

# Defining and Estimating “Value” in the LLC Setting

*State Bar of Arizona  
CLE by the Sea  
Business Law*

Charles A. Wilhoite, CPA/ABV/CFF, CMA, ASA, CGMA, CFM, **CBA**  
Managing Director

Willamette Management Associates

July 20, 2013

# Valuation in the LLC Setting

- ❖ Standard definitions of “value”
- ❖ Standard premises of “value”
- ❖ Key provisions in a representative operating agreement
- ❖ Intent of the LLC members regarding value
- ❖ “Value” examples from operating agreements
- ❖ The role of non-attorney experts
- ❖ Entity level versus shareholder level discounts and premiums
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- ❖ Standard valuation approaches and methods
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# I. Valuation in the LLC Setting - Standards

## ❖ Standard definitions of “value”

Fair market value

Investment value

Intrinsic (or “Fundamental”) value

Fair value

# I. Valuation in the LLC Setting - Standards

## ❖ Standard definitions of “value”

### Fair market value

“the amount at which property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts.”\*

Fair market value generally is understood to represent consideration on a “cash-equivalent” basis

\*American Society of Appraisers, Business Valuation Standards – Definitions.

# I. Valuation in the LLC Setting - Standards

## ❖ Standard definitions of “value”

### ☐ Investment value

“the specific value of goods or services to a particular investor (or class of investors) based on individual investment requirements ...”\*

### ☐ Valid reasons why investment value may differ from market value (from the perspective of a particular owner):

1. Differences in estimates of future earning power.
2. Differences in perception of the degree of risk and the required rate of return.
3. Differences in financing costs and tax status.
4. Synergies with other operations owned or controlled.

\*The Appraisal of Real Estate, 11<sup>th</sup> ed. (Chicago: Appraisal Institute, 1996), p. 638.

# I. Valuation in the LLC Setting - Standards

## ❖ Standard definitions of “value”

### ☐ Intrinsic (“fundamental”) value

“an analytical judgment of value based on the perceived characteristics inherent in the investment, not tempered by characteristics peculiar to any one investor, but rather, tempered by how these perceived characteristics are interpreted by one analyst versus another”\*

☐ Intrinsic value is considered to represent the “true,” or “real” worth of an item based on an objective evaluation of available facts.

\*Valuing A Business, 4<sup>th</sup> ed. (New York: McGraw-Hill, 2000), p. 31.

# I. Valuation in the LLC Setting - Standards

## ❖ Standard definitions of “value”

- ❑ Fair value (in states that have adopted the Uniform Business Corporation Act):

“the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable”\*

- ❑ Fair value (business valuation/nonfinancial reporting) is usually a legally created standard of value that applies to certain specific transactions.
- ❑ In most states, fair value is the statutory standard of value applicable in cases of dissenting stockholders’ appraisal rights.

\*Model Business Corporation Act § 13.01(3)(ABA 1984).

# I. Valuation in the LLC Setting - Premises

❖ Standard premises of value (i.e., assumption regarding transactional circumstances)

- Value as a going concern
- Value as an assemblage of assets
- Value as an orderly disposition
- Value as a forced liquidation



# I. Valuation in the LLC Setting - Premises

❖ Premises of value (i.e., assumption regarding transactional circumstances)

☐ Value as a going concern

“Value in continued use, as a mass assemblage of income-producing assets, and as a going-concern business enterprise.”\*

\*Valuing A Business, 4<sup>th</sup> ed. (New York: McGraw-Hill, 2000), p. 33.

# I. Valuation in the LLC Setting - Premises

❖ Premises of value (i.e., assumption regarding transactional circumstances)

☐ Value as an assemblage of assets

“Value in place, as part of a mass assemblage of assets, but not in current use in the production of income, and not as a going-concern business enterprise.”\*

\*Valuing A Business, 4<sup>th</sup> ed. (New York: McGraw-Hill, 2000), p. 33.

# I. Valuation in the LLC Setting - Premises

## ❖ Premises of value (i.e., assumption regarding transactional circumstances)

### ☐ Value as an orderly disposition

“Value in exchange, on a piecemeal basis (not part of a mass-assembly of assets), as part of an orderly disposition; this premise contemplates that all of the assets of the business enterprise will be sold individually, and that they will enjoy normal exposure to their appropriate secondary market.”\*

\*Valuing A Business, 4<sup>th</sup> ed. (New York: McGraw-Hill, 2000), p. 33.

# I. Valuation in the LLC Setting - Premises

- ❖ Premises of value (i.e., assumption regarding transactional circumstances)

- Value as a forced liquidation

“Value in exchange, on a piecemeal basis (not part of a mass-assembly of assets), as part of a forced liquidation; this premise contemplates that the assets of the business enterprise will be sold individually and that they will experience less than normal exposure to their appropriate secondary market.”\*

\*Valuing A Business, 4<sup>th</sup> ed. (New York: McGraw-Hill, 2000), p. 33.

# I. Valuation in the LLC Setting - Provisions

## ❖ Key provisions in a representative operating agreement

- Organization
- Purposes and Powers of the Company
- Capital Contributions, Loans, Capital Accounts
- Allocations
- Bank Accounts, Books of Account, Tax Compliance, & Fiscal Year
- Determination of Profit & Loss; Audited Financial Statements
- Rights, Obligations, Indemnification and Removal of the Manager
- Rights and Status of Members
- Special Covenants of the Members
- Meetings and Means of Voting
- Governing Board
- Transfer of Rights and Additional Members
- Company's Right to Liquidate Company Interests
- Dissolution
- Winding up and Termination
- Power of Attorney
- Miscellaneous

# I. Valuation in the LLC Setting - Intent

- ❖ Intent of the LLC members regarding “value”
  - ❑ Operating agreements generally are understood to address “value” of units or membership interests from the perspective of the members forming the LLC
  - ❑ Initial formation of LLC typically contemplates potential departure of members prior to the expiration of the finite life of the LLC
  - ❑ Historical practice suggests that “value” typically is contemplated from an equity perspective (i.e., “fairness”)
  - ❑ Valuation experts typically can address “intent” based primarily on observable, historical practice

## I. Valuation in the LLC Setting - Examples

### ❖ WMA “Freebie”

Valuation of LLC or Member’s Interest Proposed Language:

*In the event of the sale of the LLC, or substantially all of the assets of the LLC, the LLC shall hire Willamette Management Associates to develop an independent, unassailable, binding value conclusion!*

# I. Valuation in the LLC Setting - Examples

## ❖ Example 1:

### Valuation of Member's Interest

*If the Members elect to purchase the Ownership Interest of a Member pursuant to Paragraph 7.3 or 7.4 above, the **value** of the affected Member's Ownership Interest **shall be determined by agreement** between the remaining Members and the affected Member or the affected Member's legal representative. **If agreement** as to such value **cannot be obtained**, the **value** of the affected Member's Ownership Interest **shall be determined** pursuant to the Act **by the firm of accountants** then servicing the Company, **taking into account all appropriate market factors** pertaining to the Ownership Interest **such as lack of management control, inability to liquidate an Ownership Interest and lack of an established market**. The determination of the purchase price of the affected Member's Ownership Interest, when made, shall be final and binding upon all parties affected thereby. At the Company's expense, the **accountants shall be entitled to obtain such appraisals and other professional advice** in determining the **net fair value** or to complete the Company's books of accounts as they deem necessary or advisable.*



# I. Examples of LLC “Value” Definition

## ❖ Example 2:

### Option to Purchase

The Option shall be exercisable for an amount (“Option Price”) equal to the product of (i) the fair market value of the Company as a going concern taking into account the Company’s assets and the then-outstanding obligations of the Company, including any unpaid balance of the Pre-Formation Indebtedness, on the date of the Triggering Event, (ii) the decimal equivalent of the Percentage Interest represented by the Interest Subject to Option and (iii) the decimal equivalent of 60%. The 60% factor in the foregoing formula is intended to subject the product determined under clauses (i) and (ii) to a **40% discount to take into account a reasonable discount for lack of marketability and for minority interest**. This 40% discount has been arrived at through arms’ length negotiation among the parties and, accordingly, is and shall be deemed fair and reasonable under the circumstances. The Option Price shall also be subject to proration in the event of any purchase of less than all of the Interest Subject to Option and to offset and payment of the amount of any deemed loan payable under Section 5.3 to the lending Members as provided therein. The Option Price shall be determined following any Triggering Event only if, within 45 days after notice from the Company of the Triggering Event, any Optionee indicates an interest in exercising the Option by notice given to the Company (which indication of interest shall not be binding and shall not obligate any Optionee to purchase). Upon any such notice, the Optionor and the Company, acting through the Board of Directors, shall attempt to reach agreement on fair market value within 30 days after the date of receipt of such notice by the Company. If the Optionor and the Board of Directors are unable to reach agreement on fair market value within such 30-day period, either may cause the determination of fair market value to be made in accordance with the Appraisal Procedure. The Company shall promptly notify the Optionor and each Member of the Option Price determined in accordance with this Section 2.6(b).

# I. Examples of LLC “Value” Definition

## ❖ Example 2, contd.:

### Appraisal Procedure

In any case in which the Company acting through the Board of Directors and the Optionor (each a “party”) are **unable to agree upon the fair market value of the Company as a going concern** (taking into account the Company’s assets and then then-outstanding obligations of the Company, including any unpaid balance of the Pre-Formation Indebtedness) within the 30-day period for such agreement under Section 2.6(b), **each shall give a notice to the other appointing an appraiser**. If either party fails to give a notice of appointment within the specified time period, then the party giving notice shall notify the other party that if **the other party fails to appoint an appraiser within 10 business days after such second notice by the appointing party, the other party will lose its right to appoint an appraiser**. **If only one appraiser is appointed in accordance with the foregoing, such appraiser shall make the determination alone, which determination shall be conclusive as to the fair market value of the Company**. **If two appraisers are appointed in a timely manner, the two appraisers shall designate a third appraiser**. If the two appraisers fail to agree upon a third appraiser within five business days of the designation of the last of the two appraisers, then the presiding judge of the Multnomah County Circuit Court, upon request of either party, shall designate a third appraiser. **The three appraisers shall conduct such meetings as they may deem appropriate, shall make their determination of appraised value in writing** in accordance with paragraph (b) of this Exhibit A and shall give notice to the Company of such determination.

All appraisers selected shall be members of the American Institute of Real Estate **Appraisers** and **shall have had at least 10 years experience in the business of appraising real property and interests in real property**. **“Fair market value” for purposes of Section 2.6 will be the average of the two appraisals whose values are closest to one another**. If there is an equal difference between the high and the low appraisals in relation to the middle value, the middle value will be the final appraised value. Each party shall pay all fees and expenses of any appraiser selected by the party under this Exhibit A. The Company will pay all other expenses and fees of the appraisal, including the fee charged by the third appraiser.

**Fair market value determined in accordance with the provisions of this Exhibit A and the resulting Option Price for purposes of Section 2.6 after the application of the 40% discount** provided for in Section 2.6 shall be final and binding upon the Optionor, all Members and the Company for the intended purpose.

# I. Examples of LLC “Value” Definition

## ❖ Example 3:

### Valuation of Member’s Interest

The Value of the affected Member’s Units *will be determined by multiplying the Member’s percentage Membership Interest by the **fair market value** of the Company (the amount that could reasonably be expected to be realized upon sale) net of liabilities of all Company assets, **with appropriate discount for a minority interest or lack of marketability.** Provided, however, **in the event the triggering event is the death of a Member** as provided in Section 9.6 above the value of the deceased Member’s Units **will not include any discount for a minority interest or lack of marketability.** The **fair market value** of the Company assets **will be determined by agreement between a Majority in Interest of the remaining Members** holding all Units (voting and non-voting) and the affected Member or the affected Member’s successor. **In the event agreement as to the value cannot be obtained, the fair market value of the Company’s assets will be determined by appraisal.** The Company will first select an appraiser who will value the Company’s assets. The affected Member or the affected Member’s successor may elect, either before or after the Company’s appraiser has submitted a report, to select another appraiser. **In the event the two appraisers fail to reach agreement on the fair market value of the Company’s assets, the two appraisers will mutually select a third appraiser whose determination of the value of the Company’s assets will be binding on the Company and the affected Member or the affected Member’s successor.***

# I. Examples of LLC “Value” Definition

## ❖ Example 4:

### Valuation of Member’s Interest

If the Members purchase the Ownership Interest of a Member pursuant to Paragraph 7.1 or 7.4 above, ***the value of the affected Member’s Ownership Interest shall be determined by agreement between the remaining Members and the affected Member or the affected Member’s legal representative.*** If agreement as to such value cannot be obtained within 60 days immediately following delivery of notice of the election under Paragraph 7.1 or 7.4, ***the value of the affected Member’s Ownership Interest shall be determined by appraisal conducted by an appraiser selected by unanimous agreement of the Members,*** including the affected Member. ***If the Members are unable to agree upon a single appraiser*** within 15 days after the 60-day period immediately following delivery of notice of the election, then any Member shall be entitled to notify the other Member(s) of such party’s ***institution of a three-appraiser procedure.*** Within ten (10) days of such notice, the remaining Members shall appoint an independent ***appraiser experienced in the valuation of closely-held businesses and of commercial real estate of the kind held by the Company,*** and the affected Member shall appoint a second such appraiser. ***The two appraisers shall appoint a third similarly qualified appraiser*** (or, if the appraisers are unable to agree upon an appraiser within ten (10) days of their appointment, either may apply to the presiding judge of the Multnomah County Circuit Court to designate such and appraiser). ***The third appraiser shall complete an appraisal within sixty (60) days of that appraiser’s appointment.*** The cost of all appraisals shall be an expense of the Company. ***The value of the Company shall be determined on a going-concern basis, taking into account all appropriate market factors pertaining to the Ownership Interest such as lack of management control, inability to liquidate an Ownership Interest and lack of an established market.*** The determination of the purchase price of the affected Member’s Ownership Interest, when made, shall be final and binding upon all parties affected thereby.

# I. Examples of LLC “Value” Definition

## ❖ Example 5:

### Purchase Price of Member’s Interest

Upon an election by the Company and/or the remaining Members to purchase the Interest of a Member pursuant to Section 11.4 where the purchase price is to be established under this Section 13, ***the price of the interest to be purchased shall be its fair market value as determined by an appraiser selected by the Managers*** and reasonably acceptable to the affected Member or the affected Member’s successor-in-interest, ***which appraiser shall be a person qualified by training or experience to value interests in the Company and other business entities. In determining such value, the appraiser shall consider appropriate minority interest, lack of marketability and other discounts.*** The cost of the appraisal shall be borne equally by the Assignor or his or her successor-in-interest, as the case may be, and the Company, though each party shall be solely responsible for payment of its attorney fees, if any, incurred in connection with the appraisal. Closing shall take place within twenty (20) days after the purchase price has been determined by the appraiser. At the time of the closing, the Transferor-Member or the Transferor-Member’s successor-in-interest, will sign and deliver to the Company and/or the purchasing Member(s), a written assignment transferring the interest to the purchasing party(ies) free and clear of all encumbrances. Such assignment must contain warranties of title and good right to transfer.

# I. Examples of LLC “Value” Definition

## ❖ Example 6:

### Purchase Price, Involuntary Transfer

**In the event any Shareholder’s Shares are involuntarily transferred to any nonshareholder person or entity, without written consent of the other Shareholders of the Corporation,** the transferee shall be obligated to sell, and the Corporation shall have the right to purchase, all or a portion of the involuntary transferred Shares. This provision shall not apply to a transfer by a Shareholder to a revocable trust controlled by the Shareholder, nor a transfer by operation of law on the Shareholder’s death.

Under this paragraph, the Purchase Price shall be determined by the following formula:

The **value of the assets of the Corporation shall be determined at book value, without any weight given to going concern value or goodwill,** and taking into consideration any accumulated depreciation (“Asset Value”).

The total amount of current and long term liabilities shall then be deducted from the Asset Value, resulting in a “Net Asset Value”.

**Net Asset Value shall then be reduced by 50%** and from this figure, the pro rata value of the involuntarily transferred Shares (“Purchase Price”) shall be determined.

As an example, if Shareholder A holding a 25% interest in the Company has his Shares garnished by a creditor, the following formula would determine the required purchase price:

Asset Book Value	\$18,000,000
less: Total Liabilities	(2,500,000)
Indicated Net Asset Value	15,500,000
less: Required 50% Discount	(7,750,000)
Indicated Adjusted Net Asset Value	7,750,000
Shareholder pro rata Interest	x 25%
Indicated Purchase Price	\$ 1,937,500
Payable: 10% down	\$ 193,750
Balance (amortized over 8 years, plus interest)	\$ 1,743,750

# I. Examples of LLC “Value” Definition

## ❖ Example 7:

### Sale Price

Within 30 days of a Shareholder’s death, *the Deceased Shareholder’s estate and the Company shall engage in good faith negotiations* to determine the ***fair market value*** of the Shareholder’s Shares in the Company. The parties shall ***determine the fair market value of the Deceased Shareholder’s pro rata share of all assets, including goodwill and going concern value, less all liabilities and without consideration of minority discounts (“Sale Price”) provided that in no event shall the Sale Price be less than the Insurance Proceeds regarding the Deceased Shareholder.***

*If the Corporation and the Deceased Shareholder’s estate cannot agree upon a Sale Price for the Deceased Shareholder’s Shares within 30 days, the Sale Price shall be determined by a qualified third party appraiser.* If the Corporation and the estate cannot agree on the appointment of an appraiser within 10 days, then the presiding Judge of Lane County, Oregon shall appoint an appraiser. The costs of the appraisal shall be split evenly. *The appraiser shall determine the Sale Price using the same criteria as set forth in paragraph 7.1 above, provided that the Sale Price shall not be less than the Insurance Proceeds.*

# I. Examples of LLC “Value” Definition

## ❖ Example 8:

### Fair Market Value

During the first 90 days of each Fiscal Year commencing on or about January 1, 2011, and at such other times as the Board may determine, ***the Board will determine the fair market value of the Company’s Units on an enterprise basis (the “Fair Market Value”).*** The Board will determine the Fair Market Value of the Company’s Units ***without regard to discounts based on lack of marketability or minority interests.*** The determination of Fair Market Value by the Board will be final for all purposes until such time as the Board shall establish an updated Fair Market Value from time to time.



# I. Examples of LLC “Value” Definition

## ❖ Example 9:

### Events Requiring Sale of Membership Units of a Member

The following shall govern voluntary and mandatory sales of LLC Membership Units by Members:

**Deadlock.** If any disagreement shall arise among the Members creating a deadlock in decision making relating to the operations of the LLC thus hindering the ability to carry on the business of the LLC, the disagreement shall be resolved in accordance with the Dispute Resolution Provisions of this agreement. ***If any Member of this LLC is unwilling to abide by the decision obtained through the dispute resolution process relating to a deadlock*** or otherwise, then such dissenting Member shall offer Member’s Membership Units in the LLC to the LLC and the remaining Members for the fair market value of such dissenting Member’s Membership Units without deduction for minority status or lack of marketability.

# I. Examples of LLC “Value” Definition

## ❖ Example 10:

### Valuation of Membership Units of a Member

*In every instance involving the voluntary or mandatory purchase or sale of Membership Units in this LLC, if the parties cannot agree on the fair market value with or without discount for minority ownership and/or marketability of the LLC Membership Units of any Member whose Membership Units must be voluntarily or mandatorily sold as described above, then the fair market value issue, with or without discount for minority ownership or marketability, shall be resolved in accordance with the dispute resolution provisions in this Agreement. The decision obtained through the dispute resolution procedure shall be binding on the parties. Such fair market value with or without discount, as the case may be, is referred to herein as the “Purchase Price”.*

# I. Examples of LLC “Value” Definition

## ❖ Example 11:

### Right of First Refusal

As provided in Section 12.2(3), if proposed Transfer is not a Permitted Transfer, the ***Company shall be given the first option, but not obligation***, exercisable by delivery of written notice to the transferring Member or Transferee, within 30 days after the company’s receipt of the Transfer Report, ***to purchase the Units to be Transferred, for the lessor (x) the same purchase price (or other consideration) stated in the Transfer Report, or (y) the fair market value of such Units, taking into account appropriate valuation discounts including, but not limited to, minority discounts and marketability discounts.*** Fair market value shall be determined by the ***independent certified public accountants then representing the Company*** and, if none, then by a qualified appraiser selected by the Company.

# I. Examples of LLC “Value” Definition

## ❖ Example 12:

### Purchase of a Defaulting Member’s Interest

The other Members shall notify the Defaulting Member of their election to purchase the Defaulting Member’s interest, and along with such notice, shall **designate one MAI appraiser** who shall establish within twenty (20) days there after **the appraised fair market value of the Company’s assets**. The appraiser shall then **determine the fair market value** of the Member’s interest, **based on the appraisal of the Company’s assets and a determination of the liabilities of the company, including contingent and unliquidated liabilities**. **Goodwill of the Company, if any, shall not be considered in determining the fair market value. A discount in the value for a minority interest of a Member, and/or for marketability, may also be considered.** Cost of the appraisal shall be charged to the Defaulting Member.

# I. Valuation in the LLC Setting - Examples

## ❖ WMA “Freebie”

### Language for Consideration:

*“Value” is defined as the pro rata membership allocation of the aggregate fair market value of the LLC developed on a going concern, enterprise basis:*

*. . . with application of current, empirically based discounts considering member-specific ownership attributes.*

**OR**

*. . . without application of any discounts relating to member-specific ownership attributes.*

## II. Role of Non-attorney Experts

### ❖ Developing an independent, credible, defensible opinion

- ❑ Considering and applying generally accepted valuation practice
  - ✓ Business Valuation Standards (“BVS”) – American Society of Appraisers
  - ✓ Uniform Standards of Professional Appraisal Practice (“USPAP”) – The Appraisal Foundation
  - ✓ Statement on Standards for Valuation Services 1 (“SSVS-1”) – the American Institute of Certified Public Accountants
- ❑ Completing a technically and theoretically accurate analysis
- ❑ Adequately supporting key assumptions and conclusions (rationale as well as related documentation)
- ❑ “Enlightening” counsel regarding relevant valuation issues
- ❑ Developing direct examination

## II. Role of Non-attorney Experts, contd.

- ❖ Reviewing and critiquing the opposing expert opinion
  - ❑ Identifying any violations of generally accepted valuation practice
  - ❑ Identifying any technical/theoretical errors
  - ❑ Identifying issues of inadequate support/documentation as relating to key assumptions and conclusions
  - ❑ Developing cross examination
  - ❑ In-court support

### III. “Entity Level” versus “Shareholder Level” Discounts and Premiums

- ❖ Some discounts apply to the entity as a whole, while others reflect characteristics of ownership, such as control versus minority and lack of marketability.
- ❖ Such “entity level discounts” or “company level discounts” apply to the value of the company as a whole, as opposed to “shareholder level discounts,” which apply to a specific block of stock.
- ❖ “Value” sections in LLC operating agreements should be clear regarding references to the permissibility or impermissibility of “discounts.”



### III. “Entity Level” versus “Shareholder Level” Discounts and Premiums, contd.

- ❖ Discounts that apply to the entity as a whole, or to all shareholders, individually or as a group, regardless of any individual shareholder’s characteristics or attributes:
  - ❑ Discount for trapped-in capital gains
  - ❑ Key person discount
  - ❑ Discount for known or potential environmental liability
  - ❑ Discount for pending litigation
  - ❑ “Portfolio,” “conglomerate,” or “nonhomogeneous assets” discount (for an unattractive assemblage of assets)
  - ❑ Customer/supplier concentration risk
- ❖ Entity level discounts usually are applied **before** shareholder level discounts (e.g., lack of control, lack of marketability, nonvoting, blockage).
- ❖ Entity level discounts typically are applied to controlling-level values, although they can be applied to minority-level values because they affect all shareholders equally.
- ❖ Discounts can be applied directly (as a percentage of value, or as a dollar amount when dealing with trapped-in capital gains), or factored into the selection of multiples (when using a market approach) or the development of discount/capitalization rates (when using an income approach).

## IV. Impact of Historical Redemption Activity

- ❖ Seasoned LLCs often have a history of unit redemptions
- ❖ Generally accepted valuation practice (specifically, Revenue Ruling 59-60 of the IRC) requires consideration of historical transactions in a company's equity when estimating fair market value
- ❖ Historical transactions in a company's equity, **in arms'-length circumstances**, provide relevant information that reasonably can be relied upon when estimating the value of equity
- ❖ A history of transactions in the equity of an LLC can serve to neutralize "value" terms within an operating agreement if pricing/value was established in an inconsistent manner

# V. Standard Valuation Approaches & Methods

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❖ Market Approach

❖ Income Approach

❖ Asset (i.e., “Cost”) Approach

## V. Standard Valuation Approaches and Methods, contd.

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- ❖ **Market Approach** - based on the premise that the value of a company (i.e., organized assemblage of operating assets) is equal to the value that rational investors are currently paying for other similarly situated companies:
  - ❑ The **guideline publicly traded company method** is used to estimate value by comparison to similarly situated companies with publicly traded stock.
  - ❑ The **guideline transaction method** is used to estimate value by comparison to similarly situated companies that have recently been merged or acquired.
  
- ❖ **Income Approach** - based on the premise that the value of a company is equal to the present value of the future economic income the company is expected to generate:
  - ❑ The **capitalization of cash flow method** is used to estimate value by calculating the present value of a representative cash flow estimate, growing at a constant rate.
  - ❑ The **discounted cash flow method** is used to estimate value by calculating the present value of a series of projected future cash flows.
  
- ❖ **Asset (“Cost”) Approach** - based on the premise that the value of a company is the sum value of each of the individual assets of the company:
  - ❑ The **capitalized excess earnings method** (treasury method) is used to estimate value by estimating the fair rate of return on a company’s net tangible assets, and assigning any excess return to the company’s intangible assets.
  - ❑ The **adjusted net asset value method** is used to estimate value by adjusting all individual assets and liabilities to their market values, with equity value represented by the amount that assets exceed liabilities.

# V. Standard Valuation Approaches & Methods, contd.

## The Market Approach

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- ❖ The value of a company is determined based on comparisons to the values assessed by the market for similar or comparable companies

- Most valuations on Wall Street are based on the market approach
  - ✓ Nearly all equity research reports are based on multiples and comparables
  - ✓ About 1/2 of all acquisition valuations are based on market approach
- Guideline publicly traded company method
- Guideline merged and acquired company method
- Analysis of prior transactions in the company's stock



- ❖ Information Needed

- Identify "guideline" companies and obtain market values for these companies
- Convert these market values into standardized values (or pricing multiples)
- Apply the pricing multiples (with any necessary adjustments) to the fundamentals of the company being valued

- ❖ Strengths

- If similar companies can be found, this is a very persuasive method
- Relatively easy to get data

- ❖ Weaknesses

- May be difficult to find truly similar companies
- Public data on acquisitions may not be available

# V. Standard Valuation Approaches & Methods, contd.

## The Market Approach

### ❖ Method 1: Directly estimate equity value

- ❑ Earnings
  - ✓ Price/earnings ratio (P/E)
- ❑ Revenue
  - ✓ Price/sales (PSR)
- ❑ Book Value
  - ✓ Price/book value
- ❑ If numerator is equity, then earnings in denominator must be *after* interest expense
  - ✓ P/E (from comparables) X earnings of subject company = value of equity of subject company

*Market capitalization, or price of common stock X # of outstanding common shares*

*Earnings AFTER deducting interest expense*

### ❖ Method 2: Estimate enterprise value (or market value of invested capital), then deduct interest-bearing debt and preferred stock

- ❑ Earnings
  - ✓ Enterprise value/EBITDA
- ❑ Revenue
  - ✓ Enterprise value/sales
- ❑ Book Value
  - ✓ Enterprise value/book value
- ❑ If numerator is enterprise value (market value of equity, preferred, and interest-bearing debt), then earnings in denominator must be earnings before interest expense
  - ✓ EV / EBITDA (from comparables) X EBITDA of subject company = enterprise value of subject company...to get the value of equity, subtract interest-bearing debt and any preferred stock

*Market value of interest-bearing debt, preferred stock, and common stock*

*Earnings BEFORE interest, taxes, depreciation and amortization*

## V. Standard Valuation Approaches & Methods, contd. The Income Approach

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- ❖ Value = Present Value of Expected Cash Flows
  - ❑ Direct relationship between the amount of cash flow a business will generate and its value
  - ❑ Discounted Cash Flow (DCF) Method
  - ❑ Capitalization of Cash Flow Method
- ❖ Information Needed
  - ❑ Estimate life of the company (assumed to be perpetual)
  - ❑ Estimate annual cash flows during the company's life
  - ❑ Estimate growth into perpetuity for terminal year
  - ❑ Estimate discount rate to apply to cash flows for DCF method
  - ❑ Estimate capitalization rate to apply to cash flow for capitalization of cash flow method
- ❖ Strengths
  - ❑ Closest to "pure" valuation theory
- ❖ Weaknesses
  - ❑ Difficult to accurately project cash flows
  - ❑ Small changes in discount rate/capitalization rate result in significant changes in value

## V. Standard Valuation Approaches & Methods, contd. The Income Approach

### ❖ Method 1: Directly estimate equity value

#### ❑ Cash flow to equity

Net Income (after tax)  
+ Noncash charges (depreciation, amortization, deferred revenue, deferred taxes)  
- Capital expenditures\*  
- Additions to net working capital\*  
- Dividends on preferred stock  
+/- Changes in long-term debt (add cash from borrowing, subtract repayments)  
= Cash flow to equity

#### ❑ Present value @ cost of equity capital

#### ❑ Result is value of equity

### ❖ Method 2: Estimate enterprise value (or market value of invested capital), then deduct interest-bearing debt and preferred stock

#### ❑ Cash flow to invested capital

Net Income (after tax)  
+ Noncash charges (depreciation, amortization, deferred revenue, deferred taxes)  
- Capital expenditures\*  
- Additions to net working capital\*  
+ Interest expense (net of the tax deduction resulting from interest as a tax-deductible expense)  
= Cash flow to invested capital

#### ❑ Present value @ weighted average cost of capital

#### ❑ Result is enterprise value (or market value of invested capital)...to get the value of equity, subtract interest-bearing debt and any preferred stock

\*(amounts necessary to support projected operations)

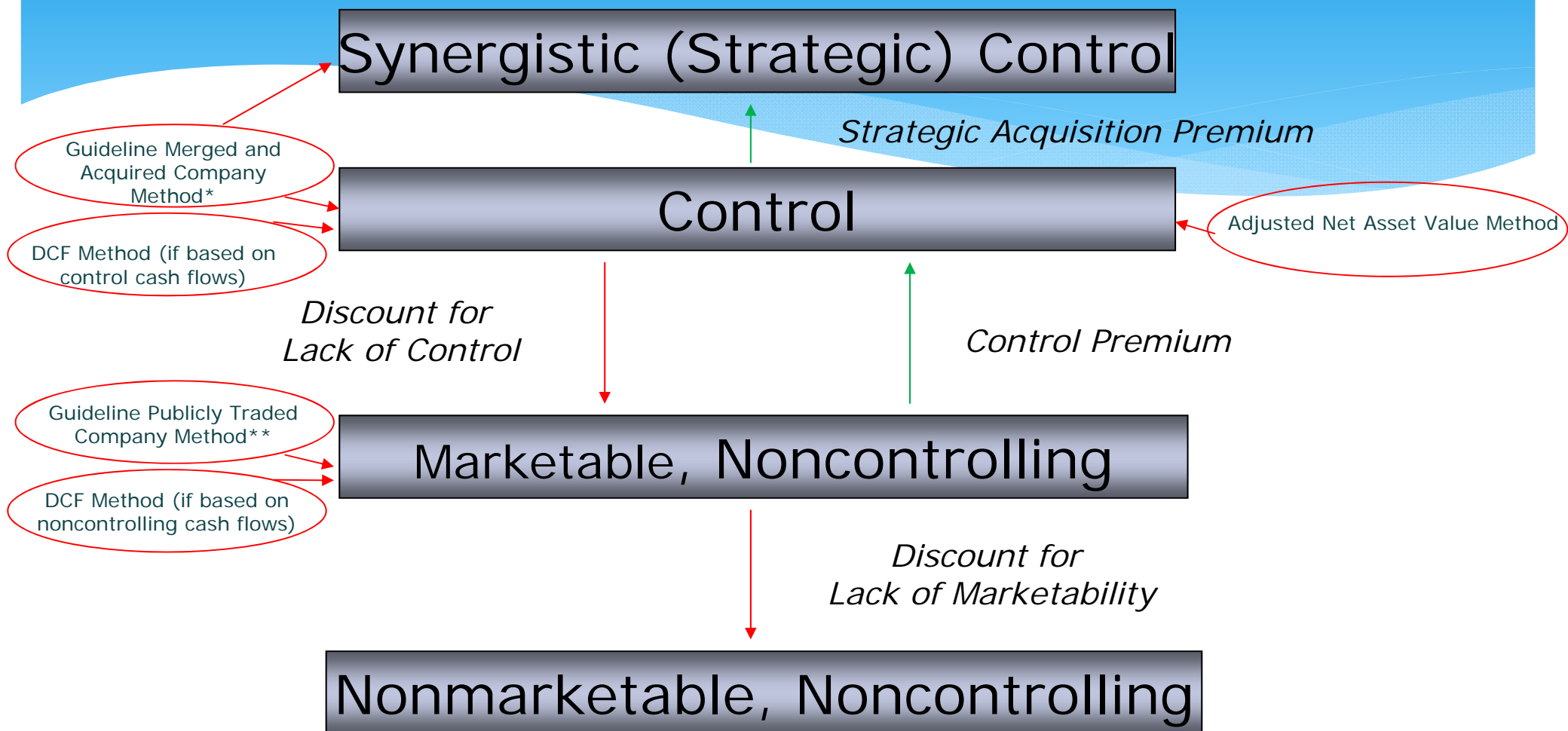


## V. Standard Valuation Approaches & Methods, contd. The Asset, or "Cost," Approach

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- ❖ Involves separate valuation of each item on balance sheet
  - ❑ Adjust all tangible and intangible assets and liabilities to their market values
  - ❑ Adjusted Net Asset Value Method
- ❖ Strengths
  - ❑ Useful for holding companies or companies with little intangible value
  - ❑ Useful for poorly performing companies, where liquidation may be a way to maximize value
  - ❑ More applicable in control interest valuations
- ❖ Weaknesses
  - ❑ Does not focus on the income that the assets produce
  - ❑ For businesses with more intangible value (i.e., service firms), the income approach is more applicable
  - ❑ Less applicable in noncontrolling-interest valuations

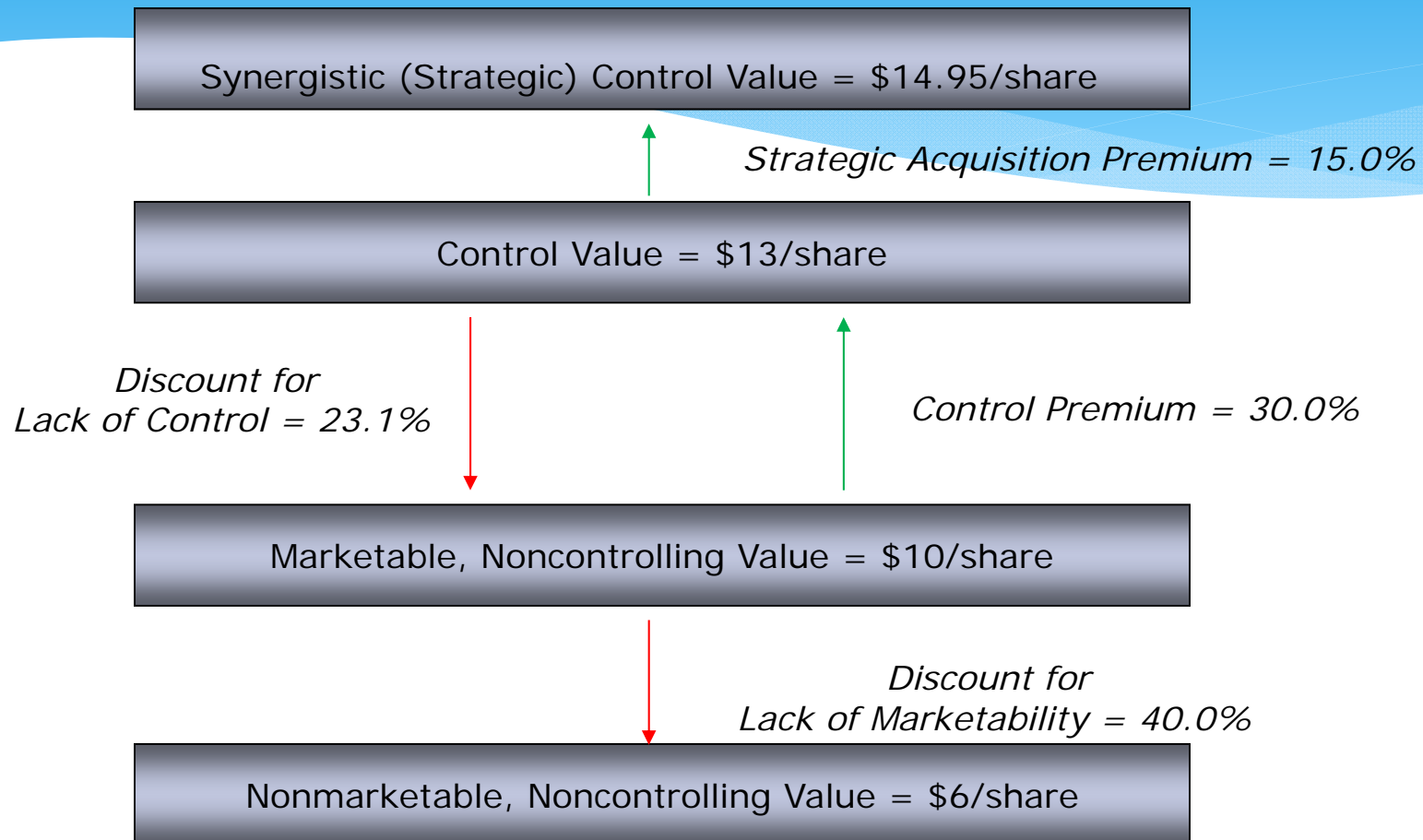
## VI. Typical Considerations: Transfer of a Less-than-controlling Interest



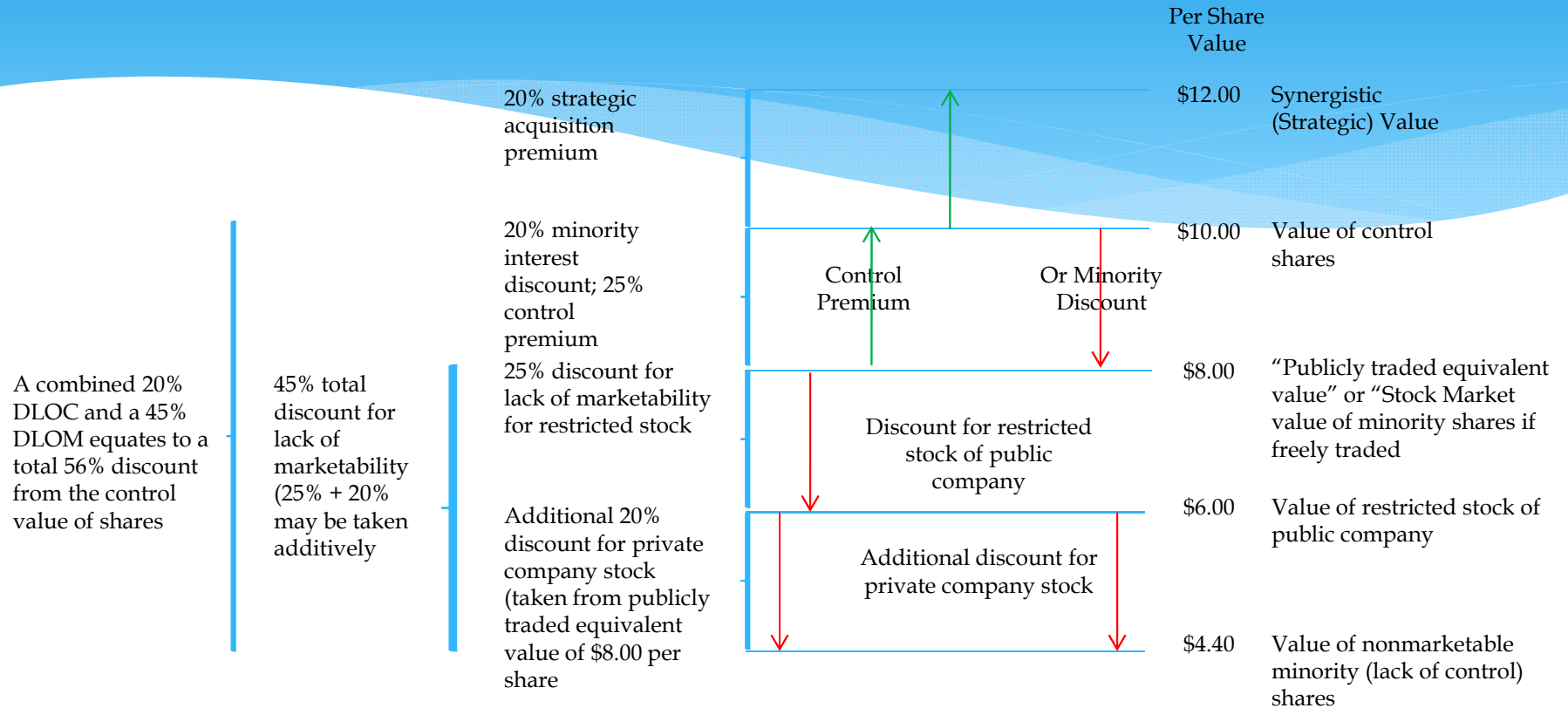
\*Could result in either synergistic control or control value depending on whether buyer was strategic or financial.

\*\*Assumes earnings of subject company have not been adjusted to control basis.

## VI. Typical Considerations: Transfer of a Less-than-controlling Interest, contd.



# VI. Typical Considerations: Transfer of a Less-than-controlling Interest, contd.



**Notes:**

<sup>a</sup> Control shares in a privately held company may also be subject to some discount for lack of marketability, but usually not nearly as significantly as minority shares.

<sup>b</sup> Minority and marketability discounts normally are multiplicative rather than additive. That is, they are taken in sequence:

\$10.00	Control Value
- 2.00	Less: Minority Interest discount (.20 x \$10.00)
\$ 8.00	Marketable minority value
- 3.60	Less: Lack of marketability discount (.45 x \$8.00)
\$ 4.40	Per share value of nonmarketable minority shares

## VII. Summary

- ❖ Founding members of an LLC are free to define “value” in any legal manner desired
- ❖ The definition of “value” incorporated in an LLC operating agreement should reflect the long-term intent of the founding members (with the understanding that founding members may leave and new members may join)
- ❖ Unless specifically defined, the term “fair market value,” when left to qualified experts, will be estimated based on consideration of generally accepted valuation practice, as influenced by the facts and circumstances



**QUESTIONS??**

**Charles A. Wilhoite, Managing Director**

**Willamette Management Associates**

**111 SW Fifth Ave., Suite 2150**

**Portland, Oregon 97204**

**(503) 243-7500**

**[cawilhoite@willamette.com](mailto:cawilhoite@willamette.com)**