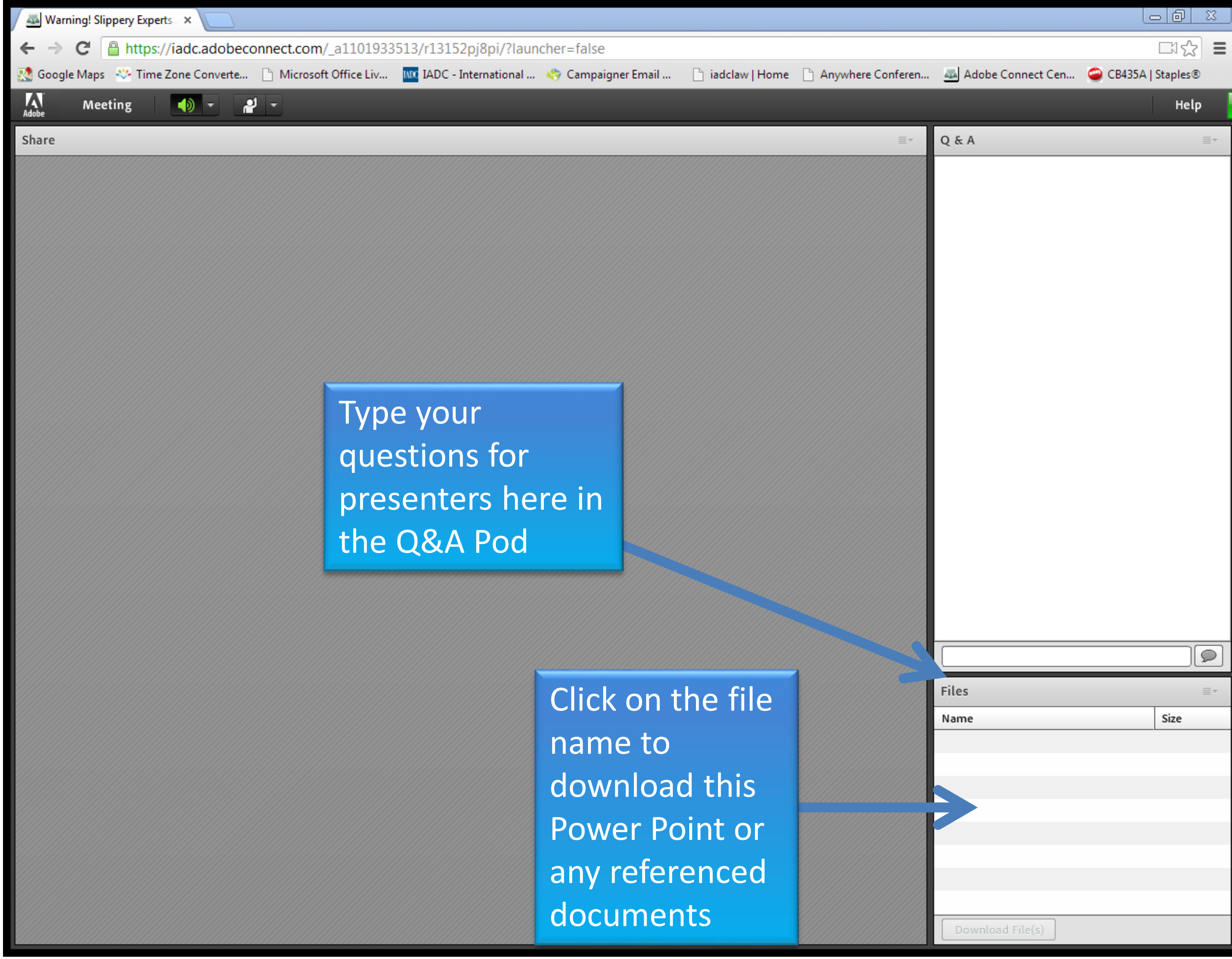
Basic Business Valuation Techniques

Wednesday, May 6, 2015

Presented By the IADC Business Litigation Committee

Welcome! The Webinar will begin promptly at 12:00 pm CDT. Please read and follow the below instructions:

- For you information, this Webinar presentation is being recorded.
- If you have not already done so, please join the conference call.
- Mute your phone line. If you do not have a mute button or are on a cell phone, press *1 to mute your phone.
- If you are on a conference phone, please move all cellular or wireless devices away from the conference phone to avoid audio interference.
- If you have questions during the presentation, you may utilize the Q&A pod on the upper-right-hand side of your screen. You may type questions here and it will be sent to the presenter for response. If your question is not answered during the presentation, our presenter will answer questions at the end of the webinar.
- Visit the "Files" pod in the lower-right-hand corner of the screen if you would like to download a copy of this PowerPoint presentation.


Warning! Slippery Experts
https://iadc.adobeconnect.com/_a1101933513/r13152pj8pi/?launcher=false
Google Maps
Time Zone Converte...
Microsoft Office Liv...
IADC - International ...
Campaigner Email ...
iadclaw | Home
Anywhere Conferen...
Adobe Connect Cen...
CB435A | Staples®
Adobe
Meeting
Help
Share
Q & A
Files
Name
Size
Download File(s)
Type your questions for presenters here in the Q&A Pod
Click on the file name to download this Power Point or any referenced documents

The Foundation
of the
International Association
of Defense Counsel

IADC Webinars are made possible by a grant from The Foundation of the IADC.

The Foundation of the IADC is dedicated to supporting the advancement of the civil justice system through educational opportunities like these Webinars. For more information on The Foundation, visit www.iadcfoundation.org.

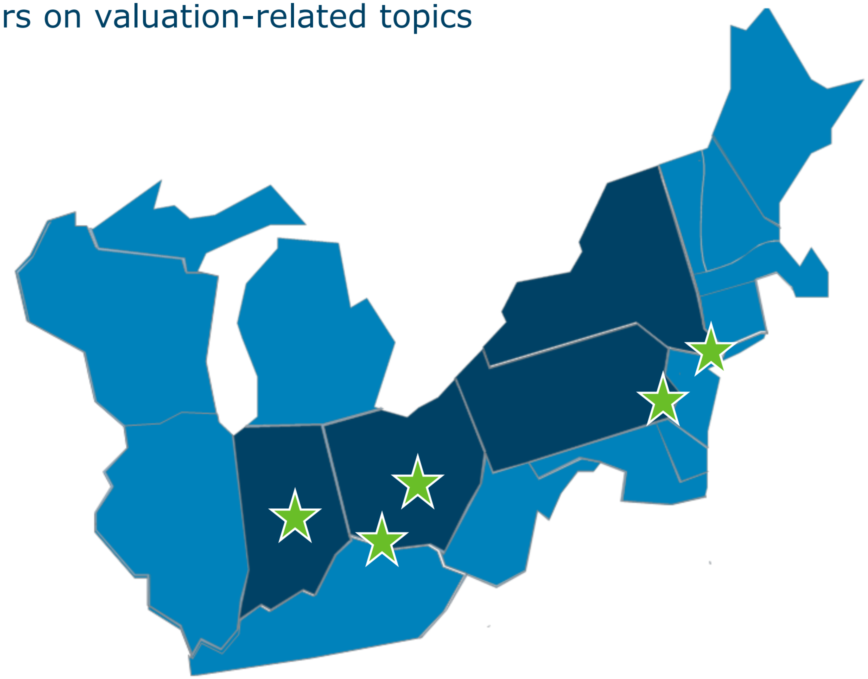
Presenters

Carl Aveni
Carlile Patchen & Murphy LLP
Columbus, OH
caveni@cpmlaw.com

Rebekah Smith
GBQ Consulting, Inc.
Columbus, OH
rsmith@gbq.com

About GBQ's Forensic & Dispute Advisory

- Founded in 1953; Largest Columbus-based CPA firm with ~140 professionals
- Rapidly growing national practice with offices in Cincinnati, Columbus, Indianapolis, Philadelphia, and New York
- Thought-leading professionals who have: (a) completed thousands of valuation and litigation support consulting engagements during the course of our careers, and (b) serve as frequent guest speakers and authors on valuation-related topics



About Carlile Patchen & Murphy, LLP

- In our decades of practice, the litigation lawyers of CPM have dealt with a vast array of disputes, whether in local or state courts and agencies, federal courts, bankruptcy courts, tax court, state and federal appellate courts, and the Ohio and United States Supreme Courts.

Presentation Objectives

This presentation will cover the following topics:

1. Why businesses are value (particularly in litigation)
2. The role of markets in valuation
3. Common approaches to valuing businesses
4. The relative strengths and weaknesses of each approach

Why Business Valuation Important

What Creates Value?

Benefit > Cost

What are the Benefits and Costs?

Benefit > Cost

Revenues
Sales
Market Share
Royalties
Competitive advantage
Reduced costs

Operational costs
R & D expenses
Overhead
Cost of development
Capital expenditures
Working capital
Litigation costs
Legal expenses

Why Does it Matter?

- Creating, managing, and maintaining a business is worthwhile only if

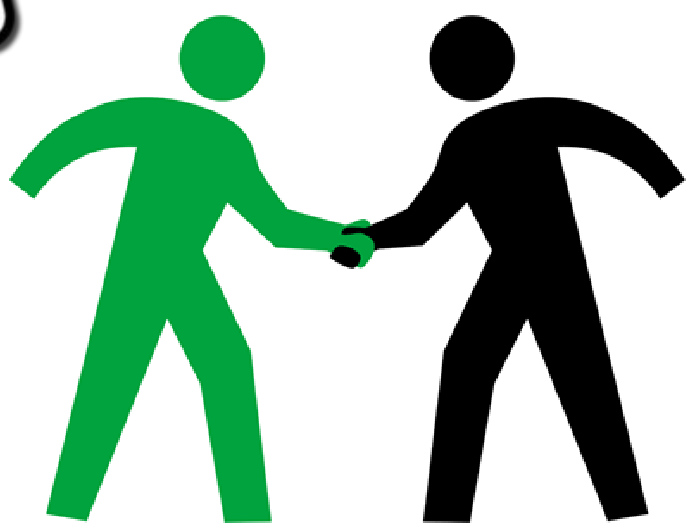
When Are Businesses Valued?

- Estate and gift purposes
- Sale or preparation of a sale
- Litigation
- Purchase price allocations
- Goodwill impairments

The Role of Markets in Valuation

What is a Market?

- A market provides a place for buyers and sellers to come together to buy and sell assets



Examples of Markets

ebay

What do Markets Provide?

Markets provide evidence of the value of an asset:

- An asset is worth what a buyer will pay to acquire it and what an owner will accept to sell it

What if There is No Market?

In the absence of a market, values are determined using commonly accepted approaches

Common Approaches to Valuation

Credentials

Credentials

CBA
Certified Business Appraiser (Institute of Business Appraisers)

ASA
Accredited Senior Appraiser (American Society of Appraisers) less experience = AM

CVA
Certified Valuation Analyst (National Association of Certified Valuation Analysts)

ABV
Accredited Business Valuator (AICPA)

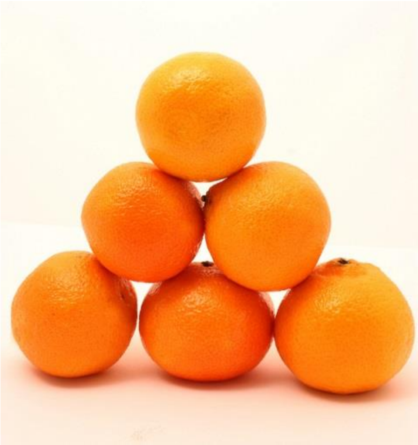
CFA
Chartered Financial Analyst (AIMR)

Standard of Value

Using an inappropriate standard

- Fair market value
- Fair value
- Intrinsic value
- Investment value

$\neq$



Rules of Thumb

Using "Rules of Thumb" as the primary valuation method

Rule of Thumb is only as good as the actual tie to value

Not a generally acceptable method of valuation

Can provide compelling results

The Three Common Valuation Approaches

- Income
- Market
- Cost

"This really is an innovative approach, but I'm afraid we can't consider it. It's never been done before."

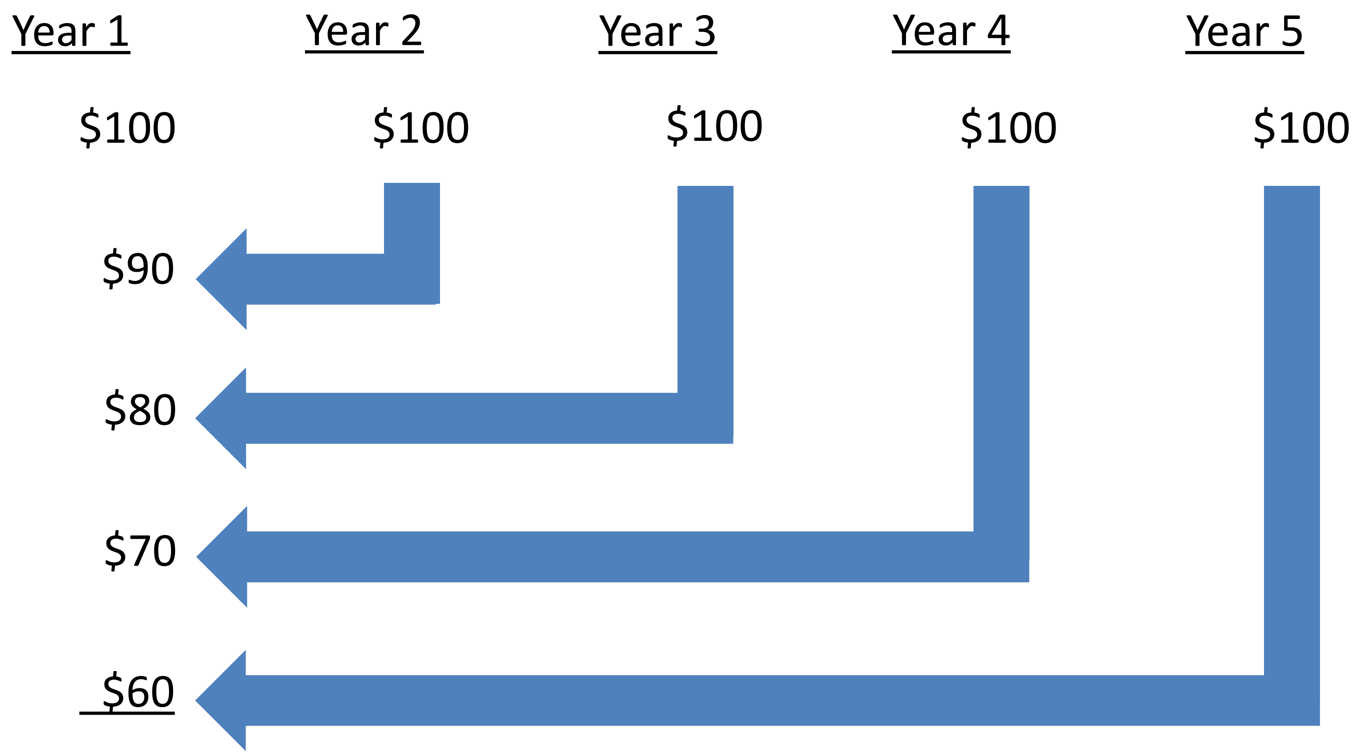
Income Approach

The *Income approach* methods determine the value of a business based on its ability to generate desired economic benefit for the owners. The key objective of the income based methods is to determine the business value as a function of the economic benefit.

- Measures the cash flow associated with the ownership of the asset
- The value is based on the net present value of expected future income streams from the ownership of the asset

Income Approach

- A dollar received in the future is worth less than a dollar received today



$400 Total present value

Income Approach

Cash Option Values

NEXT JACKPOT
$15 MILLION
CASH OPTION VALUE
$9.914085 MILLION
NEXT DRAWING Friday, March 27, 2015 11:00PM

NEXT JACKPOT
$40 MILLION
CASH OPTION VALUE
$26.8 MILLION
NEXT DRAWING Wednesday, March 25, 2015 10:59PM

The winner receives this amount only over a period of years

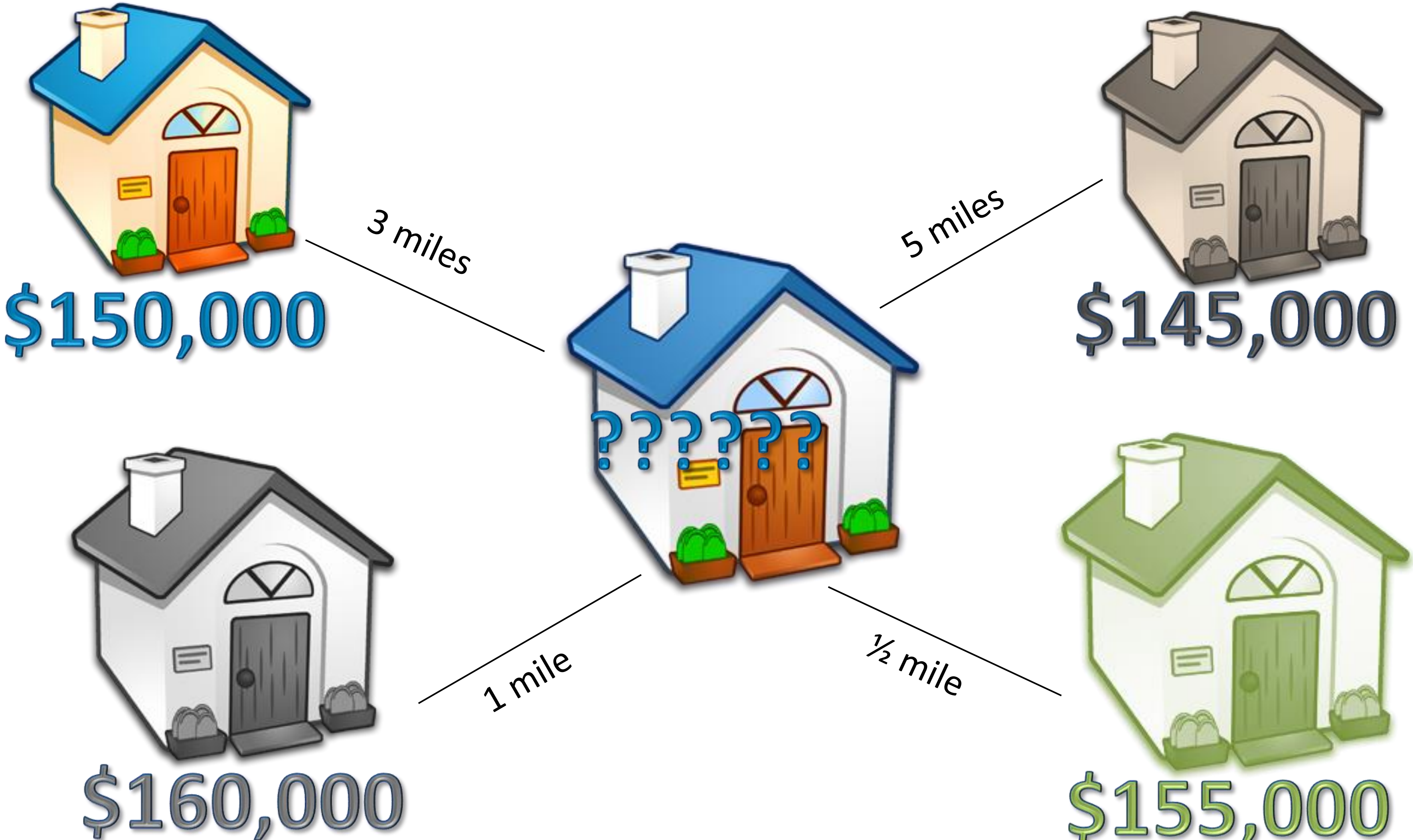
This is the present value of the award if received now

Market Approach

The *Market approach* based valuation methods establish the business value in comparison to historic sales involving similar businesses.

- Based on arms-length transactions of comparable assets
- An asset is worth what other, similar assets are worth

Market Approach



Market Approach

- The problem with valuing businesses:

Cost Approach

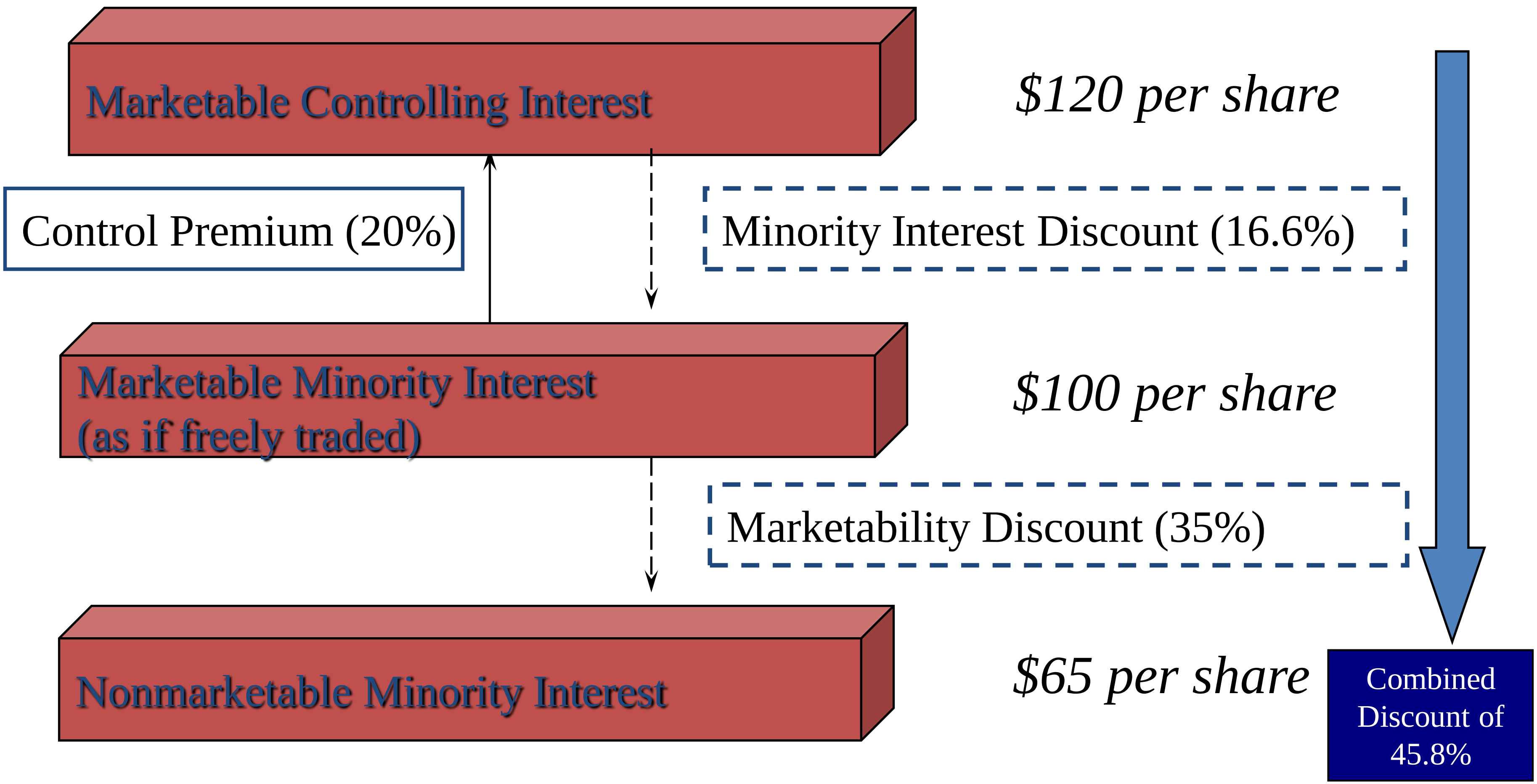
The *Asset approach* methods seek to determine the business value based on the value of its assets. The idea is to determine the business value based on the fair market value of its assets less its liabilities.

- Based on the cost to replace or re-create the asset
- A purchaser of the asset can avoid these costs by purchasing the asset instead of re-creating it

Cost Approach

- For example, a house may be worth what it would cost to re-build it

Premiums / Discounts & “Levels of Value”



The Relative Strengths and Weaknesses of Each Approach

Income Approach – Strengths and Weaknesses

Strengths

Revenue and cost estimates can be determined for the specific business in question

Weaknesses

Poor assumptions used in the net present value calculation will lead to meaningless results (i.e., garbage-in, garbage-out)

Income Approach – Developing Projections

Factors to consider:

- Economic conditions and trends
- Industry conditions and trends
  - Competition
- Company specific information, condition and trends

Assumptions should be reasonable and have a basis

Good sources of information:

- Projections, business plans, budgets, budget to actual comparisons
- Trade associations and publications, public filings and internet research (e.g., First Research, IBIS World, MarketResearch.com)

Income Approach – Revenue Projections

Projected revenues = Volume sold x Price per unit

Considerations:

What and how big is the relevant market?

- What is the company's projected share?
- Sales of related products?

Are there capacity constraints:

- Financial, manufacturing/sourcing/distributing or management?

How do price changes affect volume?

Who are the target customers/clients?

What are the appropriate growth rates?

Income Approach – Expense Projections

Need to determine expenses that are:

- Variable (change with each unit of production)
  - Raw materials, freight, commissions
- Semi-variable (change at levels of production)
  - One machine can produce 5,000 units
  - A 2nd machine is needed for units 5,001 to 10,000
- Fixed (do not change as production changes)
  - Rent, supervisor/management salaries

Yardstick measures (e.g., RMA [www.rmahq.org/home])

Market Approach – Strengths and Weaknesses

Strengths

Based on actual market transactions for similar companies:

- Transactions or agreements are “real-world” data points of the value of the business transacted

Weaknesses

There is often very little information available in the public domain to draw direct comparability to the subject company

Market Approach – Sources of Information

Commonly accepted sources (example)

– Pratt's Stats (private studies)
– IBA (Institute of Business Appraisers)
– Public Company Transactions
– Mergerstat (private studies)
– For small medical practices, Goodwill Registry

Cost Approach – Strengths and Weaknesses

<u>Strengths</u>

Costs may be easier to estimate than future revenues and expenses

Previous development of similar businesses provides data about costs incurred

Might be more relevant for certain industries.

<u>Weaknesses</u>

Fails to reflect the earnings potential of the business

- An businesses value is typically derived from its earning potential, not its cost
- With exceptions

Presentation Summary

- Value is created only when the benefits are greater than the costs
- Valuations are needed when there is not an active market for a particular asset
- Once the benefits and costs are understand, the asset can be valued using one of the three valuation approaches

Questions for Presenters?

Carl Aveni
Carlile Patchen & Murphy LLP
Columbus, OH
caveni@cpmlaw.com

Rebekah Smith
GBQ Consulting, Inc.
Columbus, OH
rsmith@gbq.com

Basic Business Valuation Techniques

Wednesday, May 6, 2015

Thank you for Participating!

To access the PowerPoint presentation from this or any other IADC Webinar, visit our website under the Members Only Tab (you must be signed in) and click on "Resources" → "Past Webinar Materials," or contact Melisa Maisel at mmaisel@iadclaw.org.