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Firm Values

A Business Appraisal Publication

Presented By:

GRW APPRAISAL SERVICES

BUSINESS APPRAISAL AND LITIGATION SUPPORT SERVICES

I offer this newsletter to provide insight into current information and trends in business and the appraisal industry. I hope you find it useful and welcome any questions or comments. If there is a topic you'd like to discuss with me or report upon, please let me know. If this is your first time reading this newsletter, welcome aboard and thanks for your interest.

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Principal

We provide services including business valuation, divorce consulting, litigation support, forensic accounting, account tracing, transaction due diligence, and operations consulting. For further information about our practice please visit us on our website at GRWAppraisalServices.com.

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This writing presents a discussion of valuation discounts relevant to minority shareholders when utilizing the income approach, and net working capital disputes in company transactions. Long as the articles may be, perhaps some short segment can prove beneficial. Previous issues of *Firm Values* can be found on our website.

Valuation Discounts Relevant to Minority Shareholder Interests - Part 2 - Discount for Lack of Control - When is it Relevant?

In our Summer 2018 issue of Firm Values I provided insight into the nature of a discount for lack of control ("DLOC") and factors that valuation practitioners should consider in its application. In this issue, I will discuss circumstances in which a DLOC may be relevant and when it may not be relevant. There are many nuances and considerations involved in determining when or how to apply a DLOC. When writing this, once again I realized just how nuanced and technical this discussion can become. In this writing I will provide some insight, but this is a less than complete discussion of the topic. For a more complete discussion please review a book by Shannon Pratt entitled: Business Valuation Discounts and Premiums (Second Edition).

Herein, I will assume that the standard of value is Fair Market Value ("FMV "). FMV is defined to include, where relevant, the consideration of any valuation discounts or adjustments to value that account for the rights and restrictions resulting from a particular ownership interest in a company. Other standards of value such as Fair Value may not include the consideration of discounts such as that for DLOC. The particular ownership interest or subject of the appraisal is important. A DLOC may or may not be relevant depending on the subject of the appraisal. Is the appraised interest a 100% controlling interest in a company, or is it something less than that? A diminution in value for a DLOC is not relevant for a 100% controlling interest in a company. Accordingly, it is important for an appraiser to understand the applied standard of value and subject interest to determine whether a DLOC is relevant. Though there are varying levels of control, for this discussion I will also assume the subject interest is one that lacks any control in the operation of the business.

Though FMV may be the applied standard of value and the subject interest may lack control, the use of a DLOC may or may not be applicable within a given valuation approach or methodology. That said, it is important for the valuation practitioner not to blindly apply a DLOC to the overall value conclusion that resulted from the averaging or otherwise of several applied methodologies. Instead, within each valuation approach a DLOC is to be separately considered. There are three general valuation approaches 1) the Income Approach, 2) the Market Approach, and 3) the Asset-Based Approach. Within these approaches there are numerous methodologies. I will limit this discussion to the income approach. Stay tuned for discussions of the market and asset-based approaches in a following issue of *Firm Values*.

Income Approach

When utilizing the income approach there are several considerations when accounting for a diminution in share value due to a shareholder's lack of control compared to an otherwise equal controlling share. When relevant, a DLOC or greater risk may be accounted for in multiple ways including:

1. Cash flows - The reported cash flows from a company may include transactions that are other than at arms-length. It is a regular occurrence that a controlling owner deducts non-business expenses such as for his/her personal water craft, for a family vacation, or otherwise. If the reported cash flows already reflect a level of income that is reduced by a controlling shareholder's discretionary expenses, then the application of a separate DLOC may not be necessary. It is argued that if an appraisal practitioner utilizes such cash flows in his/her value calculation, then these cash flows reflect the return a non-controlling shareholder may expect. Accordingly, utilizing these reduced cash flows may result in the direct valuation of a non- controlling interest.

   At times, the amount of non-business expenses deducted on the financials can be considerable, and result in a company reporting minimal income. The use of these cash flows in isolation may result in a value calculation that does not represent the value of the business, even to a non-controlling shareholder. Under this circumstance, an appraiser may need to adjust the reported cash flows by removing non-business expenses. Then he/she may account for the risk of a non-controlling ownership interest within the discount rate or on a percentage of value basis, as described below.

2. Discount rate or capitalization rate - A discount or capitalization rate represents the percentage return an investor demands as compensation for the risk of investing in a company. Capitalization rates may be derived from the observation of market data. Often, a capitalization rate is developed by adding together particular components of a cost of capital (capitalization rate) that reflect the investment risk. These components may include or partially include the return required for the risk of investing in a non-controlling interest in a company. For instance, the Capital Asset Pricing Model (the "CA PM") is a regularly utilized capitalization rate model. One component of CAPM is beta. Beta is derived from prices of non-controlling interests in public companies, those listed on public stock exchanges. As such, it is argued that a capitalization rate derived by using CAPM inputs may partially account for the risk of investing in a non-controlling company interest. Though, it is a debated issue whether the results from a pure CAPM calculation represent the cost of capital to a controlling or to a non-controlling shareholder.

   To reduce the concern with using a pure CAPM model, a valuation practitioner may add basis points to the capitalization rate and try to fully account for factors specific to the subject interest, including a lack of control. Accordingly, utilizing a capitalization rate that considers such risks results in the direct valuation of a non- controlling interest. Though difficulty arises in trying to quantify an incremental adjustment.

3. A percentage discount from the value conclusion - If the cash flows are equal to that available to a controlling shareholder or the discount rate does not reflect the risk inherent in a non-controlling interest, it may be relevant to apply a percentage discount to a value derived from an income approach methodology to arrive at the value of a non-controlling interest. The quantification of a percentage discount is hotly contested, and its derivation can result in a considerable range of discounts. Variations in approach to quantification may include the application of an option pricing model such as Black-Scholes, the comparison of the price of both a controlling and a non-controlling stock in a company, or otherwise.

The application of a basis increment or a percentage discount should be carefully considered and perhaps avoided when possible. From my experience, many times practitioners have a particular discount amount in mind and use a model to back-solve for his/her preconceived number. Generally, I try to utilize non-controlling cash flows in an income approach methodology to directly arrive at a value determination on a non- controlling basis. This method has merit in that it looks to cash flows that remain after prioritized controlling shareholder returns. Doing so removes the subjectivity in either adding basis points to a capitalization rate or applying a percentage discount.

In a following issue of *Firm Values*, I will present a review of the mechanics of considering a DLOC within the market and asset-based valuation approaches.

Net Working Capital Disputes in Company Transactions

At a recent business broker luncheon, a topic of some concern was raised. A surprising number of company purchase transactions involve working capital disputes and subsequent price adjustments. A purchase and sale agreement ("PSA ") commonly includes a purchase price adjustment provision. This provision is to address any differences between the target working capital expected by the buyer at the time the PSA is signed and the working capital received at closing. The source of disagreement often is because the calculation of working capital differs between the parties to the transaction.

What is Net Working Capital

Net working capital is the difference between a company's current assets which primarily includes cash, accounts receivable, and inventory, and current liabilities which primarily includes accounts pay able. Working capital measurements provide insight into how well a business can support its short-term financial needs through various company activities, including revenue collection, debt management, and inventory management. It is important that buyer and seller agree on a definition of net working capital and include in any working capital calculation only those assets and liabilities that will transfer to the buyer. Often, certain assets do not transfer such as the company's cash balance.

Working Capital and the Purchase Price

The price in a company transaction represents the amount the buyer is willing to pay to acquire both an expected stream of earnings and capital necessary to generate such cash flows. At the time a well written PSA is signed a target working capital is estimated and agreed upon by the parties to the transaction. The agreed upon working capital to be transferred ensures that the buyer receives the amount it expected and, if it doesn't, provides for compensation generally via a purchase price adjustment for any difference. Without an agreed upon net working capital level, after signing a poorly written PSA and before closing, the seller could alter items such as the amount of inventory on hand by delaying further purchases until after closing, perhaps making the buyer account for the shortfall.

Near closing the parties prepare a closing balance sheet. The actual working capital, calculated from the closing balance sheet, is then compared to the target working capital to determine if a working capital adjustment is necessary. Often, the PSA contains language that the proposed working capital adjustment will affect the purchase price, either upward or downward, on a dollar-for-dollar basis.

Working Capital Disputes

Disputes between the buyer and seller can arise based on 1) whether an account is properly included in working capital; 2) if properly included, whether the working capital item has been properly measured; and 3) whether subsequent events affect the presentation and measurement of financial statement items. Determining whether a working capital item is properly included and measured is usually based on generally accepted accounting principles ("GAAP").

GAAP vs. Consistency is often the most hotly contested issue in a closing dispute. Consistency refers to how the company has accounted for the financial statement item in its course of business regardless of whether the treatment is GAAP compliant. Generally, without an agreement, if the seller's past practice or methodology does not result in a GAAP-compliant presentation, then GAAP would typically prevail. However, certain accounting practices agreed to by the parties within the PSA may trump any GAAP presentation of those items. Examples of disputes over certain elements of working capital include:

Accounts Receivable

- The reasonableness of the methodology used to estimate the allowance for doubtful accounts
- If the seller is responsible for the collection of existing receivables post-close, what constitutes "best efforts" on the part of the seller?
- Are the receivables included in the estimated balance sheet prepared by the seller valid?

Inventory

- Differing approaches to cost estimation when valuing inventory
- Differences in accounting methods for inventory
- Reasonableness of the estimated reserve for inventory obsolescence
- Maintaining normal operating levels

Accruals and Contingencies

- Including and measuring any accruals and contingencies (e.g.: pay roll and benefit accruals, taxes, warranties, and litigation)

Accounts Payable

- Did the seller enter the company into any obligations after signing the PSA that the buyer may be asked to pay? (e.g.: a marketing campaign, a service contract, etc.)

Best Practices for Minimizing Working Capital Disputes

- The treatment of certain potentially questionable items should be specifically addressed within the PSA. For example, if the buyer believes that the collectability of receivables greater than 90 days is problematic, the buyer could negotiate to have these receivables removed from working capital or structure the deal so that the onus to collect these receivables is on the seller. From the seller's perspective, if it anticipates a potential dispute around how the reserve for accounts receivable is established, the seller could seek to include language in the PSA that the seller's methodology is appropriate for purposes of the working capital calculation.

- Use clear and unambiguous language within the PSA. The language used within the PSA should strive to utilize industry or company -specific historical reporting periods and terminology, define terms when the possibility of ambiguity exists, and specifically state limitations on the buyer's operation of the acquired business.

- Clearly identify all assets and liabilities that will transfer and those that will not transfer.

- Include exhibits and sample calculations within the PSA. Incorporate a detailed, descriptive calculation as an example along with step-by-step instructions.

- Agree upon and state the accounting policies to be applied as part of the calculation. Will past company practices, GAAP, or some other measurement be applied?

- Make the closing date consistent with the closing procedures in place for the target acquisition. If the closing date does not correspond with the normal month-end or quarter-end for the business, additional procedures may have to be performed such as pro-rating certain items, which can lead to disputes between the parties. If the target working capital is based on audited financial data and the closing date is prior to the completion of the audit, the PSA should address whether any adjustments should be considered for the unaudited data to make it consistent with previously audited financial statements.

Conclusion

Working capital disputes generally arise out of a lack of an agreement or because of the difference between the buyer's and seller's understanding around the accounting treatment and the elements of working capital. The PSA should stipulate that the financial information is either in accordance with GAAP, past practices, or otherwise. Any past practices that deviate from GAAP should be outlined in the PSA and include specific language, and examples as to how the target's past practice will be used to calculate the element of working capital.

When disputes involve GAAP, the question becomes whether GAAP was properly applied for a transaction, whether an element of working capital was properly included, and if properly included, whether the element was properly measured and recorded. Buyers and sellers should seek to be as specific as possible with language in the PSA so that the language is clearly understood by both parties. If either the buyer or seller has questions or expects questions from the counter party, they should seek to incorporate language within the PSA to address those issues prior to closing.

We invite you to contact us. Count on GRW Appraisal Services for the experience you need and to provide the personal attention you want. Call or email us today.

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