INSIGHTS ON VALUATION
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Chris Hamilton
CPA, CFE, CVA, DABFA
Arxis Financial, Inc

2468 Tapo Canyon Road
Simi Valley, CA 93063

Phone: 805.306.7875
Fax: 805.306.7891

chamilton@arxisgroup.com
www.arxisfinancial.com

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The Economy and Its Impact on the Value of a Business

In the midst of the most severe recession many have ever known, a common question is what impact the economy has on the value of a business. To answer this question requires a review of some of the basics of business valuation. There are two significant factors in establishing the value of a business: income and risk.

The income that a business is expected to generate has a direct impact on the amount a potential buyer is willing to pay for the business. Increased expected income results in a higher value of the business. The reverse is also true. To the extent the business is in an economy and/or industry that is depressed and expects to be for some extended period of time, the value of the business will be lower. If the reason for the depressed income is solely the economy, it could be expected that the reduced income is a temporary phenomenon. However, delayed income will always result in lower value due to the time value of money.

Risk is the factor that is used to value an expected income stream and it combines company-specific factors with systematic factors over which the company has no control. Higher risk reduces the value of the income stream. Reduced risk results in increased value. A company that is projecting steady or increasing income in an increasingly volatile and uncertain economy will lose value because of the increased risk presented by the economy.

The economy is not only in a difficult situation but the future looks increasingly uncertain for business. Interest rates are low—but credit is difficult to obtain. This makes it difficult for business to fund growth. Economic activity froze in late 2008 and is slow to get moving again. This creates less demand for products. Unfortunately, the future economic environment looks difficult—even in “recovery” mode. Most economists expect high inflation, higher fuel costs, more government regulation of business, and higher taxes. All of this increases the expected risk associated with generating business net income.

A weak economy will result in depressed income expectations depending on the industry and the broad economic environment. A weak economy will result in higher

systematic risk for virtually every business in the economy and will thus depress the value of businesses. The nature of government-imposed “solutions” and policies (weak dollar, health care reform, cap and trade, higher taxes, etc.) adds to uncertainty and volatility in the future. This increases risk and results in depressed values.

For business to maintain or increase in value, basic valuation principles dictate that profitability must be established and the risk environment must be stabilized and minimized.

Publicly Traded vs. Privately Owned Companies—Comparable?

Owners of small businesses are easily tempted to use publicly traded stock prices to estimate the value of their company. An established pizza chain with 20 company-owned stores and 20 franchisee-operated stores might feel comparison to Pizza Hut, Inc. (YUM) is appropriate. After all, both companies sell pizza and operate multiple locations. “If only” valuation of small closely held companies was as easy as finding a public company doing something similar to the subject company. The trading price of the public company could provide guidance in the valuation of the subject company.

Valuators define guideline public companies as companies similar to the subject company that trade freely in the public market on a daily basis—with similarity measured by comparable nature of the operations and comparable key financial characteristics. As a publicly traded company, the guideline company provides a value based on active daily trading. Combing this pricing objectivity with the regulatory reporting requirements and analytical information required of publicly traded companies, much information can be known about a public company. If it can be determined that the subject company is comparable, an argument can be constructed asserting that the guideline public company’s daily trading price provides a reasonable basis for an opinion of value for the subject company.

The objective of the guideline public company method is to derive multiples to apply to the fundamental financial variables of the subject company. These fundamental financial variables may be either balance sheet amounts or operating variables derived from income statements. Based on the comparative analysis between the guideline and subject company, as well as site visits, management interviews, and the nature of the industry, the valuator chooses the valuation multiples to rely on.

There are, however, fundamental differences between publicly traded and privately owned companies. These differences are frequently too significant to allow for the proper application of this methodology. Four of the most significant differences are:

1—Public stock prices are marketable, minority ownership interests. The share price reflects the value to a minority interest owner who exercises no control over the company’s operations. By contrast, many small businesses are wholly owned and controlled by a small number of investors. A single investor can exert significant control

over the company's operations.

2—Public companies are run by boards of directors and professional managers. Corporate objectives are clearly stated and designed to maximize shareholder value. By contrast, a family owned business may have a narrower corporate objective to minimize taxes or maintain key supplier or customer relationships.

3—Public companies typically have better access to capital allowing for maximization of growth potential and diversification opportunities. A small business without similar access to capital may not be able to achieve the same growth and diversification opportunities.

4—Public companies maintain detailed information systems to document goals, directions, and expectations. Detailed budgets and strategic plans are prepared for the next one, five, and ten years. A small business may have a one-year operating budget and a "wish list" capital budget. Comparing the public company's historical and projected results to the subject company's historical and projected results may not be possible due to lack of subject company information.

Frequently, valuator experience and professional judgment can be applied to reconcile these differences. Discussions with management can lead to mining valuable data necessary to establish the subject company's comparability to the public company. This effort to establish comparability will allow the public company to serve as a guide in determining the subject company's value.

Multi-Tiered Discounts

Often a business partnership or other entity may own an interest in another partnership or entity. A question arises as to whether each entity can receive a discount and the amount of discount at each level.

Handling discounts in multi-tiered partnership structures is difficult. The discounts for lack of control and lack of marketability at each tier need to be determined based on a rigorous analysis of the facts and circumstances.

The entity that holds the assets providing the value to the overall structure is commonly referred to as the "asset tier" entity. And the entity that holds as its only investment an interest in the asset tier entity is referred to as the "investment tier" entity. The subject interest being valued will usually be a minority interest in the investment tier entity.

Normally, discounts for lack of control and lack of marketability are first applied at the asset tier level and then at the investment tier level. In order to determine the applicable discounts at each level, one needs to first look at the asset tier level and determine the issues that affect the discount. Then one needs to consider the incremental differences that exist at the investment tier level. For instance, if there were different general partners at each level, there would be control issues unique to each tier. Often the investment tier partnership is a holding company. Discounts in holding companies are usually considerably less.

Due to the complex issues arising when structuring or valuing a tiered entity, you should always consult an experienced valuator.

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Chris Hamilton
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2468 Tapo Canyon Road
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