

Business Valuation Overview

Hoosier Hills Estate Planning Council

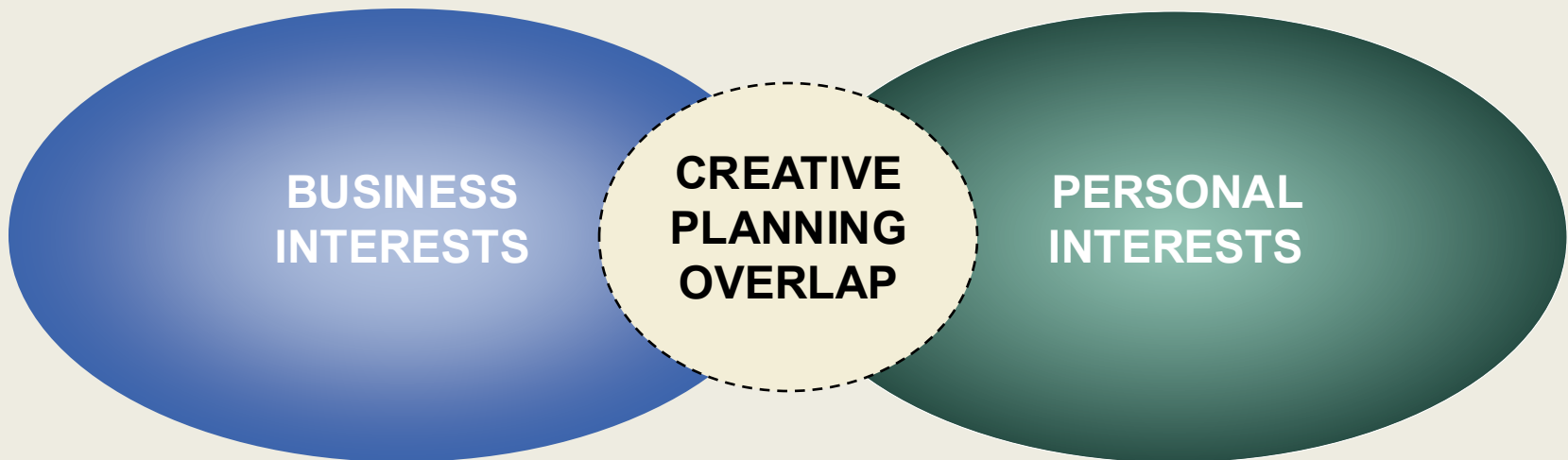
October 30, 2025



Multiple issues can overwhelm the Business Owner



Comprehensive Planning Approach



1. Shareholder Considerations
2. Executive Benefits
3. Company Considerations
4. Employee Benefits

1. Cash Flow
2. Tax Planning
3. Wealth Management
4. Wealth Distribution
5. Personal Legacy

Decisions should be made in the context of the complete picture.

What is a Business Appraisal

- Qualified opinion of equity value
- Define property, scope, timing and fees
- Proper Standard of Value
 - Fair Market Value
 - Investment Value
 - Intrinsic Value
 - Fair Value
 - Minority shareholder abuse
 - Financial reports
 - Per statute or case law



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Revenue Ruling 59-60

- Outlines the general approach, methods, and factors to be considered in valuing shares of the capital stock of closely held corporations.

Fair Market Value:

- “The price, expressed in terms of cash equivalents, at which the property would change hands between a *hypothetical willing* and able buyer, and a *hypothetical willing* and able seller, when *neither is under compulsion* to buy or sell, and when both have reasonable knowledge of the relevant facts.”
- Pension Reform Act of 2001: Qualified Appraisal by Qualified Appraiser.



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Standards of Value

- **Fair Market Value:** Arms length transaction
- **Fair Value:** Defined by Jurisdiction: Distressed, dissenting, disenfranchised
 - May be expressed in Operating Agreement
 - By Statute upon Dissociation if Operating Agreement is silent

Investment Value: Specific Investor; synergistic, strategic, irrational



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Calculation versus Appraisal

Calculation Engagement:

- Valuation analyst and client agree on the valuation approaches and methods
- Does not include all of the procedures required for a “valuation engagement”
- Results considered a calculated value.
- Calculated value is expressed as a range or as single amount
- Conclusion is NOT an “opinion of value”



Appraisal and Report Types

- Forensics 101
- Appraisal Review
- Calculation vs. Appraisal
- Appraisal - Oral Report
- Appraisal - Full Narrative

Fees

- Stability/Volatility: One-year forecast vs. multi-year
- Asset Bag or Operating Entity: Need for external asset appraisals (equipment, land, art, minerals, oil, etc)
- Single Operation or multiple affiliates, subsidiaries, with varied products and services.
- Quality and detail of financial statements, capital intensity, debt, related party assts/liabilities, working capital, owner and family compensation, rents, fees, etc.
- Stable or in transition (budgets and forecasts), Industry outlook, product lifecycle, material supply/.trends (i.e lumber, steel, fabric, components, labor, etc)



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Other Considerations

- Machinery and Equipment appraisals for loan collateral
- Real Estate appraisals for loan collateral / lease agreements / sale of real estate
- Should I appraise leasehold improvements / furniture?
 - T.C. Steele artwork on the wall
 - Antique furniture in president's office

ASA offers many appraisal disciplines



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Controversial Issues/Subjective Considerations

- Normalization” of Historical Financial Statements
- Taxation of Net Income for S-Corporations, LLCs and Partnerships
- Minority vs. Control Adjustments
- Application of Marketability and Minority Discounts (Facts and Circumstances)
- Reasonableness of Forecasts



What is Value

$$\text{Value (V)} = \frac{\text{Benefit Stream (BS)}}{\text{Discount Rate (k) - Growth (g)}}$$

Profitability

Risk & Capital Markets

Long Term Growth

The diagram illustrates the components of the value formula. The formula is centered: Value (V) equals Benefit Stream (BS) divided by the difference between the Discount Rate (k) and Growth (g). Three arrows point towards the formula: one from 'Profitability' pointing to the numerator (Benefit Stream), one from 'Risk & Capital Markets' pointing to the denominator (Discount Rate), and one from 'Long Term Growth' pointing to the denominator (Growth).

Best Practice Among Appraisers

Cash Flow Analysis

- Make sure forecasts supported by history and industry/economic data
- Make sure cash flow used matches discount rate
- Adjustments must be defensible
- Minimal subjectivity = Happy Judge
- Avoid weighting Capitalized and Discount Cash Flow methods...Pick one!



Best Practices Among Appraisers

Discounts Applied

- Address lack-of-control issues in cash flow projections
- Apply discounts from “financial” purchases not “strategic” purchases
- Most appraisers DO NOT apply marketability discount to 100% interests



Measuring the Cash Cycle

Equity Cash Flow

	Revenue
less	Cost of sales
less	<u>Operating expense</u>
=	Operating Income (EBIT)
less	<u>Interest expense</u>
=	Pretax income
less	<u>Income Taxes</u>
=	Net income
plus	<u>Depreciation & amortization</u>
=	Gross cash flow
less	Increase in working capital
less	Capital expenditures
+/-	<u>Change in debt principal</u>
=	Equity Net Cash Flow

Invested Capital Cash Flow

	Revenue
less	Cost of sales
less	<u>Operating expense</u>
=	Operating Income (EBIT)
less	<u>Taxes on EBIT</u>
=	Net operating profit after tax (NOPAT)
plus	<u>Depreciation & amortization</u>
=	Gross cash flow
less	Increase in working capital
less	<u>Capital expenditures</u>
=	Invested Capital Net cash flow

Financial Structure of the Company

Net Working
Capital

Assets	Liabilities
Current Assets Cash Accounts Receivable Inventory Other Assets	Current Liabilities Accounts Payable Accrued Expenses Income Taxes Payable Other Current Liabilities
Fixed Assets Equipment Buildings Land	Interest Bearing Debt (includes current portion and short term notes payable)
Other Assets Investments Life Insurance	Stockholders' Equity Preferred Stock
Intangible Assets Identifiable Non-identifiable	Common Stock

Invested
Capital

Client Considerations

- Who is the Client: (Company, shareholder, attorney, advisors)
- What is the Purpose (Tax, dispute, sale to market, recapitalization, etc.)
- USE and Users?
- Privilege, report distribution, confidentiality
- Planning Considerations
 - - Non-operating assets and liabilities
- Related party leases, management agreements, Licenses arms length.
- Built-in Capital Gains tax liabilities
- Who Pays the fees?



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Role of Advisors

Integrated Effort of Legal, Tax, and Investment Advisors

- Create and Preserve Wealth
- Preserve and grow the value of Assets
- Provide liquidity for Client Life Objectives
 - Transfer wealth to achieve philanthropic Objectives
 - Transfer wealth to heirs
 - Minimize Tax
 - Provide for business continuity, growth, and management



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Role of Advisors

- Capital Structure
 - Voting vs non-voting
 - Elements of control
 - Simple or super majority
 - To amend agreements, sell assets, sell the business
 - Tag along/Drag along rights
 - Provisions for “all” the members/shareholders
 - Conversion of non-voting to voting upon redemption/retirement
- Planning for Key Management (Personal versus institutional Goodwill)
 - Handcuffs, ownership interest, Directors, Trustees
 - Compensation, non-competes, etc.
 - Planning for Conflict Resolution: Control: Dispute resolution between successor family members



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Personal Goodwill vs Enterprise Goodwill

- “Goodwill” – Purchase price above market value of identifiable tangible and intangible assets.
- “Personal Goodwill” – The goodwill associated with individual practitioner.
- “Enterprise Goodwill” – The goodwill associated with the business.



Management

- Is goodwill institutionalized and Fungible?
- Is Goodwill vested in the controlling shareholder or in management/key personnel
- How are owner, related parties, and non-related management compensated
- Are children qualified to manage and grow the enterprise?
- Is ownership of minority ownership by children not active in the business rational?



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Recent Tax and Case Developments

- The One Big Beautiful Bill Becomes Law
- Connelly v. United States, US No. 23-146, 6/6/24
- Nelson v Commissioner US App Leis 32741, 11/03/21
- Kress v United States



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Thank You

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