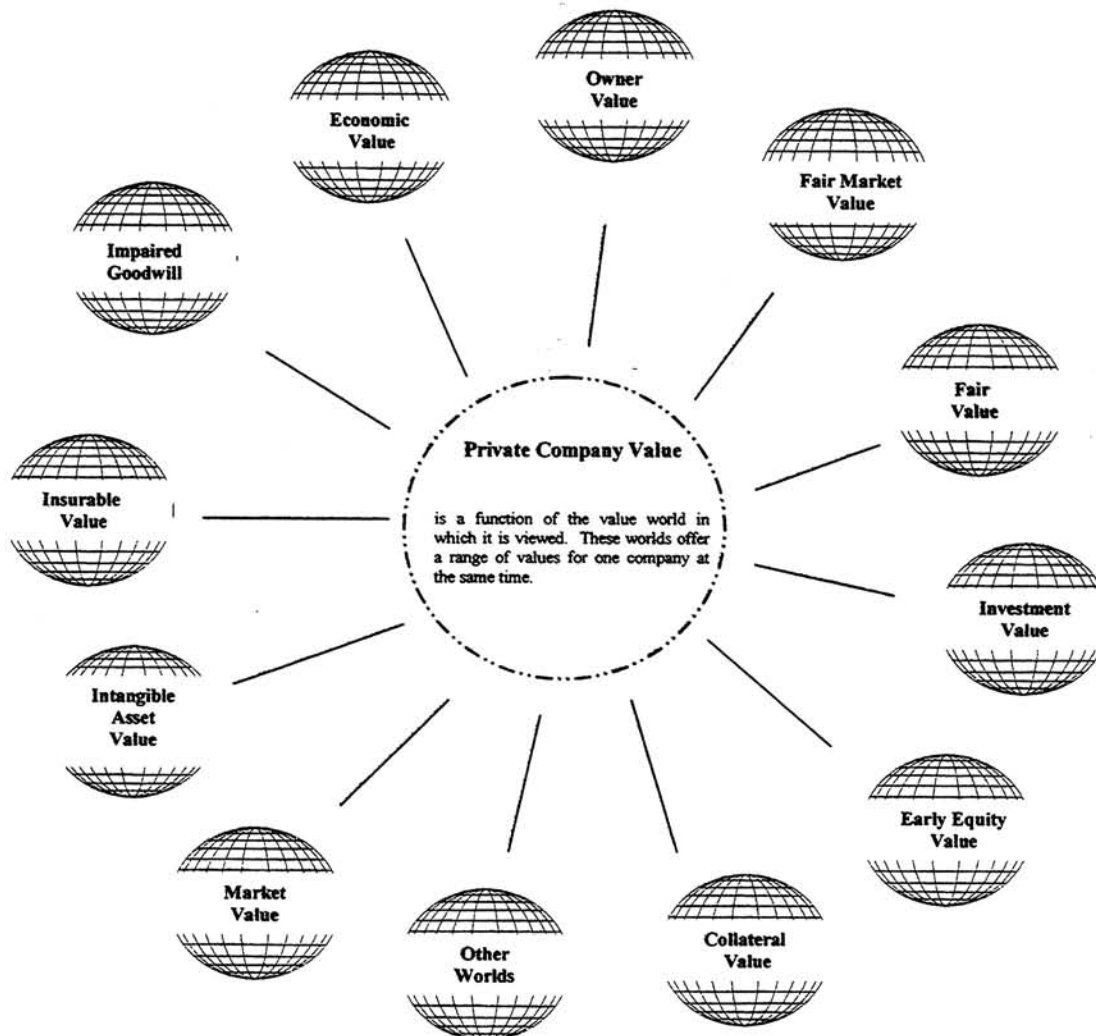
Value Worlds/Possible Worlds Criteria

1. What is the nature of the authority that governs the world?
2. Are there prescribed, or proscribed, standards of practice in the world?
3. Is there a separate lexicon and logic in the world?
4. Are there similar terms that carry different meanings in different worlds?
5. To what extent does choosing the world also choose the outcome?
6. To what extent are the worlds mutually exclusive?

A Value World then is like a Possible World or a Structured Logical Proposition. There is an authority that governs it, a language, logic and meaning that provide structure. Attempts to combine arguments, facts or conclusions from one Value World with another are risky at best. Such attempts are like playing the parlor game “Twister,” which will shortly have one doubled-back and entangled in an embarrassing manner.

Private Business Appraisal as Viewed through *Value Worlds*

The Value Worlds



The Value Worlds

The Value Worlds Concept Chart below illustrates several of the Value Worlds, in terms of purposes, functions and Authorities within the worlds. While this list is not exhaustive, it indicates a universe of appraisal possibilities currently beyond the scope of most appraisers.

If the purpose of an appraisal involves finding the highest value of a business interest in the open market, the **World of Market Value** dictates the processes used to derive value. Every private company has at least three market values at the same time. Each market value alternative, called a Sub World, represents the most likely selling price based on the most likely *Buyer type*. The Sub Worlds are: Asset, Financial, and Synergy.

The Asset Sub World reflects what the subject would be worth if the most likely selling price is based on net asset value, because the most likely buyer is not basing the purchase on the subject's earnings stream but rather the subject's assets. In the Asset Sub World the buyer is not giving credit to the Seller for goodwill beyond the possible write-up of the assets; that is, no value for the operations of the subject. For our purposes here, goodwill is the intangible asset that arises as a result of name, reputation, customer patronage and similar factors that result in some economic benefit that a buyer is willing to pay for beyond the subject's asset value.

The Financial Sub World reflects what an individual or non-strategic buyer would pay for the going concern enterprise, inclusive of goodwill. A financial buyer in the Financial Sub World must structure a deal using only the subject's income statement and balance sheet. Since the buyer brings no synergies to the deal, the deal itself must supply the earnings and the collateral that will enable the transaction to get financed. This effectively creates a boundary around the valuation, i.e., there is a definable limit to how much a financial buyer can pay for a business based on a capitalizing or discounting a Recast EBIT stream by an appropriate return expectation. The subject company itself provides much of the information used to create this boundary.

The Synergy Sub World is the market value of the subject when synergies from a possible acquisition are considered. Synergy is the increase in performance of the combined firm over what the two firms are already expected to accomplish as independent companies. The Synergy Sub World is mainly concerned with strategic or synergistic combinations, such as horizontal and vertical integrations, or any other combination where the acquirer can leverage the subject's capabilities.

Synergies can result from a variety of acquisition scenarios. Perhaps the most quantifiable group of synergies emanate from horizontal integrations. A horizontal integrator can realize substantial synergies by cutting duplicate overhead and other expenses. Some of these savings *may* be shared with the seller. Vertical integrations also can create substantial synergies. These tend to be strategic, in that the target helps the acquirer achieve some business goal. Synergies also can result from the different financial structures of the parties. For instance, the target may realize interest expense savings due to adopting the cheaper borrowing costs of the acquirer.

Value is determined in this Sub World by capitalizing or discounting a synergized benefit stream at an appropriate rate of return expectation. The Synergy Sub World Stream includes Recast EBIT plus the amount of enjoyed synergies by the subject. The amount of enjoyed synergies means the estimated synergies that are credited to, or kept by, a party in a deal. The total expected synergies with a deal must first be forecast. Then the enjoyed synergies must be negotiated between the parties. The party most responsible for creating the synergies is usually the buyer. Buyers will not readily give these synergies away, since the realization of the synergies happens while they own the business. A high level of realism is necessary when quantifying the enjoyed synergies.

If the purpose for the appraisal involves most tax and many legal matters, the **World of Fair Market Value** is in control. The process used in this world is quite systematic and follows the dictates of Revenue Ruling 59-60, which lists a number of items to consider when valuing a business interest in this world.

If the purpose for the appraisal involves legal matters, one of the other worlds *may* come into play. The choice of the appropriate world will normally be provided by the lawyers or courts, although it is surprising how much uncertainty remains in this area.

Some legal appraisal purposes may occupy several value worlds. For example, divorce appraisal is driven by the legal jurisdiction of the filing. Unfortunately, states do not always provide sufficient guidelines for valuation. In North Carolina, for instance, the statutes do not define and require a particular standard of value for divorce valuations. Nor is there a Court of Appeals case in North Carolina where the different standards have been specifically put before the Court for its consideration.³ This condition exists in other states.

Appraisal Definitions

Value World: A Value World is a valuation construct that enables a private business value to be derived in a relevant setting that is relative to the purpose and function of its appraisal.

Purpose: The intention of the involved party as to why a valuation is needed. The Authority in the Value World decides if the intention is acceptable in that World.

Function: The specific use of an appraisal, which leads directly to the choice of appropriate methods to employ.

Authority: Authority refers to that agent or agency with primary responsibility to develop, adopt, promulgate and administer standards of practice within that world. Authority decides which purposes are acceptable in its World, sanctions its decisions, develops methodology, and provides a coherent set of rules for participants to follow.

Private Business Appraisal as Viewed through *Value Worlds*

| The Value Worlds Concept Chart | | | |
|--|--------------------|---|---------------------------------------|
| Appraisal Purpose | Value World | Appraisal Functions | Responsible Authority |
| To find the highest value in the open market | Market value | Sale of a minority or control interest, to support a merger | Financial intermediaries |
| To find a value for tax matters and for some legal reasons | Fair market value | Federal estate and gift taxes, ESOP's, charitable contributions | Federal law, Administrative rulings |
| Shareholder actions | Fair Value | To support a minority dissent, or oppression claim | Statutory law |
| Shareholder wealth measurement | Economic Value | To create/measure management bonus plans, company performance measurement, capital allocation systems | The management consulting industry |
| To determine insurance coverage | Insurable value | To fund buy/sell agreements, business interruption claims | Insurance industry |
| To follow FASB No. 142 | Impaired goodwill | To determine impaired goodwill | FASB |
| To value intangible assets | Intangible asset | To value intellectual property, such as patents and copyrights, or to value intellectual capital | Intangible asset laws (patents, etc.) |
| To value the business from one investor's perspective | Investment value | Value specific to one investor, probably for purchase/investment | The investor |
| To value the business from an owner's perspective | Owner value | Value specific to owner, probably for sale | The owner |
| To determine borrowing capacity of the business | Collateral value | To obtain a secured loan | Secured lending industry |
| Start-up investment | Early equity value | To derive the value of a start-up to determine equity splits | Venture capitalists |

The World of Fair Value can be entered in one of two ways. Minority shareholders who believe that the majority shareholders have taken corporate actions that negatively affect them are called *dissenters*. Examples of corporate actions include merging or selling the assets of the corporation, or changing key tenets of the corporate bylaws. Every state has dissenter's rights statutes that serve to protect the minority, typically through the purchase of the dissenter's stock at fair value, called the *appraisal remedy*.

Oppression is a legal term that basically means the minority shareholder's reasonable expectations have not been met. Oppressed shareholders' statutes or dissolution statutes are meant to protect minority shareholders for oppressive action, fraud and mismanagement by the majority. Oppression covers actions taken against a minority shareholder in his capacity as an employee, officer, director or shareholder. If a minority holder proves to a court that he has been oppressed, the holder will receive *fair value* for his shares, which normally means he will receive the pro rata share of the enterprise value, without any minority interest discount or lack of marketability discount.

The **World of Economic Value** helps owners measure and manage the economic value of their firms. Economic value is defined as generating revenues beyond the corresponding economic costs. Economic costs include the opportunity cost of all employed capital. Thus, eco-

conomic value is a measurement by which economic income exceeds, or falls short of, the required minimum rate of return that shareholders and lenders could get by investing in other securities of comparable risk.

Further information on this world is provided in the "Summarized Valuation Process" chart below.

The **World of Insurable Value** considers the value of a business or business interest to be covered by insurance. There are a variety of circumstances where business insurance is required, and like the previous valuation worlds, within the insurable world, a business or business interest should be valued using a process that is specific to this world. By understanding how insurable value is determined and influenced, owners should be better prepared to purchase appropriate amounts of insurance to protect their business. Although there are numerous instances that require valuation for insurance purposes, several of the more important areas are: 1) to derive the value needed to fund Buy/Sell Agreements, 2) to determine the proper amount of Key Person insurance, 3) to value a claim in Business Interruption cases.

The **World of Impaired Goodwill** refers to the Financial Accounting Standards Board Statement No. 142, which describes the new accounting treatment of goodwill and other intangible assets. As opposed to amortizing goodwill over 40 years, the new rule does not allow for goodwill amortization. Rather, for just about every company that has engaged in business combinations in the United States, FASB requires an annual test for goodwill impairment, which basically means that if goodwill carried on the balance sheet is more than its current "fair value," the difference must be written off. Public *and* nonpublic companies are required to complete the impairment test each year, which means this Value World is going to be extremely active in the foreseeable future.

The **World of Intangible Assets** describes the value of all elements of a business enterprise that exist beyond its monetary and tangible assets. The World of Intangible Asset Value can be conveniently divided into two Sub Worlds. The first is the more traditional valuation of intellectual property. The second, more recent and more intangible than the first, is known as intellectual capital. The two areas differ from each other in a number of significant ways. Due to the increasing usage of intangible assets in American companies, this world is expected to become more prevalent in the coming years.

The **World of Investment Value** describes the value of a business interest to a particular investor, given a set of specific investment criteria. This world may appear similar to market value, in that it is possible for the two worlds to derive the same value for an interest. Upon further consideration, however, the worlds are quite different. Market value measures the highest value available in the market, based on likely investor profiles; whereas, investment value derives the value to a particular investor, based on this investor's benefit stream and specific return expectation.

The **World of Owner Value** is the value of a business or business interest to the current owner. Owners tend to over-value their businesses, mainly because they consider all compensation *and* all items that personally benefit them as part of the income stream. Examples of personal items include close business contracts, covered expenses such as insurances and business trips, and possibly even relatives on the payroll. Owners tend to capitalize this liberal benefit stream by a low return expectation, since the owner may view the equity risk as less risky than the market might perceive.

The **World of Collateral Value** measures the amount a creditor would be willing to lend with the subject's assets serving as security for the loan. A company enters the Collateral Value World when it seeks a secured loan, such as a commercial or asset based loan, or if it uses its assets in some financial engineered way, such as a sales-leaseback arrangement.

Finally, the **World of Early Equity** depicts the valuation process for early round investors. This world mainly involves venture capital, but also applies to any other investors in a start-up. Since early investors may not use historical earnings or assets by which to measure the initial value of the investee, the early investor must look forward and *back into* a beginning value. Early investors do this by forecasting a likely terminal value (exit value) and then determining the amount of equity they need to own to meet their return expectations. Investing in this world requires tremendous skill and market knowledge because the investment exit may not occur for 5-7 years.

Occasionally book value is used as a benchmark in a shareholder matter, such as a buy/sell agreement. Book value does not constitute a Value World, however. This is because book value is an accounting term, determined by Generally Accepted Accounting Procedures (GAAP). As an accounting concept, book value is a cost-based concept, and is not meant to represent the 'value' of the assets less liabilities of the subject.

Each appraisal world has a definition of value, an exclusive purpose of the appraisal within the world, and functions, which lead to unique processes to derive value. By way of example, the summarized process for determining economic value is as follows:

Summarized Valuation Process

Definition: Economic value is the result of generating a return in excess of the corresponding cost of capital.

Purpose of Appraisal: To measure the creation or incremental change to economic value in an entity, such as a company, product line or financial management system.

Function of Appraisal: For use in creating management bonus plans, project performance and subsidiary value measurement, as well as capital allocation systems, and business planning.

Responsible Authority: The management consulting industry (the economic valued added concept was originally developed by Stern Stewart & Co.)

Valuation Process Summary: $\text{ModEVA} = \text{Recast EBITDA} - (\text{Cost of Capital} \times \text{Capital Employed})$

Where:

ModEVA equals modified economic value added

Recast EBITDA equals earnings before interest, taxes, depreciation and amortization, recast for owner discretionary expenses and one time company expenses

Cost of Capital equals the subject's weighted average cost of capital (WACC)

Capital Employed equals total liabilities less non-interest bearing liabilities

A positive ModEVA figure means that shareholder value is created by the number of dollars calculated.

This process is different in each Value World and must be followed for a correct economic value determination.

The Value Worlds concept is important for several reasons. First, the range of possible values for a business interest at a *point-in-time* is wide. An interest may be worth nearly nothing in one world, while its value could be tremendous in another. Starting off in the correct world is

Private Business Appraisal as Viewed through *Value Worlds*

paramount to understanding the value proposition. Keeping the worlds separate involves keeping the arguments, logic and facts consistent in that world and separate from the other Value Worlds. For example, the Fair Market Value World rotates with a fairly strict set of assumptions.

Second, with no ready market pricing for their private shares, owners must rely on point-in-time appraisals for most of their valuation decisions. Once the correct Value World is chosen, a replicable valuation process is available. These processes provide relatively accurate answers to difficult questions.

Third, private business appraisal is expansive, with fair market value representing only one world in the valuation universe.

Finally, the Value Worlds may collide, i.e., an Owner may be faced with several decisions at the same time that requires knowledge of the Value Worlds. This "War of the Worlds" is important, mainly because it happens often to unsuspecting business owners. We recently were involved with a client who was unknowingly caught between several Value Worlds. Within the same quarter, the following events occurred. First, the owner of this private company considered gifting all the shares of stock to a charitable remainder trust (Fair Market Value World - company valued at \$6.1 million). Second, the owner created a buy/sell agreement with one of his partners (Insurable Value World - company valued at \$8.5 million). Finally, a competitor offered to acquire the company's shares (Market Value - Synergy Sub World - company valued at \$16.6 million). Each of these values is correct - within their respective worlds!

In the current practice of private business appraisal, many owners are advised to use the same valuation number for all valuation purposes. This advice can be costly to an owner.

The foregoing offers that the intention of the involved party leads to a purpose of an appraisal. Purposes for undertaking an appraisal are referred to herein as giving rise to Value Worlds. The logical construct of a Value World is independent of the experience of individual appraisers and individual assignments. Value then is expressed only in terms consistent with that world. Once the project is located in a Value World, the function of the appraisal governs the choice of appraisal methods. These methods are prescribed by the responsible Authority in each Value World. The choice of appropriate appraisal method ultimately may lead to a point-in-time singular value. Thus, a private business value is relative to the *purpose* and *function* of its appraisal.

Rob Slee, CBA, CPIM, MA, MBA, is an investment banker with Robertson & Foley in Charlotte. His forthcoming book, *The Private Capital Markets*®, describes the foregoing concepts in much greater detail. It will be published in 2004.

Endnotes

1. Whitehead, Russell, Principia Mathematica, Cambridge University Press, 1910.
2. Kuhn, The Structure of Scientific Revolutions, University of Chicago Press, 1970.
3. As reported by Tom Elam, CPA, CBA, in a paper entitled, "The standard of value in North Carolina: How should the business appraiser proceed?," 2002.