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Mercer Capital's Family Law Valuation and Forensic Insights

Business Valuation 101

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Valuation is both an art and a science requiring technical knowledge and experience, informed judgment, and a clear understanding of the context in which an opinion of value will be applied. Whether for marital dissolution, shareholder dispute, estate planning, or transaction advisory, the valuation of a privately held business or business interest demands careful consideration of purpose, standard of value, premise of value, and facts and circumstances unique to the engagement and other factors.

This guide is designed to provide business owners and family law attorneys with a foundational understanding of key valuation concepts, definitions, and methodologies. It explores the framework that guides valuation analyses, the information typically required, and the approaches and methods used to determine value.

Additionally, this guide highlights special considerations that arise in divorce-related valuations, such as distinctions between personal and enterprise goodwill, active and passive appreciation, and the relevance and applicability of discounts for lack of marketability and control.

As the title implies, this is meant to be an overview and guide to assist non-valuation industry professionals in understanding a complex process. There are many detailed publications, and this piece is not meant to replace those. Our professionals can refer you more resources shall you prefer more in-depth publications.

Table of Contents

This guide is generally organized as an overview of the valuation process from planning to conclusion.

What Is a Business Valuation?

Business valuation is the process of determining the value of a business or a specific ownership interest in a business at a particular point in time. At its core, a business valuation seeks to answer the question: What is the value of this business?

The process by which one values a privately held business aligns with the same fundamentals by which publicly traded stocks are valued and traded daily – drawing on the same principles of accounting, economics, and corporate finance to arrive at a professional opinion of value. Common methods used to value a business fall under three approaches: asset, income, and market.

Who Needs a Business Valuation and Why?

Anyone with an ownership interest in a privately held business may want or need to know the value of their investment. Common scenarios that call for a business valuation include:

- **Estate and gift tax planning:** To assess the value of a business interest for compliance with IRS regulations and proper tax reporting. This type of analysis may include valuation discounts (e.g., discount for lack of marketability) that can reduce tax exposure in a gifting transaction or after death.
- **Mergers and acquisitions ("M&A"):** To establish a basis for negotiations and deal-making between parties in a transaction.
- **Litigation support:** To provide expert valuation opinions in disputes including economic damages, shareholder litigation, divorce, post-M&A disputes, and other scopes.
- **Partnership or shareholder transactions:** To set entry or exit prices for ownership stakes.
- **Divorce proceedings:** For division and/or income determination purposes when a marital or separate business interest is owned. Sometimes this can be multiple businesses with varying ownerships and further complexities.

- **Strategic planning and internal decision-making:** To discuss with/inform management about a company's strengths, weaknesses, opportunities, and threats ("SWOT") based on its financial position, including potential succession planning. We commonly see annual valuations for large, multi-generationally owned businesses where shareholders request knowledge of the business, which may be material to their net worth.

- **Raising capital or acquiring debt:** To demonstrate a company's value to lenders, venture capitalists, or private investors.

- **Employee stock ownership plans ("ESOPs"):** To determine the fair market value of shares transferred to employees under qualified plans.

Valuation Triggers: 4 Basic Quadrants

(Generally) Not Regulatory Driven

Litigation

- Buy/Sell Disputes
- Family Law
- Contract Disputes
- Commercial Litigation
- Tax Disputes
- Shareholder Disputes
- ESOP/ERISA Disputes
- Bankruptcy
- Economic Damages

Transactional

- Sale of Business
- Buy/Sell Agreements
- Stock Exchange / Public Co. / IPO
- Installment Sale
- ESOPs
- Fairness Opinions
- Incentive / Corporate Planning

Regulatory Driven

GAAP / Financial Reporting

- ASC 805 - Allocation of Purchase Price
- ASC 350 & 360 - Impairment
- ASC 718 - Equity Based Compensation
- ASC 820 - Portfolio Valuation

Tax

- Estate & Gift Taxes
- Charitable Gifting
- 409(a) Transactions
- Transfer Pricing
- IRC 197 – Allocation of Purchase Price
- Corporate Reorganizations & Basis Step Ups
- IRC 280G "Golden Parachute"

Steps in a Business Valuation: What Does a Typical Process Look Like?

There are four core steps when performing a business valuation; however, variations to this process exist, particularly when the ownership of entities or the organization of related entities is more complex than a single company being valued.

Step 1: Define and Plan the Assignment

Every valuation engagement begins with defining and planning the assignment and this first step addresses the question "What is the purpose of the business valuation needed?" This step frames the work to be performed and clarifies what is being valued, the specific circumstances of the assignment, and intended uses, among other pieces of information. A well-defined assignment ensures that all parties, including valuation experts, attorneys, clients, and other shareholders, are aligned on the scope, assumptions, and expectations for the engagement. Next, we discuss key components involved in defining a business valuation.

Subject Interest

The subject interest that is being valued might be the whole business (100%) or less than a 100% interest. In more complex situations, especially with tiered entities or holding company structures, the subject interest may consist of multiple indirect or fractional ownership stakes in multiple operating entities.

Understanding ownership is important because it may give rise to marketability and minority discounts and require necessary additional analyses if the ownership interest lacks prerogatives of control and liquidity, which are commonly associated with interests of less than 50% or a limited partner interest. This distinction often informs decisions around the appropriate level of value, which is discussed in detail on the following page.

Valuation Date

Similar to a publicly traded stock, the value of a privately held business changes over time; therefore, valuations are "as of" a specific date called the valuation date. Factors such as economic conditions, company performance, and market sentiment influence changes in the value of a business. The valuation date, which can be thought of as the "effective date," may precede the delivery of the report (also known as "issuance date") by weeks, months, or even years. This can be particularly true in litigation or estate planning contexts. In certain engagements, such as divorce or shareholder disputes, courts may require the valuation to reflect a date as close to a specific "triggering" event (e.g., separation, death, or dissolution) as possible, dependent on state laws and specific facts or circumstances. Furthermore, certain engagements require multiple valuation dates – for example, date of marriage, date of separation, and current date are all potential valuation dates in a divorce engagement. Lastly, professional standards require analysts to opine based on what is "known or reasonably knowable" as of the valuation date.

Standard of Value

The standard of value represents the perspective from which a business or business interest is being valued. Standards of value include the following:

- **Fair Market Value** is the price at which a business or business interest would change hands between a willing buyer and a willing seller, both having reasonable knowledge of the relevant facts and neither being under compulsion to buy or sell. This is common in divorce and tax matters and often includes valuation discounts.

- **Fair Value** is typically used in financial reporting, shareholder litigation, and statutory appraisals. It often excludes valuation discounts and is based on legal definitions within specific jurisdictions.

- **Investment Value** is value to a specific buyer, reflecting potential synergies or strategic attributes unique to that buyer. This value can differ from fair market value due to buyer-specific factors.

- **Other.** Some jurisdictions have case law and/or statute that presents a variation of the above, or an alternative definition. It is best to confirm the standard of value specific to the scope at hand.

Premise of Value

The premise of value establishes the basis for determining the value of an asset under its current circumstances. It can be either **going concern** or **liquidation** and impacts the valuation. Going concern assumes a business will continue to operate into the future. Liquidation value is used when a business is ceasing operations or selling off assets. This standard assumes a piecemeal or orderly liquidation scenario and is generally much lower than going concern.

Levels of Value

The level of value reflects both the economic realities and characteristics of a subject interest, including, but not limited to, investor rights, liquidity, and control (or lack of control). As an example, the level of value can help explain the difference between a 100% interest in a business at a control value and a 25% interest in a business receiving a discount to determine a nonmarketable minority value.

- **Control Value** pertains to buyers who seek control over a business, whether it be financial control buyers like private equity firms or strategic control acquirers like competitors. Financial control value may be similar to marketable minority value if the acquirer expects similar performance. Strategic control value could be specific to a particular buyer and may carry a premium to the marketable minority/financial control level of value, reflecting anticipated synergies, cost savings, or revenue enhancements that a specific buyer can expect or provide. In rare circumstances, strategic control and potential premiums may exceed the fair market value standard of value.
- **Marketable Minority Value** reflects what a business would be worth to a hypothetical investor if its shares were publicly traded on the stock market. This is a common starting point in privately held valuations and assumes an investor has no control over a business's operations but does benefit from liquidity.

- **Nonmarketable Minority Value** reflects the value of a minority interest in a privately held company. Such investors tend to lack both control and the ability to readily sell their shares. As a result, discounts are typically applied to reflect:
  - » Lack of liquidity, which limits exit opportunities
  - » A longer expected holding period
  - » Limited capital appreciation (e.g., if retained earnings are not reinvested effectively)
  - » Uncertain distributions, such as dividends or owner draws
  - » Increased risk due to lack of information, rights, or oversight, among other factors which limit control and/or liquidity

These valuation discounts, often referred to as the discount for lack of control ("DLOC") or discount for lack of marketability ("DLOM"), reduce the value of a subject interest as compared to a marketable minority or controlling interest. Valuation discounts will be discussed in more detail later in this handbook.

Step 2: Gather & Analyze Information

While valuations are data-intensive and require detailed analyses depending on the unique facts and circumstances of the assignment, the process typically follows a structured and logical sequence. This section outlines what can generally be expected in a typical valuation engagement, from initial data collection through the financial analysis.

Data Collection

Once engaged, the valuation process begins with the collection of key data, documents, and information to help the valuation expert understand a company's financial condition, operations, corporate governance, and market environment, among other factors. While every business is different, the following items are commonly requested:

- Five years of financial statements (e.g., balance sheets, income statements, cash flow statements)
- Five years of business tax returns
- Budgets, forecasts, or financial projections

- Owner, officer, and/or key management compensation details
- Corporate governance documents (e.g., operating agreements, shareholder agreements, bylaws, etc.) and dividend or distribution policies
- Any recent valuations (of the business or its assets, such as real estate)
- A list of major customers, including revenue concentration
- Key supplier contracts or relationships
- Information on competitors or overall industry conditions
- Lending agreements (e.g., bank loan documents or covenants)
- Recent transactions within the company's equity (internal or external), including pricing and participants
- An ownership or capitalization table outlining the ownership structure
- Board minutes or shareholder communications (if available)
- Industry-specific information pertinent to the subject company or other documentation available that is identified during the process of defining the engagement

Not every company will have the same requested items and some may not be applicable to a specific company. There may also be additional requests related to certain items depending on the facts and circumstances of each engagement.

Due Diligence and Management Interview

Once initial documentation is received, the valuation team begins the due diligence phase, which includes reviewing historical financial results, performing various financial analyses, researching industry and economic trends, and evaluating operational drivers of success and business risks. This is where analysts review and evaluate the quantitative and qualitative elements of a business. Some may perform an analysis akin to a "SWOT" analysis. Depending on the level and quality of information provided, initial due diligence may be more limited and require follow up requests.

The due diligence phase typically includes a management interview with owners, management, and/or others deemed appropriate to help answer questions about the business. In this phase, valuation analysts gather further understanding of the "why" behind certain trends observed in the financial statements, such as revenue growth, margin expansion/compression, etc.

A site visit may occur during this phase; however, some types of businesses or industries may not necessitate a site visit. In recent years, some trends have shown site visits may be performed virtually or deemed not necessary.

Step 3: Determine a Value

When determining a value, the valuation analyst considers the three approaches to value: the asset approach, the income approach, and the market approach. The relevance, applicability, and weighting of each approach in determining the value depends on the nature of the business, among other factors. The valuation approaches will be discussed in detail later in this handbook.

Step 4: Issuance of Deliverable

The deliverable varies based on both scope and intended use and can range from valuation worksheets to a detailed or summary valuation report. The process may also include the issuance of draft worksheets or a draft report, intended for review of facts presented in the work product. Sometimes, this results in revisions before finalizing the report.

It is important to understand why the deliverable may take a few different forms. Valuation worksheets may suffice for mediation purposes; however, shall a matter go to trial, professional standards (and good practice) necessitate a full detailed report.

Three Approaches to Value a Business

There are three approaches to value a business: the asset approach, the income approach, and the market approach. Revenue Ruling 59-60 and various professional standards provide the framework and requirements for appraisers to consider each approach in every valuation, and ultimately determine which most appropriately captures a business's value. Within each approach, there are methods which apply based on facts and circumstances.

TIP: *Within each approach, there are methods. While this may seem like a play on words, it is helpful to understand and remember that methods fall under the approaches.*

Asset Approach

The asset approach is a general way of determining a value indication of a business, business ownership interest, or security using one or more methods based on the value of the assets net of liabilities. Asset valuation methods include those methods that seek to write up (or down) or otherwise adjust the various tangible and intangible assets of a business.

Income Approach

The income approach is a general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated future economic benefits into a present, single amount. Valuation methods under the income approach include those methods that provide for the direct capitalization of earnings or cash flow, as well as the forecasting of future benefits (earnings or cash flow), and discounting those benefits back to the present value at an appropriate discount rate (discussed in a later section).

Market Approach

The market approach is a general way of determining a value indication of a business, business ownership interest, security, or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold. Market methods include those methods that compare the subject with transactions involving similar investments and publicly traded guideline companies. Consideration of prior transactions in interests of a valuation subject is also a method under the market approach.

Adjustments to the Financial Statements

Before we dive further into the three valuation approaches and various underlying methodologies, we discuss **normalizing adjustments**, as these are identified during the valuation analysis. This process involves adjusting items that are unusual, non-recurring in nature, not related to the core operations of the business, or discretionary in nature.

> ***TIP:*** *Sometimes, analysts use the terms "adjustments" and "normalizations" interchangeably, as they are synonymous. The goal of the normalization process is to adjust the financial statements to arrive at a public-equivalent business. The process to value a privately owned business follows the same theories and methodologies used by the public markets.*

There are two common categories of adjustments:

1. **Non-Recurring or Unusual Items** are eliminated to remove one-time gains or losses, non-recurring income/expenses, or other extraordinary items. Examples include the following:

    a. **One-time legal settlement.** The income (or loss) from a non-recurring legal settlement is eliminated. Conversely, if a business regularly has legal settlements (e.g., workers compensation due to a large laborious workforce), that may be considered more normal and not a necessary adjustment.

    b. **Gain or loss from sale of an asset.** If an asset of a business is sold and is not core to business operations, the one-time gain or loss is eliminated.

    c. **Restructuring costs.** If a company incurs infrequent restructuring costs and this happens infrequently, the costs are eliminated.

2. **Discretionary Items** can be paid to, or on behalf of, owners of privately held businesses and support potential adjustments. Examples include the normalization of owner/officer compensation to comparable market rates or the elimination of non-business purpose expenses paid by a business (e.g., non-business automobiles, planes, personal living expenses, etc.).

Normalized financial statements serve as the foundation for determining the value of a business.

Next, let's dive deeper into each approach, the underlying methods, and various valuation definitions and principles.

The Asset Approach

The asset approach is an intuitive approach to valuation, based on the market value of a company's assets minus its liabilities, resulting in the market value of its equity. A valuation expert reviews a company's balance sheet and assesses any adjustments necessary to reflect market value of the underlying assets and liabilities. Sometimes, additional appraisals may be necessary, such as property or equipment appraisals. The asset approach is commonly utilized in the valuation of real estate holding companies, investment holding companies,and capital-intensive operating companies; however, valuation professionals consider the asset approach during every business valuation.

Net Asset Value Method

The Net Asset Value ("NAV") method is the most common method within the asset approach. While there are variations of/from this method, the NAV tends to capture the nomenclature used for all variations, but can be referred to by different terms, such as "cost method," "book value" (or "adjusted book value"), or "replacement method." To determine the NAV, an appraiser analyzes the book value of a company's assets and liabilities and adjusts balances (as needed) to reflect market values. The adjusted market value of a company's liabilities is then subtracted from the adjusted market value of a company's assets to arrive at the NAV.

TIP: *It's important to note that the indicated net asset value should not be interpreted as an estimate of liquidation value unless explicitly stated by the valuation professional in their report.*

We list five general categories of assets and potential adjustments:

1. **Financial Assets** include cash and equivalents, marketable securities, accounts receivable, and prepaid expenses. These assets are typically straightforward, as the book values of cash and receivables usually require no adjustment to reflect market value. *TIP: One must understand if the balance sheet is recorded with the cash or accrual accounting method. If it is cash-based and accounts receivables accrued are not booked, this may warrant adjustments both on the asset and liability side of the balance sheet.*

2. **Inventory** may require adjustments such as capturing any impact of last-in-first-out ("LIFO") reserves and/or obsolete, slow-moving, or damaged stock. In rare situations, an additional appraisal may be necessary for certain types of inventory.
3. **Tangible Real Property** includes fixed assets such as furniture, fixtures, and equipment. Adjustments to consider include depreciation methods used (tax vs. GAAP) and the current market value of the asset. While the valuation analyst may be able to make these adjustments, at times, external appraisals may be necessary.
4. **Real Estate** book value may reflect current market value of the underlying property if recently purchased, but may require a current real estate appraisal if dated. *TIP: Typically, appraisals or purchases within three (3) years are acceptable*.
5. **Intangible Assets** include customer relationships, customer files, existing favorable contracts, existing workforce, trade names, intellectual property, proprietary technology, and goodwill, and are typically added to the balance sheet during an acquisition. However, some businesses will not have any intangible assets. The value of any intangible assets is usually removed during the adjustments process, as the NAV presents a tangible, operating basis of the balance sheet.

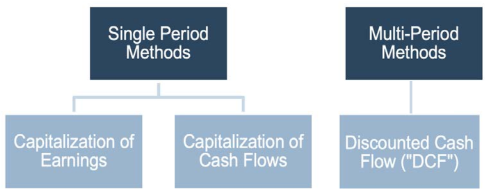
Other potential adjustments to consider include non-operating or non-business-related assets and liabilities, which can be captured separately in the overall analysis. The goal of a valuation professional is to capture the value of a business attributable to/from its core operations.

Examples of non-operating assets and liabilities include an investment account or an unrelated piece of land (and accompanying mortgage).

TIP: *These are items that would not be sold/transferred alongside a potential sale of the core business. Non-operating assets increase equity value, but do not increase the amount a hypothetical buyer would pay for core operations. Rather, the non-operating assets would be distributed to existing owners prior to a sale of the core operations.*

The Income Approach

The income approach is a way of determining the value of a business by converting anticipated future economic benefits into a single present value amount. In other words, the value of a business is the present value of all future cash flows a business is reasonably expected to produce. All methods under the income approach require valuation analysts to estimate ongoing cash flow, assess risk, and evaluate growth potential. Methods under the income approach vary, but typically fall into one of two categories:



Single-Period Methods vs. Multi-Period Methods

When deciding between a single-period income method and a multi-period income method, one consideration is a company's stage in its life cycle. A single-period method may be appropriate for mature, stable businesses with predictable earnings and limited growth or change on the horizon. In contrast, a multi-period method is typically more suitable when a company expects varying levels of performance over time, such as during a growth phase, recovery period, or planned strategic shift. Other considerations include the availability and reliability of financial projections, the degree of business or industry volatility, anticipated changes (such as an acquisition), stability of capital expenditures and/or working capital needs, among others.

Consideration	Single-Period (Capitalization) Methods	Multi-Period Method - DCF Method
Cash Flow Pattern	Businesses with stable, predictable cash flows	Businesses with varying or uneven cash flows over time
Growth Stage	Mature, steady-state businesses	Growth companies, startups, or firms in transition
Time Horizon	Focuses on one representative year and capitalizes it into perpetuity	Considers multiple years of projected cash flows plus a terminal value
Complexity	Utilizes a single normalized earnings/cash flow number and capitalization rate	Requires forecasts, capital expenditures, terminal value, and other assumptions
Data Needs	Requires fewer inputs, but assumes stability and sustainability	Requires detailed projections and assumptions (revenues, expenses, reinvestment, growth, etc.)
When to Use?	Valuing mature companies with stable earnings and risk profiles	Valuing high-growth firms, cyclical businesses, or those with expected changes impacting earnings and/or cash flows

Single-Period Capitalization Methods

Single-period capitalization methods convert a company's "ongoing" stream of earnings or cash flow into value using a single representative measure and a capitalization rate. Rather than projecting multiple years, as in the DCF method, these methods assume that a business will generate a stable, sustainable level of economic benefit into perpetuity, subject to an implicit long-term growth rate. Two common single-period methods are:

Capitalization of Earnings Method: This method applies when earnings (often net income or another equity-based earnings measure) are deemed a reliable proxy for a company's ongoing earning capacity. The discount rate applied corresponds to the required return on equity.

Capitalization of Cash Flow Method: This method uses cash flow available to all capital providers (i.e., debt and equity) as the base benefit stream. In this case, the discount rate applied is the weighted average cost of capital ("WACC").

In a single period capitalization method, the valuation professional determines the sustainable ongoing earning power (or cash flow), discount rate, growth rate, and a capitalization rate (or multiple). The ongoing earning power/cash flow represents the base from which long-term growth can be expected. The following captures the methodology:

The Gordon Growth Model

$$\text{Value} = \frac{CF}{(r - g)}$$

CF = Next year's cash flow
g= perpetual growth rate
r= discount rate for projected cash flows

Value increases when:

- Cash flow increases;
- Growth increases; and
- Risk decreases

The denominator (r–g) is referred to as the capitalization rate and the reciprocal is the familiar valuation multiple applicable to ongoing earnings. These components are present in both single-period and multi-period methods. The capitalization rate is the mathematical result of the discount rate minus the growth rate, both of which are determined by analyst judgment and informed due diligence. The growth rate is based on review of the subject company's history, current market and industry conditions, and future growth expectations.

TIP: *For a capitalization of earnings method, an equity discount rate is used; however, for a capitalization of cash flow method, a WACC is used to consider the cost and leverage of debt.*

Multi-Period Methods

The **Discounted Cash Flow method** is commonly used to determine the net present value of all expected future cash flows. The DCF allows for modeling of varying or near-term differences in growth in revenues, expenses, and other sources and uses of cash over a discrete period. Beyond the discrete projection period, it is assumed that a business will stabilize and grow at a constant rate into perpetuity, known as the terminal value. The terminal value in the model is effectively a single-period capitalization.

This method requires three basic elements:

1. **Projected future cash flows** are forecasted over a discrete period necessary to anticipate a stabilized earnings stream. *TIP: This is commonly in the range of 3 to 10 years.* Ideally, projections are sourced from management; however, a valuation professional may develop a forecast based on historical performance, industry data, and discussions with management, supplemented with a reasonableness test comparing historical/projected performance and expectations. For projections received from management, the analyst should review and evaluate any need for adjustment(s).
2. **Discount rate** is a rate used to convert future cash flows to present values as of the valuation date.
3. **Terminal value** capitalizes the value of a company into perpetuity using a terminal growth rate, discount rate, and final year cash flow to arrive at a capitalized value, which is then discounted and added to the discrete cash flow projections. The terminal value of a multi-period method is very similar to the single-period method, with the main difference attributed to the terminal value being set some time in the future after the discrete cash flows are accounted for.

Discount Rate

The discount rate is a critical component of any income-based valuation method, as it is intended to reflect the risk (or expected return) associated with a subject business. Factors for consideration include, but are not limited to, business risk, supplier/customer concentrations, financial volatility (or lack-of), market and industry risk, size of the company, financial leverage, capital structure, etc. In essence, the discount rate serves as a rate of return that compensates an investor for the time value of money and the specific risks tied to a subject company's operations, industry, size, and other relevant factors.

There are several generally accepted methodologies to "build up" a discount rate. When we refer to "building up" a discount rate, we mean the process of assembling it piece-by-piece from various risk components. We begin with a baseline rate (such as the risk-free rate) and then layer on successive premiums to account for market risk, industry characteristics, company size, and company-specific factors. Each component is designed to capture a distinct dimension of risk that an investor would consider when deciding whether to commit capital.

The discount rate goes by many names including "equity discount rate," "cost of equity," "return on investment," "WACC," and "rate of return," with variations representing either synonyms or the addition of debt. For companies that leverage debt, the appropriate discount rate is likely the WACC, because it considers the cost and amount of debt in a business's capital structure.

TIP: *A higher level of perceived risk results in a higher discount rate, which mathematically reduces the present value of expected future cash flows, and in turn, the conclusion of value. Conversely, lower perceived risk and a lower discount rate mathematically result in a higher conclusion of value.*

Cost of Equity

The equity discount rate, also referred to as the cost of equity, is the sum of the following components:

1. Risk-free rate is the prevailing risk-free rate at the valuation date, typically based on long-term treasury security yields. This rate is considered to be "risk free" because of the lack of default risk on government loans.
2. Equity risk premium is generally defined as the premium in return of large capitalization stocks over some measure of U.S. Treasury returns. This premium is meant to represent "market risk" for businesses in the United States. *TIP: Other names for "market risk" include "systematic risk" or "undiversifiable risk."*
3. Beta is a measure of the degree to which returns on a specific investment move in relation to overall market returns, typically based on either the market or guideline public companies.
4. Beta adjusted equity risk premium is the product of the equity risk premium and the selected beta. This is a mathematical result of multiplying the equity risk premium by beta.

5. Size premium is applied as historically, investments in smaller capitalization common stocks have achieved a higher investment return compared to the S&P 500, or the large capitalization stocks, due to the higher level of risk associated with smaller companies.
6. Company specific risk premium ("CSRP") is an additional premium that captures the unique risk profile of the subject company above and beyond market, industry, and size risks accounted for in the other "build-up" components. In simple terms, the CSRP captures the unique risk profile of the subject company. *TIP: Ask "what are some of the specific risk factors a company may face and questions to consider?"*

Geographic Concentration	• Does the company serve a local, regional, or national market? What about its competition? • Does geographic concentration impact growth or expansion? • How does the market served compare or contrast to the overall national economy?
Customer/ Supplier Concentration	• Any revenue concentration with one or a few customers? • Does the company depend on only a few suppliers for inputs? If so, is any risk mitigated by long-term contracts and/or lengthy history of relationship?
Competitive Environment	• Are there low barriers to entry in the company's industry? • How does the company compare or contrast to peers? • Does the company offer differentiated products/services?
Earnings Volatility	• Is there any further risk to the earnings of the business which has not been captured in the estimation of ongoing earnings? • This is an area to exert caution to avoid potential double counting of "risk" in both earnings and the discount rate.
Depth and Quality of Management	• Is there rapid turnover/short tenure for the management team? • Does management have limited industry experience? • Is there lack of succession planning, such as the absence of a clear management transition strategy?
Key Person Risk	• Does the company depend on one or a few individuals? This could be management and/or revenue generation. • Would a key individual leaving lead to a decline in revenue?
Operations	• Employee turnover compared to its industry? • Are there any challenges hiring a qualified workforce? • Are there any inefficiencies or opportunities the company faces that are not standard in its industry?
Technological Obsolescence	• Is outdated technology a risk for inefficiency? • Does the company have older equipment with higher maintenance costs compared to competitors? • Adaptability of software and programs to evolution?

Cost of Debt

The cost of debt can be based on different metrics. It seeks to quantify the market rate a company would be charged on debt financing (by a bank for example), as of the valuation date. If a company has debt outstanding, this may provide an important data point. However, if a company's prevailing interest rate is a fixed interest rate that was determined prior to a material increase or decrease in market-wide interest rates, the historical rate for a company may not be indicative of current rates.

As a result, valuation analysts consider many factors when determining the cost of debt capital. A common indication includes the yield on Moody's seasoned Baa corporate bonds. This data is reported on a daily basis by the Federal Reserve and is the lowest level of "investment-grade" debt. This rate sits between the lower rate associated with high-quality corporate debt (typically associated with much larger companies), but not as high as the risk associated with high-yield "junk" bonds, which may indicate levels of distress.

Capital Structure

Valuation analysts using the WACC must determine the cost of debt and equity capital. Once these are determined, weights (i.e., percentages) must be applied to each method, for example: 75% equity, 25% debt. The weighting of debt and equity considers a company's historical capital structure, that of its peers, and future financing needs of the business.

The Market Approach

The market approach is a way of determining value through comparison to similar businesses and/or historical transactions of the subject business. There are two primary methods: the guideline public company method ("GPCM") and the guideline transactions method ("GTM"). These methods start with a known value, whether from the publicly traded stock price (GPCM) or an acquisition price (GTM). Analysts then divide the indication of value by a relevant metric, such as revenue or earnings, to arrive at a multiple. This multiple can then be applied to the subject company's metric to imply an indication of value, demonstrated on the following pages. The third method, the internal transactions method, considers transactions in the stock of the specific company being valued.

__TIP:__ Generally speaking, some companies may simply be too small for reasonable comparison to large publicly traded companies, and some data may be insufficient. Therefore, professional judgment is required in the "consideration" of whether or not this approach and the underlying methods are applicable.

Guideline Public Company Method

Guideline public companies ("GPCs") are publicly traded companies in the same or a similar industry as the subject company that provide a reasonable basis for comparison. Research is conducted to identify a group of GPCs based on a subject company's industry and a review of operating, financial, geographical, and/or market characteristics. The valuation analyst then reviews the information and pricing metrics, including historical and forward multiples and revenue and earnings trends to further analyze the appropriateness of using each GPC for valuation purposes.

Once GPCs have been selected, analysts determine "valuation multiples" from the GPC data based on the formula illustrated below:

$$\frac{\text{Value}}{\text{Metric}} = \text{Multiple}$$

Common valuation multiples include:

- **Revenue multiple:** Compares enterprise value to sales
- **EBITDA multiple:** Compares enterprise value to EBITDA (earnings before interest, taxes, depreciation, and amortization)
- **Price to Earnings (P/E) multiples:** Compares a company's market capitalization (or stock price) to its net income (or earnings per share)

Analysts then review the range of indicated multiples and select the multiple(s) to apply to the subject company. Analysts must use their professional judgment in determining appropriate multiples, and it is common to see adjustments to multiples for differences between GPCs and the subject company, such as size, risk, growth, or other company-specific attributes.

Applying the selected multiple(s) to the relevant metric for the subject company derives an indication of value, as illustrated below:

$$\text{Metric} \times \text{Multiple} = \text{Value}$$

To finalize this method, the valuation analyst considers which indication(s) are the most relevant.

Guideline Transactions Method

As with the GPCM, transactions of privately held companies in the same or similar industry are ideal GPCs and may provide a reasonable basis for valuation of a company. Research is conducted by analysts to identify a group of guideline transactions and further reviewed to determine applicability for valuation purposes. However, unlike public company data, transaction data of privately held businesses can be limited due to voluntary reporting for non-publicly traded buyers.

Unlike public company stock prices, which can be viewed on a daily basis, guideline transactions occur at a single point in time. Therefore, timing is an important consideration, as market conditions may change between the guideline transaction date and a company's valuation date.

If the analyst determines that the GTM can be used, the process by which multiples are applied to the subject company is similar to the GPCM.

Internal Transactions Method

The internal transactions method develops an indication of value based upon consideration of actual transactions in the stock of a company. Transactions are reviewed to determine if they have occurred at arms' length and within a reasonable period of time relative to the valuation date. The valuation analyst may even extract valuation multiples from an historical internal transaction and apply the multiple(s) to current date metrics of the subject company.

Comparing the Approaches

The chart below presents typical strengths and weaknesses of each valuation approach, but should not be used in isolation, as facts and circumstances differ for each assignment. What may be appropriate in one particular valuation may not be applicable in the next.

	Asset Approach	Income Approach	Market Approach
STRENGTHS	Accounting formula is straight forward to follow Indicator of value for a liquidating company or a company in a declining industry Can, at times, establish the minimum value of a company; conversely, can set fair market value	Flexibility in valuing companies at different stages of life cycle Reflects value of a company based upon its earnings and growth potential, as well as its unique risk profile	Straightforward calculation based on market data Value indications rely on valuation metrics, i.e., revenue and EBITDA
WEAKNESSES	Does not factor in a company's earnings Does not consider the intangible or goodwill value of a company May need additional market values of certain underlying assets via outside appraisals	Potential reliance on company or management-produced projections, which should be reviewed by analysts Sensitivity of assumptions	Sources of data (private or internal transactions) and sample size Time / relevance of transactions and comparability to the subject company Arms' length transaction vs. motivation of buyer/ seller

Valuation Discounts

Discount for Lack of Marketability and Discount for Lack of Control

For non-controlling business interests, two of the most significant and debated valuation adjustments are the discount for lack of marketability ("DLOM") and the discount for lack of control ("DLOC," or together, "valuation discounts"). Whether valuation discounts apply depends not only on the facts and circumstances, but also on the state laws where the divorce is filed.

What Is a DLOM?

A DLOM reflects the reduced value of an ownership interest that cannot be quickly or easily sold. Unlike public company shares with prospects for quick liquidity, privately held company interests often face no active market, transfer restrictions, and uncertain liquidity events, among other factors influencing liquidity and marketability.

DLOMs are especially relevant for non-controlling interests in privately held companies, where lack of marketability (not lack of control) is the key differentiator from public shares. The size of a DLOM depends on factors such as expected holding period, interim cash flows, anticipated appreciation, and measures of risk.

Simply put, a discount for lack of marketability reflects the concept that a business interest that cannot be readily sold is worth less than an investment that can be freely traded, like shares in a publicly-traded stock.

By illustration: if you own 100 shares of Apple stock, you can sell them today with the click of a button. But if you own 25% of a family-owned construction company, finding a buyer for that 25% minority interest can be much more complicated. You may be subject to approvals or rights of first refusal by other owners, among other attributes or restrictions, that preclude swiftly selling your interests. The lack of a ready market reduces the attractiveness of the investment, and thus, its value.

In business valuation, experts often apply a DLOM when valuing non-controlling interests in privately held companies. That is because majority stakes in private companies can often exercise some level of control to achieve liquidity. It is important for a business valuation expert to understand the company's governance structure, among other considerations, and how that influences the marketability of the subject interest, and therefore, its valuation. As there is a range of possible discounts, the analyst reviews and analyzes various qualitative and quantitative attributes to support his/her concluded valuation discount(s).

Experience and Clarity Matters

Not all business valuation experts have experience valuing subject interests that are subject to minority and marketability discounts. These discounts are applicable in valuation scopes, such as transaction advisory, shareholder matters, and estate/tax valuations. Fifteen years ago, the IRS published the *Discount for Lack of Marketability Job Aid for IRS Valuation Professionals* which defined the DLOM, discussed the benefits and drawbacks of available methodologies at the time, and provided a general framework for professionals when valuing companies for gift and estate tax purposes.

Some practitioners may bifurcate the various negative valuation influences of a discount for lack of control (such as the ability to compel a sale or dividends) rather than marketability. While this can be reasonably defended, it is important that practitioners do not double-count the same negative consequence in both a DLOC and DLOM, and some practitioners prefer to capture all of this in a single DLOM that considers all factors.

TIP: *Regardless of the method used, careful professional judgment is required to assess whether control characteristics are truly absent and whether the selected valuation method already reflects a minority level of value.*

The standard of value applied in a divorce valuation has ramifications, as seemingly identical terms have different implications. The specific definition for each term can vary depending on the context and the standard-setter or regulatory authority. Below, we provide definitions and explain how each standard of value impacts the applicability of a DLOM.

Fair Market Value vs. Fair Value

Fair Market Value ("FMV") can be defined as "the price at which the subject interest would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts" (IRS Revenue Ruling 59-60, 1959-1 C.B. 237, Section 2.02). It is important to understand that under fair market value, the buyers and sellers are hypothetical parties and not the actual parties that own an interest.

Under the fair market value standard, valuation discounts are often considered because the discounted value reflects what an outside investor would likely pay. All else equal, prospective buyers of a minority interest want to be compensated for the uncertainty surrounding their future ability to sell that interest.

Fair Value ("FV") can be defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date" (FASB ASC 820). In many jurisdictions, fair value is used in shareholder disputes and family law. Under this standard, courts frequently limit or even prohibit valuation discounts, reasoning that such discounts penalize the spouse who is not retaining the business interest.

Whether a state uses fair market value or fair value may determine whether valuation discounts are applicable in divorce. We note, however, that some states may have their own versions and/or definitions based on interpretation that do not directly correlate to the above definitions.

Jurisdiction Is Important

It is important to understand the relevant statutes in the local jurisdiction, as states differ in their approach. See below for two examples of states that differ in their acceptance of valuation discounts:

- **New Jersey (No DLOM in Divorce):** New Jersey courts have consistently rejected the application of a DLOM in marital dissolution cases. In *Brown v. Brown* (348 N.J. Super. 466, 2002), the Court held that applying such a discount would unfairly reduce the non-owner spouse's equitable share. Because the business owner is not actually selling the interest, marketability is not deemed a real issue in the divorce context.
- **Florida (DLOM Can Apply):** In contrast, Florida courts have permitted DLOMs in some divorce valuations, because the valuation should reflect the real-world limitations of a privately-held business interest, even if no actual sale is taking place. From this perspective, ignoring the discount for lack of marketability inflates value beyond what the market would bear.

These examples show the importance of state statutes (or judicial interpretation of those statues). Two otherwise identical divorces can have very different outcomes depending on where they are filed. Furthermore, many cases are settled outside of the courts, and outside of any appeals process, providing further nuances to current considerations.

Arguments For and Against Valuation Discounts in Divorce

Proponents of applying a DLOM in divorce assert that valuations should reflect economic reality. If a 25% stake in a privately held company couldn't realistically be sold for "full" pro rata value in the open market, why should it be valued that way in a divorce? From this perspective, not applying a DLOM creates an inflated conclusion of value that does not reflect the true financial worth of the marital interest. This could leave the owner-spouse saddled with an obligation (such as a buyout or cash settlement) based on an unrealistic valuation conclusion. A DLOM recognizes that privately held company stock is not as liquid as public stock.

On the other hand, some assert that applying a DLOM unfairly harms the non-owner spouse. In most divorce cases, the owner isn't actually selling the business interest. Instead, they continue to run the company and benefit from its cash flow. Applying a DLOM in this situation results in a lower valuation and less economic benefit for the non-owner spouse. This may be especially problematic in cases where the business is the family's largest marital asset. The underlying point of contention is: Why should the non-owner spouse bear a discount for a problem (marketability) that doesn't actually exist in the divorce context? In other words, why assume a hypothetical sale when no such sale is contemplated?

Family Law Unique Valuation Issues

Business Valuations and Forensics in Divorce

In the last section of this booklet, we highlight services and analyses which are specific to working on business valuations for divorce purposes, such as nuances and/or additional scopes, plus the benefits of hiring a financial expert with business valuation expertise.

Benefits of a Financial Expert in Family Law: Why and When to Hire

The services of a financial expert can be vital for complex financial issues in divorce matters, assisting through each phase of the process: discovery, deposition, and trial. Along with valuation, tracing of assets, and testifying, a skilled financial expert can provide the following services to help uncover and understand financial issues:

- Determine financial documentation requests for subpoena
- Examine submitted financial documents
- Evaluate the accuracy of previously mentioned documents
- Assess whether further support is needed
- Assemble relevant information
- Quantify the financial elements of a case
- Identify and classify marital and nonmarital assets and liabilities
- Assist with interrogatory drafting
- Support deposition and cross-examination questionnaire drafting
- Attend depositions and trial for real-time financial support

The use of a financial expert is beneficial, especially in financial situations that may be scrutinized, such as by regulators, courts, tax collectors, and other adversaries.

Essential Financial Documents to Gather During Divorce

There are common financial documents needed in the divorce process which financial experts use based on the facts and circumstances of the case. Most financial documents fall into one (or multiple) of the following categories:

- Determining the value of the marital estate (marital balance sheet or net worth), and the individual assets and liabilities which comprise such
- Determining income and expenses for spousal and/or child support (akin to an income statement or budget)
- Determining the value of the business(es) or business interest(s)
- Providing support for forensic services

Business Valuation Documents Needed for Divorce

Below is a compilation of common documents needed for divorce engagements.

> ***TIP:*** *It is important to note not all documents may need to be requested, based on the facts and circumstances of the case, and the analyses to be performed by the financial expert.*

- » 5 years of financial statements (balance sheet, income statement, etc.)
- » 5 years of business tax returns
- » Budget/forecast/projections
- » Compensation of owners and/or key management
- » Corporate documents such as operating, shareholder, buy-sell agreement(s), etc.
- » Recent valuations of the business or its underlying real estate
- » List of top customers or relations and revenue levels
- » Key suppliers and any contractual relationships
- » Available information on competition and/or industry
- » Documents provided to/received from a lending institution (bank) to receive financing
- » Detail regarding recent transactions within the stock of the company

    - Capitalization table (detailing ownership interests)
    - Distribution policy
    - Shareholder communications/Board minutes
    - Potential non-recurring and/or unusual expenses

- **Personal Goodwill Analysis**
    - Revenue generated by provider (% attributable to divorcing spouse and other revenue generators)
    - List of roles/responsibilities of divorcing spouse and other relevant non-parties
    - Other company-specific or personnel-specific items

- **Active vs. Passive Analysis**
    - Efforts of divorcing spouse vs. efforts of others (management, leadership, owners, employees)
    - Efforts of third parties
    - Relationships with vendors, customers, etc. (held by divorcing spouse or other members of the management team)
    - Characteristics of the business at various valuation dates (ex., date of marriage, date of separation, current date)
    - Source of additional funding/capital, if applicable
    - Other supporting items

The Importance of Valuation Date in Divorce

During the divorce process, the marital balance sheet (a listing of assets and liabilities), is established for the purpose of dividing assets between the divorcing parties. One of the key considerations is the valuation date (discussed in a previous section). A majority of states have adopted the use of a current date, usually as close as possible to mediation or the trial date. However, other states use the date of separation ("DOS") in addition to, or instead of, the date the divorce complaint/petition was filed. The date of marriage ("DOM") is considered for any pre-marital and/or active/passive analyses.

***TIP:** It is important to understand the state-specific precedent and scope of the engagement.*

The valuation date(s) matter as laws differ state-to-state and the expert must incorporate relevant known and knowable facts and circumstances as of the date of valuation when determining a valuation conclusion. These facts and trends are reflected in historical financial performance, anticipated future operations, industry/economic conditions, and can fluctuate depending on the date of the valuation. It's also important to consider matters that extend into multiple years from DOS to time of divorce decree, as the value of a business may change significantly during this time.

TIP: *If material change has occurred, such as expectations for the future performance of the business, a secondary valuation using a current date may be required. A final consideration to contemplate is dependent on jurisdiction, as state law may deem the value of a business after separation but before divorce as separate property (in which case, two valuation dates would be necessary).*

Personal vs. Enterprise Goodwill: Issues to Consider in Divorce Valuations

What is goodwill? It is the difference between the value of a business less its tangible net assets and is synonymous with intangible assets (non-physical assets). Some of the intangible assets are separable and quantifiable (ex., an assembled workforce), while others fall into the catch-all "goodwill" category.

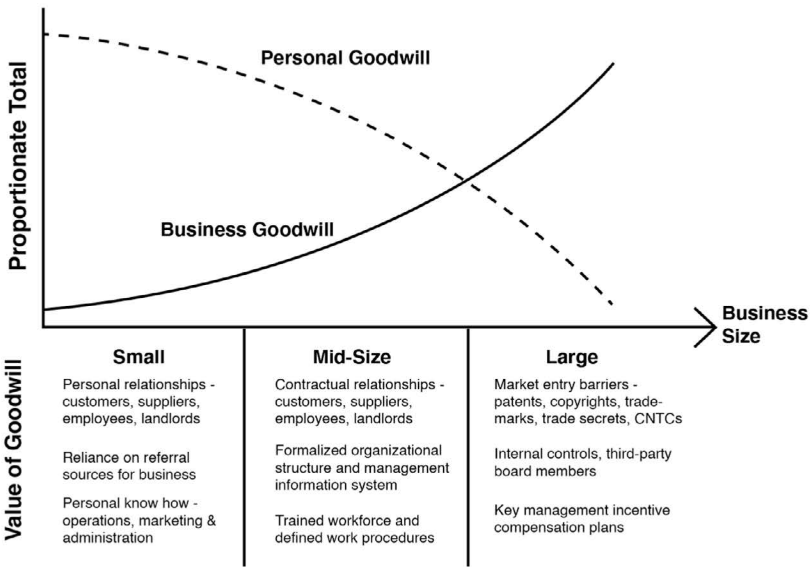
When valuing a business in the context of divorce purposes, it is important to not only understand the business and industry, but also the efforts of the divorcing spouse(s) and non-divorcing parties.

Personal goodwill represents attributes that are unique to, and inseparable from, an individual which are not able to be transferred; whereas enterprise / business goodwill represents value that is owned and/or that has been created by an enterprise and can be transferred.

Why and How Is Personal Goodwill Important?

Many states identify and distinguish between personal and enterprise goodwill; some states consider personal goodwill to be a separate asset, while others make no specific distinction for it and include it in the marital assets. This may have a significant impact on the division of the marital estate. *TIP: Personal goodwill tends to be more prevalent in certain industries, such as professional services (law practices, accounting firms, and physician practices); however, it can apply to other industries if the owner/principal exhibits a unique set of skills that specifically translate to heightened performance of their business and these attributes are unable to be transferred to another person/business.*

The image below illustrates the relationship of changing attributes of business size relative to the proportion of personal vs. enterprise/business goodwill.



Source: Business Valuation Resources

Goodwill analyses are complex and require subject matter expertise, as there are no uniform standards or guidelines to govern it.

TIP: *From a theoretical perspective, personal goodwill should show the difference in value of the business with and without the contributions from the divorcing party.*

Active vs. Passive Appreciation

The value of a business often appreciates over time and certain states require an active versus passive analysis.

- **Active Appreciation** is an increase in the value of separate property resulting from contributions of one or both spouses during the marriage and before DOS. These contributions may be financial, managerial, or involve some other type of "marital" effort.
- **Passive Appreciation** is an increase in the value of separate property resulting solely from inflation, changing economic conditions, or other circumstances beyond the control of either spouse.

Methods for allocating appreciation vary by state, and there is no generally and widely accepted method for allocating appreciation into active and passive components. Some methods rely purely on analyst professional judgment, whereas others attempt to place contributors to appreciation into a formal structure or quantitative framework within which to exercise judgment.

TIP: *Valuation of a closely held business in the context of divorce may require additional forensic investigative scrutiny for irregularities in financials in anticipation of divorce. Certain adjustments may impact and support additional forensic services, such as income determination, tracing services, lifestyle analyses, marital vs. separate analyses, etc.*

Forensic Services Resulting from Valuation Adjustments

This booklet previously introduced normalizing adjustments in valuations, highlighting the complexities of valuing a business and the importance of adjusting the income statement to portray financial results from ordinary operations of a business and ongoing earnings capacity. A few examples include the following:

- **Owner compensation.** Owners may reduce earnings in anticipation of divorce to appear to have lower earnings capacity or may have arrangements with the company to receive a post-divorce payout. A financial expert can help establish support of the "true earnings" through review of financial statements, tax returns, and even a lifestyle analysis.
- **Rent expense.** Business owners may own the land and/or building to which the business's rent expense is paid. *TIP: This is known as a "related party." If rent has increased in anticipation of divorce, the related party may be taking on pre-paid rent or higher-than-market rental rates, reducing income.*

- **Discretionary expenses.** Owners may use business capital to pay for personal, non-business related expenses (such as vacations, personal cars, entertainment, etc). A financial expert can review historical expenses to assess if items are ordinary to operations or, if determined to be non-business related, prepare normalization adjustments.

TIP: *These types of situations are especially important to evaluate if only one spouse is involved in the operations and management of a company (known as the "in-spouse.") There is potential for the in-spouse to alter the financial position of a business in anticipation of divorce.*

Lifestyle Analysis

A lifestyle analysis, also referred to as a 'pay and need' analysis, is used during the divorce process to examine each party's sources of income and expenses. It demonstrates the standard of living during the marriage and determines living expenses and spending habits of each spouse.

TIP: *It is typically more in-depth than financial affidavits and can help a judge determine equitable distribution of martial assets and alimony needs.*

The analysis provides a snapshot of income and expenses over the remaining life expectancy, illustrating net worth at a point in time and over time.

Conclusion

This guide has outlined the fundamentals of valuation, particularly of privately held businesses and interests. We defined various engagement descriptors, such as selecting the appropriate standard, premise, and level of value, to necessary information to gather. We discussed the three approaches to valuation – asset, income and market, and underlying methods within each of the approaches. We also addressed issues unique to divorce, including the treatment of personal versus enterprise goodwill, active versus passive appreciation, and the applicability of a DLOM/DLOC, together with the role of lifestyle analyses and targeted forensic procedures.

If you are navigating a matter that would benefit from seasoned valuation and forensic insight, Mercer Capital welcomes a confidential conversation about your matter. We combine rigorous analysis with clear communication to equip counsel and clients with defensible, decision-ready conclusions.

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- Valuations of Compensation Agreements
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- Lost Profits Analysis
- Assistance with Depositions, Mediations, and Trial Preparation

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- Lifestyle Analysis / Pay and Need Analysis
- Income Determination
- Alimony Scenario Analyses
- Classification of Assets and Liabilities
- Tracing Services
- Dissipation Analysis
- Business Disruption Analysis
- Damages Analysis
- Lost Profits Analysis
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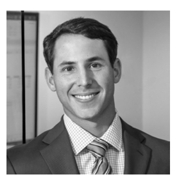

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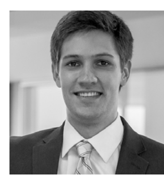

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For more information or to discuss a potential matter in confidence, contact one of our professionals.

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