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VALUATION AND APPRAISAL OF THE SMALL BUSINESS (Methodology and Practice)

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The market value of a publicly traded company's equity can be calculated at a point in time by multiplying its share price by the number of shares of common stock outstanding. The share price is determined in the public marketplace by buyers and sellers who trade the stock. Buyers of publicly traded company shares such as IBM expend money now (invest) for the right to receive uncertain future economic benefits. The price (value) an investor pays for a share is based upon his or her assessment of the size, timing and certainty of receiving future economic benefits. Likewise, a seller of IBM equity is willing to forego his or her expectation of future economic benefits if the investor believes that the benefits given up are worth less than the proceeds (value) from selling the ownership position. Thus, the share price of IBM at a given point in time represents the value of future economic benefits as perceived by buyers and sellers of IBM equity at a point in time. This value is observable through transactions in the marketplace. In contrast, closely held businesses generate also economic benefits for their owners but the value of those companies cannot be directly observed by activity in traded markets.

The Ingredients of Value

Estimates of the market value of non-traded entities are needed for various reasons. Naturally, when buying or selling a business each side of the transaction needs to form their opinion of value. Owners of closely held businesses often gift shares of the business to their children. The IRS may require that these gifts be valued. Financial litigation related to divorce, shareholder oppression action and economic damage, to name a few, are situations that often require a determination of the market value of a business. Business owners often find it useful to value their business on a periodic basis as way of assessing performance over time.

Valuation professions estimate value by applying valuation theory. The value of financial assets whether traded or not is generally based upon the following:

- The level of expected distributable future cash flows
- The timing of those expected distributable cash flows
- The uncertainty in receiving expected future cash flows

This chapter and learning-module begins with a discussion of the underpinnings of these value drivers. How these value drivers are included in the various approaches to value is also discussed. Examples of valuation issues that can result in errors when moving from valuation theory to practice are explored. Our chapter ends with a case study illustrating the valuation process.

Fundamentals of Value

The value of a closely held firm is based upon what is expected to occur in the future. This fundamental concept of valuation is often misunderstood. An investor will not pay now for benefits generated in the past. Revenue Ruling 59-60 promulgated by the IRS to establish a framework for valuing non-traded financial assets and states this fundamental principle in the following manner¹, “Valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal.”² This concept is one of most important valuation fundamentals. That is not to say that an analysis of the historical financial performance of a business is unimportant. Rather, past financial performance should be utilized to develop a forecast of expected future benefits.

The value of a closely held business is driven by the expected future distributable cash flows the business is expected to generate, not by their expected accounting earnings. Distributable cash flow represents monies that can be distributed to a business owner after the needs of the business are met. Simply stated, one cannot spend accounting earnings. As is often stated, “Cash is King.” Expected accounting earnings is often useful, but only as a reasonable proxy for expected future distributable cash flow. The relationship between accounting earnings and distributable cash flow must be carefully analyzed as frequently forecasting expected accounting earnings will provide a better indication of future distributable cash flow than forecasting historical cash flow. When expected accounting earnings are not an adequate proxy for cash flow, specific adjustments to the earnings must be made to more closely project future levels of distributable cash flow.

An investor in a closely held business pays for equity in the business by using cash or a cash equivalent, for example, a loan. The investor compares the cost and expected returns of the business with the cost and expected returns of alternative investments. The investor will choose to invest in the business only if the business’ future distributable cash flows are expected to exceed both the initial investment and the cash flow that could have been generated by the alternative investment. Naturally, no one would pay \$1,000 for equity in a business expecting to receive a total of \$900 in cash flow in the future. In fact, no one would even make an equity

¹ Rev ruling 59-60 (1959-1 C.B. 237)

² Id. Sec. 3.03

investment expecting to receive a total of \$1,010 in the future.

The \$1,000 investment could be placed in a savings account earning 4% with the investor receiving \$1,040 at the end of a year.

As stated above, cash flows generated by a business only create value to the extent they are distributable to the business owner. For example, if a business generates \$500 of cash flow but \$300 is required to purchase equipment to sustain the existing business there will be \$200 of distributable cash flow. Value must be based upon the \$200 of cash flow that can be distributed to the business owner. Investments in equipment may lower distributable cash flow in the short run but often provide greater cash flow in the future by allowing a business enterprise to grow. Many public and private companies have significant market value while experiencing negative cash flows while they invest for the future. An analysis of the trade-offs between less distributable cash flow in the short run and greater distributable cash flow in the long run is an important component in the valuation process. The conversion of expected future cash flows into a current value is called discounting.

Converting Expected Economic Benefits into Present Value - An Example of Discounting

As indicated earlier, the timing, level, and risk associated with future cash flows must all be considered in the valuation process. The timing of distributable cash flows is as important as the level of those cash flows. It is a well-known axiom of finance that a dollar received today is worth more than a dollar received next year. This is referred to as the time value of money.

The impact of timing on value is captured through what is commonly called discounting the cash flows. The following example illustrates the process of discounting considering the timing and level of expected cash flows. For purposes of this example, it is assumed that the risk or uncertainty of future cash flows is similar, and therefore will not affect value.

First, the issue of timing is illustrated. Let us assume that an investor can purchase a financial asset that will provide a guaranteed cash flow of \$500 in two years or another investment that will provide a guaranteed cash flow of \$500 in five years. An investor will always pay more now for the right to receive the return sooner rather than later. In this example the investor will pay more for a guaranteed return of \$500 in two years than the same return in five years. The shorter time frame is preferable and therefore more valuable, because the investor can spend, or reinvest the return sooner rather than later.

Next analysis of alternate investments must be discussed. Let us assume that a company has been formed to execute a government contract that is expected to generate distributable cash flow of \$150 at the end of one year. The contract is on a cost-plus basis with the U.S. government, and therefore it is assumed that the expected distributable cash flows bear no risk. How much would an investor pay for this company? That is, how is a series of expected future distributable cash flows converted into a present value? This process is called discounting.

The discounting process begins by developing an estimate of expected future distributable cash flows. Second, the investor's alternative investment opportunities of similar duration and risk are estimated and analyzed. For this example it is assumed that the investor's choices are investing in a one-year Certificate of Deposit (CD) earning 6% per annum, or buying the equity of the company and receiving the \$150 at the end of one year.

If the investor purchased a one-year CD for \$141.50 and earned 6% interest the investor would have \$150 at year-end as shown below. The calculation of the future value of an investment after including the interest earned is called compounding.

$$\begin{array}{rcl} \text{Present} & & \text{Interest} & & \text{Future} \\ \text{Value} & * & \text{Factor} & = & \text{Value} \\ \$141.50 & * & (1.06) & = & \$150.00 \end{array}$$

We assume that the business's potential cash flow and the risk attached to those cash flows are identical to the cash flow and risk attributed to the one-year CD and that therefore their values are equal. Consequently, the business also has an equity value of \$141.50. At that value the investor would be indifferent between investing in the business and purchasing the CD. In the valuation of the business the 6% represents the investor's required rate of return (rrr). As mentioned above, this is the mirror image of the compounding utilized above to calculate the future value of the investment. The conversion of future expected distributable cash flow into a present value is called discounting.

The expected cash flow is discounted, or reduced to its present value, by the investor's required rate of return, as illustrated.

$$\frac{\text{Future Value}}{(1 + \text{rrr})^n} = \text{Present Value}$$

Where rrr = Investor's required rate of return
n = number of periods

$$\frac{\$150.00}{(1.06)^1} = \$141.50$$

The investor's would pay \$141.50 for an investment that is expected to distribute \$150 next year when the investor has a required rate of return of 6% for one (1) year.

This calculation may be used for longer-term investments by adjusting the formula. As illustrated in the next example, if the cash flow projected was projected to last two years the value of the equity would increase to \$275. The \$275 present value is calculated by discounting the expected future cash flows at the investors required rate of return of 6%. The expected future return for the first year of \$150 is discounted by the 6% for one year, and the second year's return of \$150 is discounted for 2 years.

Present Value	$\frac{\$ 150.00}{(1.06)^1} =$	\$141.50
Year 1 Cash Flow		

Present Value	$\frac{\$ 150.00}{(1.06)^2} =$	<u>\$133.50</u>
Year 2 Cash Flow		

Total Present Value Of Cash Flows:	
Total Value of Equity	<u>\$275.00</u>

The discounting process converts future expected distributable cash flows to arrive at their present value that is also the value of the equity. This example demonstrates several core valuation principles.

1. The discounting process is one of converting expected future cash flows into a present value.
2. The value of an investment is based upon the level of expected future cash flows, the timing of those cash flows and the risk or uncertainty attached to those cash flows.
3. The discount rate represents the investor's required rate of return.
4. The discount rate or required rate of return is based upon an investor's opportunities to invest in alternative investments whose cash flows have similar risk and duration.

These concepts are further expanded upon in the valuation portion of the case study, which follows at the end of this chapter module.

The Impact of Cash Flow Duration and Growth

The prior examples assumed that the cash flows were certain, short in duration and identical in each year. The following example illustrates the effect on value of the duration and growth of cash flows. Assume that \$150 of distributable cash flows generated by a business was projected to persist indefinitely. Its value can be determined using the dividend discount model developed in the 1950s. The dividend discount model assumes that the cash flow, in this case \$150, is projected to occur in each year into the future for an unspecified lengthy period of time. The first calculation assumes that the cash flow will not grow, and remains flat at \$150 per year.

$$\frac{\text{Expected Cash Flow}}{\text{rrr} - \text{g}} = \text{Value}$$

$$\frac{\$150}{20\% - 0\%} = \$750$$

As shown below in Table 1, 60% of the total value is captured by the first five years of cash flow, almost 85 percent by the tenth year, and after fifteen year of cash flows, almost 95% of the value has been realized.

TABLE 1
Example of Duration and Value

Year	Expected Cash Flow	Present Value @20%	Cumulative Value	Percentage Of Value
1	150	125.00	125.00	

2	150	104.17	229.17	
3	150	86.81	315.97	
4	150	72.34	388.31	
5	150	60.28	448.59	60%
6	150	50.23	498.83	
7	150	41.86	540.69	
8	150	34.89	575.57	
9	150	29.07	604.64	
10	150	24.23	628.87	84%
11	150	20.19	649.06	
12	150	16.82	665.88	
13	150	14.02	679.90	
14	150	11.68	691.59	
15	150	9.74	701.32	94%

In this example, the cash flows were projected to be flat. However, expected growth in future distributable cash flow generated by a closely held business has a large impact on its value. For example, in the situation described earlier, expected distributable cash flow of \$150 per annum was shown to have a present value of \$750. If those cash flows were expected to grow at 7% per annum the value would increase by over 50% to \$1,154. Thus, we see that expected growth could have a dramatic impact on value.

$$\frac{\text{Expected Cash Flow}}{\text{rrr} - \text{g}} = \text{Value}$$

$$\frac{\$150}{20\% - 7\%} = \$1,154$$

The interaction of growth and an investor's required rate of return in expected cash flow are illustrated in Table 2. The values in the table represent the present value of distributable cash flow of \$100 per annum that is expected to grow at annual rates ranging from 0 percent to 14 percent while required rates of return vary from 15 percent to 30 percent. As shown, when the required rate of return is relatively low (15 percent), changes in expected growth will have a large impact on value. For example changing the growth assumption

**TABLE 2
PRESENT VALUE OF \$100 AT DIFFERENT GROWTH AND REQUIRED RATES OF RETURN**

Growth Rate		0%	5%	8%	11%	14%
Required Rate of Return	15%	667	1,000	1,429	2,500	10,000
	20%	500	667	833	1,111	1,667
	25%	400	500	588	714	909
	30%	333	400	455	526	625

from 5 percent per annum to 8 percent per annum increases value by 43 percent. When the required rate of return is high (30 percent), the same change in expected growth only increases

value by 14 percent $[(455-400)/400]$.

The Impact of Risk On Value

It should not be surprising that guaranteed future cash flows are worth more to an investor than uncertain or risky future cash flows. In financial and valuation theory, the terms uncertainty or risk refer to the likelihood of actually receiving future cash flows. This assessment of probability is separate from the expected timing of those cash flows. One must be careful to make the distinction between expected cash flows and the risk of those cash flows.

For example, in the two situations depicted here, Opportunities 1 and 2, the expected cash flow is \$1,500. However, the probability of obtaining the \$1,500 is very different. In Opportunity 1, there is a 10 percent chance that the investor will suffer a negative cash flow of \$600. There is also a 10 percent chance that the cash flow will be a positive \$3,200. Assessing the level of each possible cash flow and the probability of each level occurring, results in an expected total cash flow of \$1,500.

OPPORTUNITY ONE		
Likelihood of Occurrence	Outcome	Weighted Outcome
10%	(600)	(60)
20%	(100)	(20)
40%	1,900	760
20%	2,500	500
10%	3,200	320
Total Expected Cash Flow		1,500

OPPORTUNITY TWO		
Likelihood of Occurrence	Outcome	Weighted Outcome
20%	1,375	275
60%	1,450	870
20%	1,775	355
Total Expected Cash Flow		1,500

Opportunity One is viewed as more risky since the outcomes are more uncertain, due to the range of outcomes. Therefore, Opportunity One will sell for a lower value than Opportunity Two. The second opportunity also has an expected cash flow of \$1,500, but with no probability of a negative cash flow, and a 60 percent chance of a \$1,450 positive cash flow it will have the higher value.

Financial theory tells us that the greater the risk of the potential cash flows, the greater the investor's required rate of return. The higher required rate of return converts the expected cash flows into a lower equity value since the receipt of the cash flows is riskier. This can be see

by examining Table 2 which illustrates that increasing the required rate of return lowers value.

Determining the Required Rate of Return

A business owners required rate of return as discussed earlier takes into account that monies received sooner have a greater value than those received later, the greater the risk in receiving future cash flows the lower their current value and one must always keep in mind returns that can be earned on alternative investments. A required rate of return takes all these factors into account.

The process of selecting an appropriate required rate of return begins with an assumption that all investors will require, at a minimum, the riskless rate of return offered by government securities. Government securities with a maturity similar to that of the duration of the investment in a private company are selected, and normally, a duration of ten to twenty years is used. Because of the minimal default risk associated with government securities, the rate is referred to as the risk free rate.

Investors typically require returns greater than the risk free rate. The additional return (in excess of the risk free rate) is called the risk premium. Risk premiums are generally calculated through an analysis of historically realized rates of return segmented by varying levels of risk. This analysis illustrates that higher historical rates of return occur in situations of higher risk. For example, securities issued by the U.S. government have lower rates of return than securities issued by large corporations. Returns on the equity of large corporations are greater than those of debt securities issued by the same firms. Thus, historical rates of return are generally used as a proxy for future required rates of return.

When valuing a business one must compare the risk of the expected cash flows of the firm being valued to the risk of the cash flows of publicly traded securities and to determine an appropriate required rate of return based on that assessment.

It is generally assumed that the expected cash flows from an investment in a closely held business are at least as risky as those of large publicly traded firms. The combination of the large firm equity risk premium and the riskless rate of return provide an indication of the required rate of return for an investor in a large public firm. Beyond that, additional risk premiums related to firm size, proportion of debt, and industry conditions, and many other possible company specific risk factors may be appropriate. When valuing a small business, appraisers generally employ required rates of return 15 percent to 25 percent beyond the current long-term risk free rate.

In summary, the required rate of return used to value a closely held business represents the return an investor demands to invest funds now with the expectation of the uncertain cash flows associated with ownership of a private company.

Defining the Standard of Value

The term “value” in and of itself is too broad to be useful in business appraisal. It must be given a context. Business appraisers generally refer to four standards of value. **Fair Market Value** is the most common context given to the term value.

Fair market value is defined by the IRS through Revenue Ruling 59-60 as:

*... the amount at which property would exchange hands between a willing buyer and a willing seller when the former is not under compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts*³

It is generally agreed that fair market value is based upon a hypothetical arm's length transaction before direct consideration of taxes to be paid as a result the transaction. That does not imply that taxes are not part of the relevant fact set that a willing buyer considers when determining the value. Fair Market Value is the standard of value that is used in valuations for estate tax and generally for valuations related to divorce.

Investment Value focuses on value to a specific buyer rather than value to a hypothetical buyer. For example, let us examine an owner of an employment agency who is considering the acquisition of a competitor employment agency that operates in the same geographic market. The owner might calculate value based upon the knowledge that the combination of the two agencies will create economies of scale and less competition. This would result in greater profitability per dollar of revenue. Therefore, such a buyer, all else equal, may assess a greater value to the company than a buyer who would expect to operate the employment agency in its current free standing situation, without the expected cost saving and corresponding expectation of increased cash flow.

Intrinsic Value is similar to investment value however the firm is typically viewed in a stand-alone mode as a going concern. That is, value is based upon the expected cash flows of the firm based upon its current operating configuration. However, changes in operating policy such as changing its financial structure can have an impact on its intrinsic value.

Going Concern Value vs. Liquidation Value

A business cannot be worth less than its liquidation value. Thus, liquidation value sets a floor for value. Liquidation value assumes that a firm's operations cease and assets are sold either piecemeal or in groups and obligations are satisfied. Liquidation value is generally based on an "orderly liquidation" process where assets are sold in manner to realize the greatest possible value for them. In contrast, a "forced liquidation" process is where assets are sold as quickly as possible often through an auction. Going Concern Value views a firm as a holistic combination of tangible and intangible assets in which the sum is often greater than its parts. This synergistic view of the firm is typically what is being valued.

Control Premiums and Minority Discounts

All the above standards of value must be viewed in the context of the appropriate discounts and premiums that need to be applied to the standard of value being used. When a controlling interest in a business is being acquired some valuation professionals will add a control premium to the value. Control premiums generally range from 20% to 40% of value.

³ Id. Sec 2.02.

The basis for a control premium is that control provides a business owner with the ability to:

- Set business strategy
- Hire and fire workers
- Determine compensation and perquisite levels

To a large extent the benefit of these control prerogatives should be captured in the forecast of distributable cash flow. When distributable cash flows have been adjusted for the benefits of control then a control premium should not be added to value.

Minority discounts that are also referred to as a lack of control discount range generally from 5% to 30% of control value. They are most common in estate tax situations where a minority interest is valued based upon a control value. A minority shareholder will generally pay less per share than a controlling shareholder as the minority shareholder cannot direct the actions of the firm.

Marketability Discounts

Value determined by discounting expected distributable cash flows at market based required rates of return generally result in a value assumed to be marketable. That is, the owner can receive can sell (liquidate) their equity and receive full value in reasonably short time period. Marketability discounts take into account the value diminution that recognizes that an owner of a closely held business cannot liquidate their equity interests and receive full value as quickly as the shareholders of public companies. Observed marketability discounts tend to fall into the range of 35 percent. Observed marketability discounts range from 5% to 50% with a median value of about 35%. The size of the discount depends upon how quickly an ownership interest can be sold at its full value. Generally, an ownership interest whose value is based upon high distributions with low future growth will have a lower marketability discount than an ownership interest with the same value that is based upon low distributions that are expected to grow rapidly.⁴

Which Value Standard Should a Business Owner Use

There is no one right standard of value for all situations. The context of a given valuation will determine which standard of value should be utilized. Both sellers and buyers need to understand both a firm's intrinsic value as well as its investment value to a particular buyer in order to effectively negotiate a transaction price.

What is Being Valued – Invested Capital or Equity

When valuing an equity interest in a closely held business various methods may be used to calculate value. The methods may arrive at an equity value directly by estimating the value of distributable cash flow that accrue directly to owners. Alternatively equity value may be derived as a residual. For example, if the assets (or invested capital) of business are being valued, then the value of all liabilities must be deducted from the value of assets (total invested capital) to

⁴ See: Guide to Business Valuation 11th ed., Jay E. Fishman, et al. Practitioners Publishing Company, Texas 2001 Chapter 8, for a more complete discussion of marketability discounts.

arrive at equity value.

Selecting the Approach to Value

In calculating value there are three major valuation approaches each with several implementation methods:

- Discounted Benefit (or Income) Approach
 - Single-Period Method (Capitalization Method)
 - Multi-Period Method (Discounted Future Returns Method)
- Market Approach
 - Direct Comparison Method (Transaction Method)
 - Public Guideline Company Method
- Asset Approach
 - Excess Earnings Method
 - Mark to Market Method
 - Liquidation Method

A full discussion of each method can be found in several leading valuation texts⁵

For small business owners the Discounted Future Returns Method and the Direct Comparison Method are most appropriate. The concepts of the Income Approach are also illustrated in the case study, which follows at the end of this chapter.

Discounted Future Returns Method

The discounted future returns method takes a direct approach to determining value. The multi-period method is illustrated below. It allows for specific forecasts in distributable cash flow for a number of time periods before an estimate of the long-term growth rate in DCF is made. Specific forecasts can be made for as little as one year, or as many as ten or more to ten years into the future. Clearly, since projecting future cash flows is in itself a risky undertaking, the analyst must assess the relevant future time period.

$$\frac{3_1 \text{ (DCF)}_t}{(1+rrr)^t} + \frac{\text{(DCF)}_{t+1}/(rrr - g)}{(1 + rrr)^t} = V_0$$

Where: V_0 = Value of a firm's equity at time period 0 which is typically the valuation date.

DCF_t = expected distributable cash flow in year t, or a proxy for DCF, like net income.

⁵For example see: Valuation: Measuring and Managing the Value of Companies, 2nd ed., Tom Copeland, Tim Koller, Jack Murrin, John Wiley & Sons, New York, 1994. Guide to Business Valuation 11th ed., Jay E. Fishman, et al. Practitioners Publishing Company, Texas 2001. Valuing A Business 3rd ed., Shannon P. Pratt, et al. Irwin Professional Publishing Illinois 1996.

rrr = the investor's required rate of return .

g = the expected long-term growth rate of DCF beyond year t.

The business owner must make explicit assumptions about:

- The appropriate measure of future cash flows
- The level of expected distributable future cash flows
- The growth of those expected distributable cash flows
- The uncertainty in receiving expected future cash flows

The advantage of the Discounted Benefit approach is that it is the most flexible model and can be constructed to handle almost any expected pattern and risk profile of expected distributable cash flows. The flexibility of this approach is also a weakness in that it requires the business to make a series of explicit assumptions about the future financial performance of a company. The following paragraphs examine several of the assumptions the appraiser must make, and highlight potential errors that may occur. Appendix One contains a case study illustrating the application of the discounted benefit method.

Financial Statement Adjustments

When analyzing a set of financial statements adjustments are generally needed in order to produce a clearer picture of likely future income and distributable cash flow. This normalization process usually consists of three types of adjustments to a firm's income statement.

Non-Recurring Items

Estimates of future distributable cash flow should exclude non-recurring items. Proceeds from the settlement of litigation, one-time gains/losses from the selling of assets, and large write-offs that are not expected to reoccur each represent potential non-recurring items. The impact of non-recurring events should be removed from a firm's financial statements in order to produce a clearer picture of likely future income and cash flow.

Perquisites

A buyer of a business may plan to spend more or less than the current business owner for executive compensation, travel and entertainment expenses, and other perquisites of current management. When determining future distributable cash flow, income adjustments to the current level of expenditures should be made for these items.

Non-Cash Expenses

Depreciation expense, amortization expense, and bad debt expense are all non-cash items which impact reported profitability. When determining distributable cash flow the link between non-cash expenses and expected cash expenditures must be analyzed. For example, annual

depreciation expense is a proxy for likely capital expenditures over time. When capital expenditures and depreciation are not similar over time an adjustment to expected cash flow is necessary. For example, a concrete company may have a fleet of trucks with a useful life of fourteen years that are depreciated over seven years for tax and financial reporting.

Depreciation expense will likely overstate the funds needed to maintain the fleet as the useful life exceeds the depreciable life and distributable cash flow. In determining distributable cash flow one must add back the annual non-cash depreciation expense and subtract an estimate of funds needed to fund truck replacement. In this way the cash flow available for distribution to owners will be more properly stated.

Many firms reduce income through the use of bad debt expense rather than direct write-offs. Bad-debt expense is a non-cash expense that represents an estimate of the dollar volume of write-offs that are likely to occur during a year. If bad debt expense is understated firm profitability will be overstated. A close examination of accounts receivable to see if any past due accounts need to be written off is generally part of the due diligence a buyer of a business will undertake. The calculation of distributable cash flow avoids this problem as the actual monies received from customers rather than the revenue generated by customers is measured.

Adjustments can also be made to a firm's balance sheet to remove non-operating assets and liabilities and to restate asset and liability value at market rather than cost. Assets and liabilities that are unrelated to the core business being valued should be added to or subtracted from value depending on whether they are acquired by the buyer. Examples include, the asset value less outstanding debt of a vacant parcel of land, and marketable securities that are not needed to operate the business. Other non-operating assets such as the cash surrender value of officer life insurance are generally liquidated by the seller and are not part of the business transaction.

Examples of the adjustments mentioned as also illustrated in the case study that follows at the end of this chapter.

Distributable Cash Flow v. Net Income

When using the discounted benefit approach the analyst must make an assumption concerning the economic construct best used as a proxy for future distributable cash flow, which will accrue to the equity holder. Many analysts use expected net income as a proxy for future distributable cash flow and others prefer to directly forecast future distributable cash flow. It is generally true that over time net income and distributable cash flow will be similar. Thus, the use of either financial construct can be appropriate for the determination of value.

The use of expected net income as a proxy for future distributable cash flow is appropriate when over time net income is expected to be equal to distributable cash flow. However, when expected distributable cash flow and net income are expected to be materially different over time the use of distributable cash flow is the appropriate economic benefit for determining value.

The following example provides insight into how valuation outcomes vary when

distributable cash flow and net income are permanently different. Tables 3 and 4 are forecasted income and cash flow statements for Saul's Book Shop. Revenue is expected grow at 20 percent per annum over the next three years. Purchases are 60 percent of revenue and Selling, General and Administrative (SG&A) expenses are expected to be 35 percent of revenue.

With a tax rate of 30 percent we see that Saul's business is expected to generate profits of \$420,000 next year, \$504,000 of profit two years from now and \$605,000 three years from now.

However, as illustrated on Table 4 Saul's cash flow is expected to be significantly less than expected profit. This is because not all Saul's revenue is collected in the current year. Rather many of Saul's customers purchase goods on credit and pay later. In fact, an analysis of Saul's Book Shop collection history indicates that 10 percent of sales in a given year are collected in the following year. Thus expected cash revenue of \$11,800 in Year 1 will be 90 percent of current period sales (90 percent of \$12,000 equaling \$10,800) and 10 percent of previous period sales (10 percent of \$10,000 equaling \$1,000). Consequently, assuming sales are expected to grow, Saul's Book Shop cash flow is projected to be less than its net profit.

TABLE 3
Saul's Book Shop
Forecasted Income Statement

Saul's Book Shop
Forecasted Income Statement (\$000)

	Current Yr.	Year 1	Year 2	Year 3
Revenue	10,000	12,000	14,400	17,280
Purchases		7,200	8,640	10,368
Gross Profit		4,800	5,760	6,912
SG&A		4,200	5,040	6,048
Earnings Before Taxes		600	720	864
Taxes		180	216	259
Net Profit		420	504	605

TABLE 4
Saul's Book Shop
Forecasted Cash Flow Statement

	Year 1	Year 2	Year 3
Cash In – Revenue	11,800	14,160	16,992
Cash Out – Purchases	7,200	8,640	10,368
Cash Out – SGA	4,200	5,040	6,048
Cash Out – Taxes	180	216	259
Distributable Cash Flow	220	264	317

In this situation, when distributable cash flows are permanently less than net income, value should be based upon distributable cash flow not net profit. To base value on expected net profit would overstate value.

The Timing of Economic Benefits: Mid-Point Analysis

Traditional valuation techniques are based upon discounting economic benefits, such as annual bonuses, under the assumption that they occur at year-end.

However, many firms distribute benefits throughout the year. When this is the case the use of year-end discounting will understate fair market value.

Table 5 assumes expected distributions to the equity holder are expected to be \$100 a year for the next five years. Assuming the distributions occur at year-end and using a required rate of return of 22% results in a present value of \$286.36. Using mid-year discounting, which implies the distributions occur throughout the year, with the same rrr, results in a present value of \$316.30.

TABLE 5
Mid-Year Discounting

Dec. 31	Expected Bonus	Yr. End Disc.	Mid-Yr. Disc.
2001	\$ 100.00	\$ 81.97	\$ 90.54
2002	\$ 100.00	\$ 67.19	\$ 74.21
2003	\$ 100.00	\$ 55.07	\$ 60.83
2004	\$ 100.00	\$ 45.14	\$ 49.86
2005	\$ 100.00	\$ 37.00	\$ 40.87
Value @ Dec. 31, 2000		\$ 286.36	\$ 316.30
Percentage Change in Value			110%

The present value using mid-year discounting captures the additional value that occurs since expected distributions are to be received sooner by the equity holder. This results in a value 10 percent higher than when the distributions are projected to be received at year-end.

Using The Past to Predict The Future

Typically, a firm's future performance is linked to its historical performance, and valuation professionals generally look to a firm's recent performance to establish its probable future performance. This may not be appropriate when the future is unlikely to repeat the past. For example, performance of firms such as car dealerships and construction firms may be cyclical. Analyzing three to five years of history may not capture the cyclical nature of a firm's performance. Using historical profit or cash flow margins as estimates of future earnings and cash flow may generate values that do not capture likely future performance. A well-researched industry analysis can assist in adjusting past financial performance to likely future performance. However, one should be wary of future performance, which rests solely on past performance with little justification.

A common valuation error in applying the discounted benefit approach is to use historical benefit dollars rather than historical benefit margins to determine future economic benefits. As shown in Table 6 Saul's Book Shop revenue has grown at an average of 7.1 percent from 1996 to 2000.

TABLE 6
Saul's Book Shop Revenue 2000-1996

	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>1996</u>
Revenue (REV)	\$ 150,000	\$ 143,000	\$ 134,000	\$ 126,000	\$ 114,000
Earnings Before Taxes (EBT)	\$ 18,150	\$ 16,159	\$ 16,750	\$ 14,742	\$ 13,908
EBT/REV	12.1%	11.3%	12.5%	11.7%	12.2%
Revenue Growth (96-00)	7.1%				
Median Profit Margin	12.0%				
Average Profit Margin	12.0%				
Average Profits (96-00)	\$ 15,942				
Expected Profit 2001	\$ 19,260 based upon 7% growth and a 12% profit margin				

This is expected to continue into the future. Pre-tax earnings (or pre-tax income) have increased from \$13,908 in 1996 to \$18,150 in 2000. The pre-tax profit margin has ranged between 11.3 percent and 12.5 percent of sales. This indicates that for each \$1.00 of sales, the company generates approximately 12 cents of pre-tax profit.. In projecting future profits it is important to recognize that revenue is expected to grow at 7% per annum producing revenue of \$160,500. The pre-tax profit margin is expected to continue at historical levels of 12%. If this expected margin is applied to the expected sales for 2001, it results in an expected profit of \$19,260. However, using average dollar profits for the past five years results in \$15,952, which thus does not capture the expected future performance of the company. The use of historical dollar profit levels instead of a firm's profit margin will lead to an understatement of value when the firm has been growing and when the growth is expected to continue into the future.

Market Approach

In the market approach valuation multiples of firms assessed to be "comparable" are applied to the closely held firm being valued. The market approach is based upon the concept that stock prices, company transaction prices, and their resulting valuation multiples are based upon the valuation considerations of well informed investors who have actually spent money to acquire equity and investors and who have sold their equity position. From the perspective of valuation theory the Market Approach and the Discounted Benefit Approach are derived from the same principals and value is derived from the same underlying value drivers. This is illustrated below:

Discounted Benefit Approach (constant growth version)

$$\text{Price (Value)} = \frac{\text{DCF}}{(\text{rrr} - \text{g})}$$

dividing both sides by a firm's earnings (E) results in the following:

$$\text{P/E} = \frac{\text{DCF/E}}{(\text{rrr} - \text{g})}$$

$$\frac{\text{Value}}{\text{Earnings}} = \frac{\text{Dividends/Earnings}}{(\text{rrr} - \text{g})}$$

The numerator represents the portion of earnings paid out as dividends, which is generally referred to as a firm's payout ratio. As indicated earlier, we find that a firm's P/E multiple used in the market approach is directly related to a firm's payout ratio. That is, the greater the proportion of earnings paid out as dividends, the greater the expected growth of dividends, the higher the P/E ratio. As expected, a higher required rate of return (rrr) results in a lower P/E ratio.

In the market approach we observe that the multiple such as the P/E ratio determines value by multiplying the market multiple (P/E in this example) by the closely held firm's earnings to arrive at value. Estimates of the value drivers have been incorporated in the market multiple. When the two approaches produce very different conclusions of value it must be that the underlying valuation assumptions in the discounted benefit approach and the market approach are at odds with each other. A recognition and reconciliation of the different valuation assumptions embodied in each approach will ultimately lead to a more sustainable opinion of value.

A challenge for the appraiser is to select publicly traded firms and firms involved in transactions with operating and financial characteristics sufficiently similar to the private firm being valued so that the resulting pricing multiples can be employed to value the private firm. There are no hard and fast rules for selecting guideline companies. The valuation concept is that the operating and financial characteristics of the public companies or the acquired companies should be similar enough to that of the private company to draw valuation parallels. Investor opinions of the current and likely future operating and financial characteristics of the selected companies ultimately result in the valuation multiples of those companies, which are observed. If the subject private company has similar operating and financial characteristics, then the appraiser makes the valuation assumption that the public company's observable valuation multiples (often with some adjustments) can be applied to the subject company.

Common Errors in Applying the Market Approach

Severe biases in value can result unless differences in growth expectations between the firm being valued, and firms from which the multiples have been derived are recognized and adjusted. Public companies often grow through acquisition or external growth. In fact, this is one reason why firms go public, to finance revenue growth through issuing additional equity. High growth expectations produce high pricing multiples as shown below:

$$\text{Value or Price} = \frac{\text{Dividends (Div)}}{\text{rrr} - \text{g}}$$

divide both sides by EPS (E)

$$\begin{aligned} P/E &= \frac{\text{Div} / E}{rrr - g} \\ &= \frac{\text{Payout Ratio}}{rrr - g} \\ &= \frac{30\%}{.17 - .15} = 15 \end{aligned}$$

Assume a public firm has a payout ratio of 30 percent. This means that the firm distributes 30% of earnings as dividends. Also assume that investors in this firm have a required rate of return of 17% and expect revenues and profits to grow at 15% per annum into the foreseeable future. As illustrated above the firm will have a P/E or Price/Earnings ratio of 15.

Private companies tend to grow through organic or internal growth financed through reinvesting the profits of the company. As a result, private companies often grow at much lower rates than public companies. Take a private firm in the same industry as the public firm discussed above, but now assume that the private firm pays out 75% of earnings, has a long-term growth rate in revenue and earnings of 7% per annum and a required rate of return of 22%. As shown, the resulting P/E ratio falls to 5.

$$\frac{.75}{.22 - .07} = 5$$

The interaction of expected rates of growth and required rates of return also provide us insight into magnitude of pricing multiples. With expected cash flows of \$100 and a required rate of return of 20% with no expected growth the value is \$500. This equates to a Price Earnings ratio of 5 (500/100). However, the same cash flow with expected growth of 11% per annum produces a Price Earnings multiple of 11.1 (\$1,111 / \$100). Controlling for expected growth between the target company and public companies using the market approach is an important, and often neglected, aspect of implementing this approach to value.

Summary and Conclusion

The determinants of value for a closely held firm are well understood. Value is based upon the level, timing and uncertainty of future distributable cash flows. However, given that value is based upon expectations for the future, it is clear why sellers and buyers often generate divergent opinions of value. Both the income approach and the market approach are based upon the same valuation factors. Each approach addresses these factors differently. In the income approach, each valuation factor is explicitly identified and estimated. In the market approach, the pricing multiples that emerge from transactions are observed in the marketplace. Investor views incorporating the valuation factors are included in the pricing multiples.

CASE MODEL: ILLUSTRATION OF VALUATION ISSUES

To bring the concepts we have been discussing relating to valuations to life, and to understand how buyers and sellers of businesses can arrive at divergent negotiation values, we have prepared a case study relating to the values determined by a buyer and seller for Sally's Shoe Stores, Inc.

SALLY'S SHOE STORES, INC. CASE STUDY

Joseph Smart, the president of Sally's Shoe Stores, Inc is 55 years old and in good health. A regional shoe retailer, after reviewing the financial statements of SSS has offered Joseph and his co-owner, Robert Smart, \$3M for the equity in their business. The question is whether the Smarts should sell their business for this price. One aspect of the decision is the determination of the business value.

The controller of the business has hired a business valuator to prepare a valuation using a discounted future returns method based upon their assessment of the going concern value of Sally Shoe Stores from the prospective of both the buyer and the seller. By understanding the valuation prospective of both the buyer and the seller the controller believes they can negotiate the highest value for the seller(s).

The valuator has gathered the history of the company to assist in the valuation.

HISTORY – COMPANY BACKGROUND

Sally Shoe Stores, Inc., (SSS) founded in YR-10, operates a chain of eleven women's shoe stores in New Jersey, Pennsylvania and Delaware. This Pennsylvania corporation began in Garmentville, Pennsylvania, as a single store selling women's footwear. As the market developed, SSS gradually expanded to eleven stores. The Company carries a wide variety of women's shoes.

SSS's stores are located mostly in suburban communities, where there is less price competition but an adequate customer base. Sales are primarily affected by fashion trends and consumer spending patterns. The Company sells both major brands and private labels. The market is very fragmented and intensively competitive.

The Company's major publicly held competitors that touch upon some part of SSS's market are Parade of Shoes, Payless Shoesource Inc., Shoe Pavilion Inc., Aerosoles, Inc. and Shoe Carnival, Inc.,(lower price), and some department stores. With the exception of the department stores, which are diversified, the Company's competitors sell similar types of products. Most of the Company's competitors have a larger market share and more sales volume than SSS.

There are no divisions. Each store operates somewhat independently, with each store manager reporting to the retail operations manager. The business is very labor intensive. Current employee relations are good with turnover about average for the retail industry. However, there was a retail clerk strike in YR-3 to YR-2.

SSS buys from a number of manufacturers, with no dominant supplier. As is typical for this industry, lead times tend to be rather long, as much as six months or more, especially for imports.

Key management of SSS includes Joseph Smart, president; Robert Smart, vice present of Retail Operations; Jane Williams, vice president of Purchasing; Victor Smith, controller; and Regina Smart (Joseph's wife), corporate secretary.

The Company has a single class of common stock with one million shares authorized and 100,000 shares issued and outstanding. The stock is distributed as follows:

Joseph Smart	50,000 shares	50%
Robert Smart	<u>50,000</u> shares	<u>50%</u>
Total	100,000 shares	100%

Over the past five years, SSS has increased its number of stores to meet the expanding demand for quality footwear for career women. According to the president, the Company's plans to have moderate expansion for a few years by opening 1 store a year by entering markets with significant opportunities. Joseph Smart expects strong growth over the next year as the Company's new stores build market share and as the industry recovers from the sluggish period of the last two years. The Company has prepared a budget for YR-0, which projects a 15 percent growth rate.

In addition to assembling the history of SSS, the valuator also has independently researched the retail shoe industry to give them more insight into the valuation.

THE WOMEN'S RETAIL SHOE INDUSTRY CONDITIONS AND OUTLOOK

S&P Industry Surveys indicates that the momentum in consumer spending will shift from big-ticket furniture and appliances to shoes and apparel. Within this shift, the outlook for women's shoes appears very promising. The sector began to emerge from its eighteen-month slump in the fourth quarter of YR-2 and should extend the gains through all of YR-1. Also, fashion trends are taking a more practical and widely acceptable direction, so pent-up demand should boost overall shoes sales in YR-1. Demand was pent up because American women were largely dissatisfied with retail shoe selections through YR-3 and into YR-2, according to S&P

U.S. retail sales rose 7.0 percent in the first four months of YR-2 and are estimated to have ended the year with a 5.5 percent increase to \$1.7 trillion, following a 4.9 percent gain in YR-3. Full year increases estimated for YR-2 include 5.9 percent for shoes and accessory stores, according to Business Statistics.

U.S. retailers are undergoing a reorganization of their physical premises and marketing objectives to use capital and manpower more efficiently and to meet consumer needs. In general, YR-1 should be a healthy year for retailers. However, the only foreseeable price increase may come at the wholesaler level, and retailers may well find it difficult to pass these price hikes along to the consumer. While earnings will not be boosted by a lower tax rate, as in the two preceding years, careful monitoring of inventories and expenses will enhance the bottom line for many retailers.

According to retail trade associations in Pennsylvania and Delaware, retail sales for the region are expected to grow at rates that are at or above the national rates.

Having assembled the company history and researched the industry the valuator then prepared a financial analysis for use in the valuation. The purpose of the financial analysis and the adjustments to the financial statement which follow were set forth in the chapter text and are illustrated in the following portion of this case study.

FINANCIAL ANALYSIS OF THE COMPANY – YR-5 through YR-1

An analysis of SSS's historical sales trends, earnings growth and financial condition serves to place its financial performance in an historical context and provides a starting point for estimating SSS's future financial performance and current market value. The information below is drawn from SSS financial statements and discussions the consultant had with management.

In addition, Income Statement adjustments were made to reflect the future earnings capacity of SSS without regard to non-recurring and/or non-operating expenses. In addition, a number of adjustments were made to reflect the expenses of SSS that were discretionary and primarily because the Company's owners are also its key employees. Examples of these types of adjustments are the officers' compensation paid to Joseph and Regina Smart's compensation and discretionary travel.

Sales and Sales Growth

Exhibit 1 presents the Company's comparative income statements for YR-5 through YR-1, and Exhibit 1A presents comparative common size income statements for the same period.

Sales have shown a generally increasing trend amounting to \$6,269,714 in YR-5 and rising to \$9,732,602 in YR-1. During the YR-5 through YR-1 period, sales grew at a compound annual rate of 11.6 percent. Growth has occurred due to both an increase in same store sales as well as the increase in the number of stores. Same store sales have grown between 5 percent and 8 percent over the past few years. Management has plans to open additional stores that will maintain current revenue growth for the next three to five years.

Income Statement Adjustments

Income Statement adjustments were made to reflect the future earnings capacity of SSS without regard to non-recurring and/or non-operating expenses.

In addition, a number of adjustments were made to reflect certain discretionary expenses of SSS that might not be made by a new owner. Based on the information obtained, it was determined that the following income statement adjustments were necessary:

1. Adjusting compensation for Joseph and Regina Smart as well as eliminating compensation for Ms Clothier. These adjustments reflect the compensation a willing buyer would pay others for the same services provided by Joseph and Regina Smart. It was also assumed that Mrs. Clothier a cousin of Joseph would not be retained or replaced by a willing buyer
2. Eliminating discretionary expenses for automobiles and boat travel and entertainment. These expenses are beyond what a willing buyer would spend on travel and entertainment.
3. Eliminating nonrecurring expenses related to the retail clerk strike. These expenses were removed as they relate to a rare strike by retail clerks. The last strike was over ten years ago and another strike in the foreseeable future is highly unlikely.

As a result of the adjustments adjusted pre-tax income is greater reported pre-tax income as shown on Exhibit 2. The average reported pre-tax profit margin was 5.47% over the last five years while the adjusted profit margin is 7.14%. Both the adjusted profit margin and the reported profit margins reflect a downward trend. Management has indicated that both selling and general & administrative expenses have grown faster than revenue as the firm as opened new stores. This trend is shown on the Adjusted Common Size Income Statement (Exhibit 3A). Management anticipates that these expenses will return to historical levels once the new stores are operational.

Balance Sheet Analysis

Exhibit 4 presents the comparative company balance sheets for YR-5 through YR-1, and Exhibit 4A presents comparative common size balance sheets for the same period.

Inventories generally increased from YR-5 through YR-1 because of new stores and increases in sales volume. Increases in property and equipment from YR-5 through YR-1 generally related to fixtures and equipment for new stores. Investments consist of a painting bought for \$50,000 and a boat (original cost \$60,000). These investments are considered non-operating assets. Accounts payable increases from YR-5 through YR-1 generally related to increases in inventories.

SSS receives advances from another company owned by Joseph Smart. According to Joseph Smart, SSS pays the affiliate interest at market rates. There are no plans to repay the advances in the near future. Some of those advances were used to fund the investment purchases and thus represent excess debt.

Long-term debt consists of a revolving line of credit with a bank. This debt was used to finance capital expenditures. The increases in debt levels in YR-3 and YR-1 were related to increases in property and equipment. Cash dividends of \$100,000 were paid in YR-4.

Balance Sheet Adjustments

We also made adjustments to the balance sheet to reflect the changes made to the Income statement. We determined that the following balance sheet adjustments were needed:

1. Removing the non-operating assets (boat and painting)
2. Reclassifying the payable to affiliate as long-term debt

The valuator now has the adjusted financial statement data needed for the valuation of the company.

VALUATION OF SALLY'S SHOE STORES, INC. AS OF OCTOBER 27, YR-1

Based on the financial analysis presented above, as well as the valuator's understanding of the facts and circumstances, the valuator used the discounted future returns method or discounted cash flow method to value the company. This method of valuation was discussed in the chapter text and is illustrated in the remainder of this case study.

In arriving at the Fair Market Value of 100% of the common stock of SSS, the Discounted Cash Flow method based on a forecast of the Company's net cash flow was the primary approach to value. Exhibit 5 presents the expected cash flow based upon the views of the seller and Exhibit 5A presents the cash flow based upon the views of the buyer.

Sellers Perspective

Based upon the assumptions below which are drawn from SSS's adjusted historical financial statements and discussions with management the distributable cash flow is expected at \$451,000 next year and will grow to just over \$919,000 in five years (see calculations on Exhibit 5).

Future sales growth will continue at 12% for the next four years while new stores are opened and then sales growth will continue into the future at a moderate 6% rate.

SSS pre-tax profit margin will gradually increase from 5% to 10% as the firm begins to realize economics of scale from increase sales volume and better price concessions from suppliers.

SSS will have a 40% combined tax rate.

Capital Expenditures will exceed depreciation expense during the next four years as new stores are opened (see line 7 and 8 on Exhibit 5). However, over the long-run depreciation and capital expenditures will be at approximately the same level.

Working capital needs will continue to be a drain on cash flow as revenue grows (see line 8 on Exhibit 5). However, the drain will be reduced in the long run as revenue growth moderates.

SSS will be issuing new debt and refinancing the existing debt to help cover the cost of anticipated capital expenditures (see line 10 on Exhibit 5).

To evaluate these cash flows a required rate of return of 20% was utilized. This based upon the current long-term risk free rate of 5%, a equity risk premium of 12% for small public companies and an 3% additional risk premium for SSS to account for their lack of management depth, lack of geographic diversification as well their small revenue base relative to public companies.

The present of value of the first four years of cash flows are shown on line 13 Exhibit 5 and are summed on line 14 of Exhibit 5. The present value of cash flows expected to occur beyond year four is shown on line 15 of Exhibit 5. This value is calculated as follows:

$$\$919 / (.2-.06) = \$6,565$$

$$\$6,565 / (1.2)^4 = \$3,167$$

As indicated two-thirds of SSS value is due to expected cash flows, which will occur beyond year four.

Buyers Perspective

Based upon the assumptions below which are drawn from SSS adjusted historical financial statements and discussions with management distributable cash flow is expected at \$451,000 next year and will grow to just over \$919,000 in five years (see calculations on Exhibit 5A).

Future sales growth as a going concern will continue at 6%. This is different from the seller's growth assumption because the buyer does not see a need to pay for value created by themselves through stores they open in the future.

SSS pre-tax profit margin will average 6% based upon the firm's historic performance.

SSS will have a 40% combined tax rate.

Depreciation expense related to the current stores (line 7 on Exhibit 5A) will exceed capital expenditures necessary to maintain the stores (line 8 on Exhibit 5A). Thus, depreciation will provide funds increasing distributable cash flow. However, over the long-run depreciation and capital expenditures will be at approximately the same level.

Working capital needs will continue to be a drain on cash flow as revenue grows. However, the drain will be reduced in the long run as revenue growth moderates.

SSS will be issuing new debt and refinancing the existing debt to help cover the cost of anticipated capital expenditures (lines 9 and 10 on Exhibit 5A).

To evaluate these cash flows a required rate of return of 22% was utilized. This based upon the current long-term risk free rate of 5%, a equity risk premium of 12% for small public companies and an 5% additional risk premium for SSS to account for their lack of management depth, lack of geographic diversification as well their small revenue base relative to public companies.

The present of value of the first four years of cash flows are shown on line 13 of Exhibit 5A and are summed on line 14 of Exhibit 5A. The present value of cash flows expected to occur beyond year four is shown on line 15 of Exhibit 5A. This value is calculated as follows:

$$\begin{aligned} \$540 / (.22-.06) &= \$3,375 \\ \$3,375 / (1.2)^4 &= \$1,524 \end{aligned}$$

As expected the buyer places a much lower value on SSS than does the seller. To a large extent this is because the buyer is not willing to pay for value created by new store growth, the buyer is not willing to accept the firm will have a higher profit margin than it has had the past several years and sees more risk in realizing expected cash flows than does the seller.

Coming to a Compromise

Although the values determined by both the buyer and the seller are far apart it is important to note both values are substantially greater than SSS's reported book value of \$1,821,255 as indicated on Exhibit 4.

Finding a value that both parties are willing to accept is both a qualitative and quantitative process. There are a wide range of non-financial reasons that drive the decision process for both the buyer and seller. A robust financial analysis will often assist both parties frame the qualitative issues.

THE END

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