MAXIMIZING VALUE THROUGH KNOWLEDGE

Hot Valuation Issues in Estate Planning

NATIONAL ASSOCIATION OF Estate Planners & Councils

The Association of Choice for Estate Planning Professionals

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April 19, 2017

ADAMS CAPITAL INC. BUSINESS VALUATION SERVICES

Agenda

1. Valuation

2. How valuation relates to family enterprise and succession planning

3. Working with Appraisers

4. Hot Topics – Personal Goodwill, Respect for the Entity, and S Corporation Tax Premiums

Valuation

The numerical result is easy

Persuading a judge is a very different thing

Adams Capital has a 20 year history of winning

Introduction to Valuation

Understanding value for:

- Estate and Gift Tax Planning
- Marital Divorces
- Business Divorces or Shareholder Buy-outs
- Executive Buy-ins
- Financial Reporting
- Selling a Business or Transitioning Ownership
- Recapitalizations
- Debt Financing
- Tax Compliance for Stock Compensation
- Bankruptcy

BETTER DECISION MAKING!

Valuation Approaches

Only three approaches to measuring value:

- Income approach – future cash flow
- Market approach – publicly traded or recent transaction multiples
- Asset approach – replacement or liquidation

Liabilities must be repaid before measuring equity value

Many methods/variations

There are only two ways to make money:

CURRENT INCOME OR LONG TERM CAPITAL GAIN

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Succession Planning - Discover

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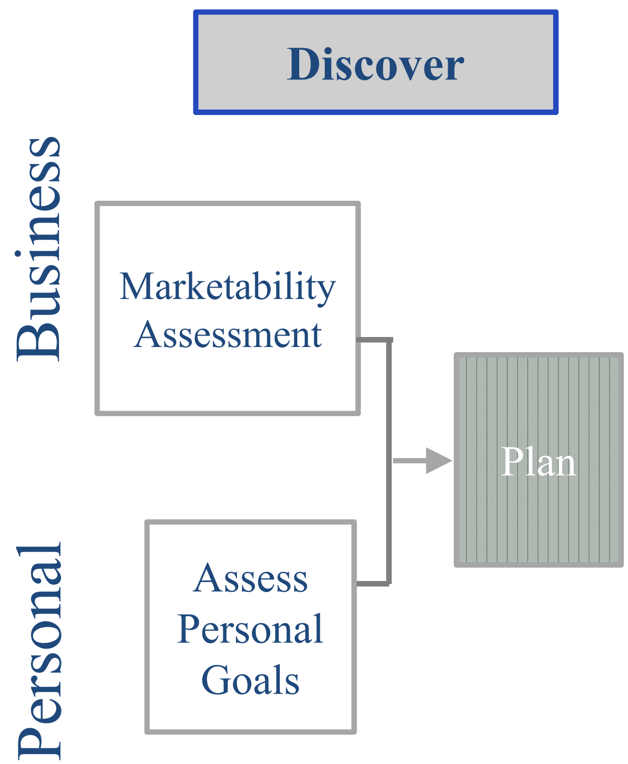

90 to 180 days

Key Milestone

Develop business goals and personal goals:

- Business = maximizing value
- Personal = succession plan

Advisory team:

- CPA
- Attorney
- Financial Advisor
- Business Valuation Expert

Family Enterprise – Value Allocation

- Family members active or inactive in the business?
- What is equitable/logical
  - Income or post sale?
  - Transfer/gift?
  - What is good for the family may not be good for the business and vice versa
- Better Business is better for everyone (employees/management and family members)
    - Transparency
    - Keep focus on business
      - Time
      - Resources

Succession Planning

Business

- Intersection of Business and Personal Goals
- Marketability Assessment
  - Financial Performance
  - Customer Analysis
  - Market Analysis
  - Senior Management Team Analysis
  - Growth/Opportunity Analysis

Personal

- Succession Planning
  - Discover
  - Prepare
  - Decide
- Grow or Transition?

Succession Planning - Prepare

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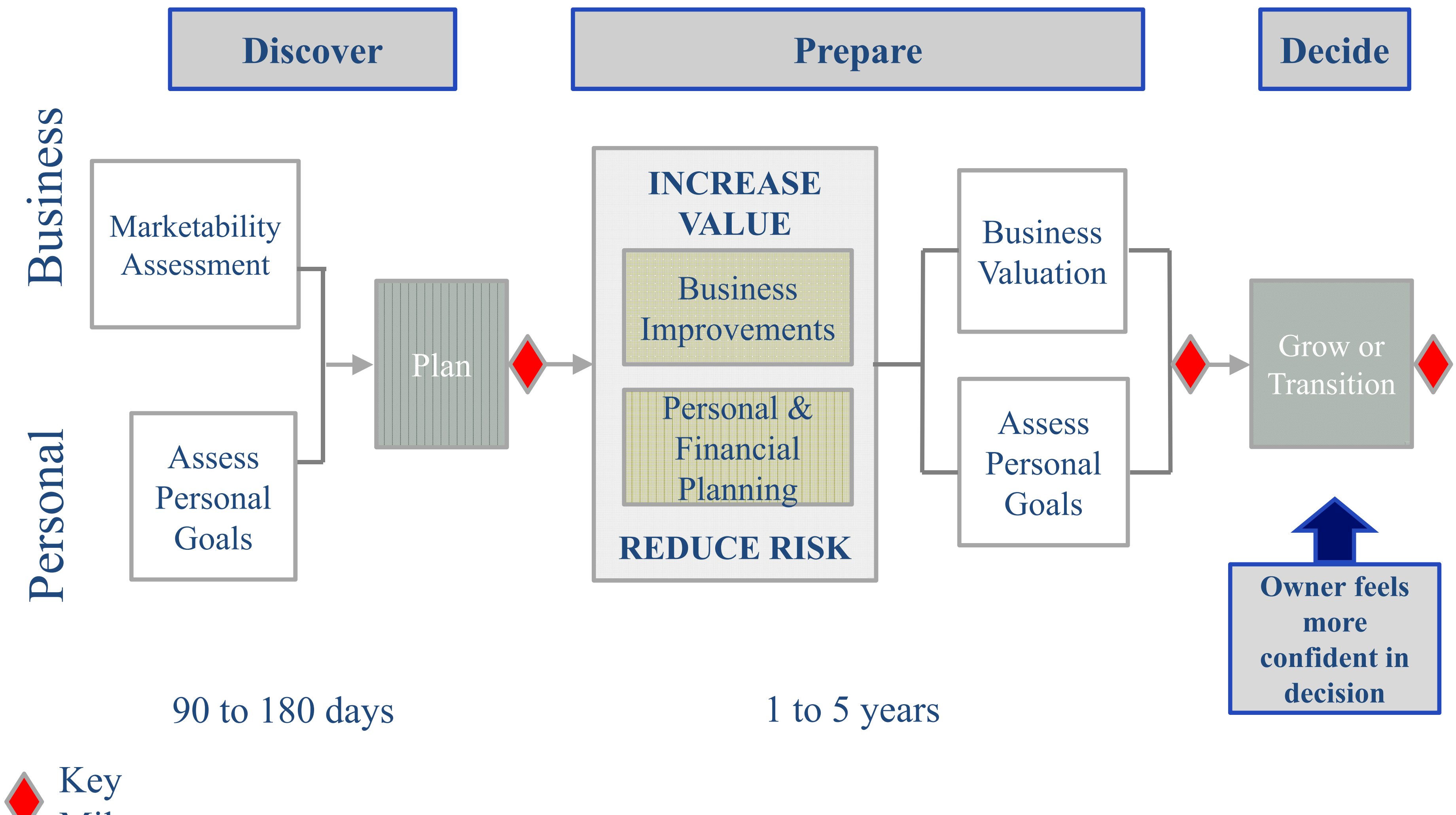

Prepare - Increase Value

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Key Value Drivers		
Profitability	Increasing profitability leads to higher valuations in both the income and market approaches by resulting in higher cash flow to the owner in the income approach and higher income metrics in the market approach.	Profitability ↑ Value ↑
Risk	Decreasing risk results in higher valuation in both the income and market approaches. In the income approach, the risk of receiving future cash flows is reduced, which increases the present value of those cash flows. In the market approach, a company with less risk will trade at or recieve a higher valuation multiple.	Risk ↑ Value ↓
Growth	Higher potential growth leads to higher valuations in both the income and market approaches. Higher growth results in greater future cash flows in the income approach and warrants a higher multiple in the market approach.	Growth ↑ Value ↑

Profitability

Financial Performance

- Trends
  - Revenue, expense, margin, and cash flow trajectory?
- Revenue and margin relative to:
  - Peers
  - Industry
- Revenue:
  - New Customers?
  - Recurring?
  - Predictable?

- Reflected in financial statements without adjustment

Risk

Risk	Mitigation
Customers	Contracts, documented sales pipeline
Technology	Security, patents, R&D budgets, and plans
Financial Risk	Hedging instruments, lines of credit, liquid assets, audit
Management Risk	Non-compete agreements, key person, employee ownership
Legal Risk	Contracts, liability insurance, directors' insurance, lawsuits/disputes
Safety Risk	Safety audits, crisis contingency plans
Supplier Risk	Supply contracts, vendor concentration
Regulatory/Tax Risk	Good inspection/compliance records. Good tax records. Make sure all inspections are current.

Growth

- Opportunity for growth?
  - New products or services?
  - New customers?
  - Geography?
- Opportunities for earnings or margin improvement?
- Is growth documented in financial statements?

Great Inventions powered economic growth from 1870 to1970:

1. Electricity
2. Urban sanitation
3. Chemicals and pharmaceuticals
4. The internal combustion engine
5. Modern communication

We need another invention!

Marketability – Sustainable Competitive Advantage

Barriers to entry

- What stops competitors from entering the market?

Market share

- In the entire industry?
- In your region?

Positioning/differentiation

- What makes you different?

Positioned as 1 or 2 in your market

Key People – Personal Goodwill

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Management analysis and succession planning

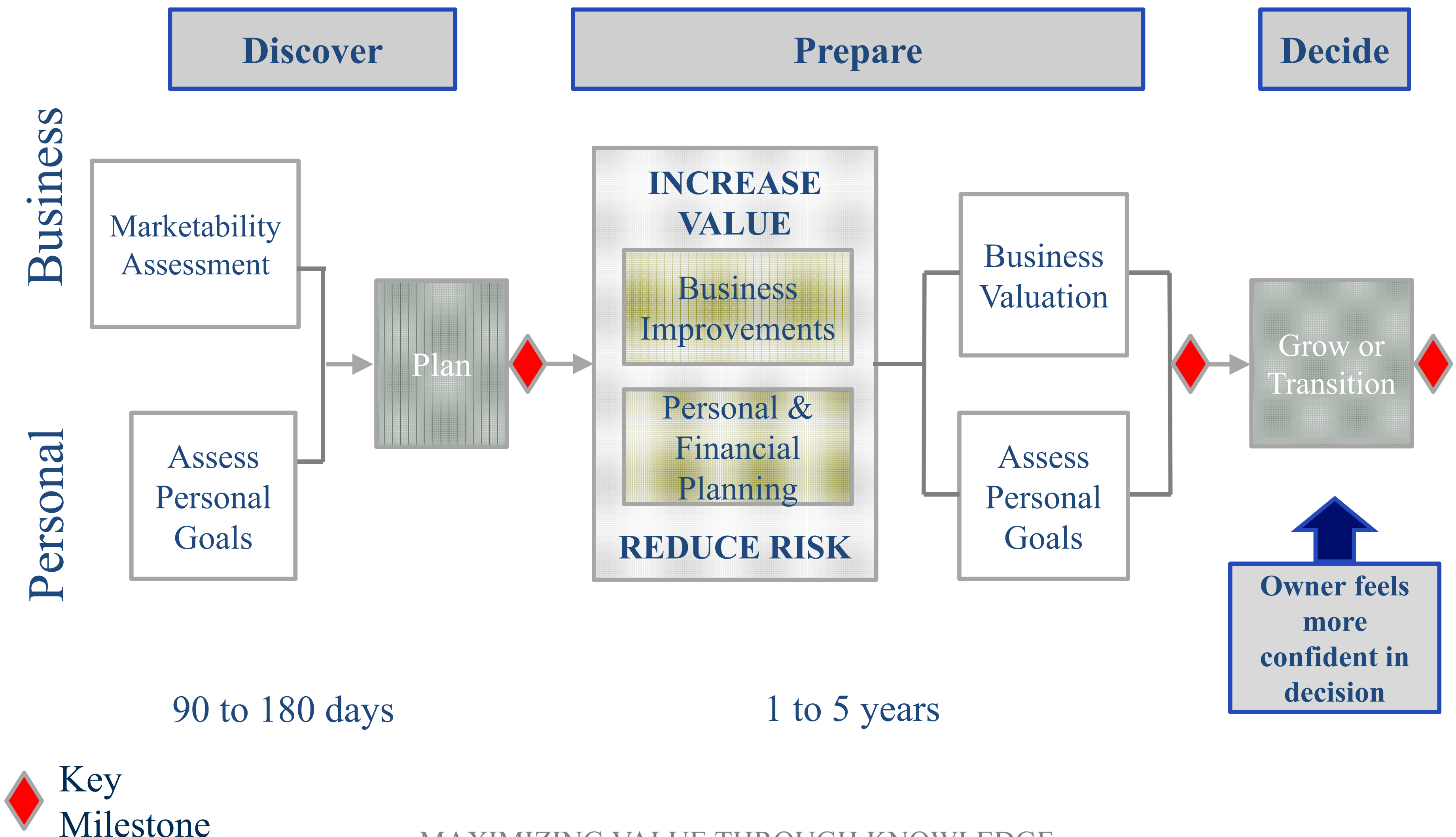
- Ages of the management team?
- Management team tenure with the company? In the industry?
- Succession plan in place?
- Key employee non-compete and/or confidentiality agreements?

Buyers worry - If I buy you and pay you lots of money, how do I know you will continue to work? How do I know you will work in my best interests? How is my purchase impacted if you compete? Is competition a realistic possibility?

Self Analysis

Would you buy your business?

Succession Planning – Decide



Grow?

- Risk/Reward
  - Requires time
  - Requires investment
  - Adds complexity to business and personal planning
  - Significant value increase

Transition?

- Explore and compare transition options
  - Sell or gift to the family
  - Sell to management
  - Sell portion to third party
  - Sell all to third party
  - Family succession
  - Clipping coupons – delegate to management
  - Timing
    - Now
    - Over time (tiered sale)
- Initiate transition program
  - Delegate to transition team:
    - Accountant
    - Business broker/investment bank
    - Corporate attorney
    - Business valuation expert
    - Insurance

Homework

- Better Businesses
  - Sell faster at higher multiples
  - Are not key person dependent
  - Diversified customer/supplier base
  - #1 or # 2 in your market
  - Sustainable competitive advantage
  - Superior margin/volume
  - Recognized by peers as best in class

But why sell a better business?

Small Businesses

- Rules of Thumb Guide
- Income approach is often difficult to apply because of:
  - Variability
  - Lack of financial projections
  - Normalization of owner's compensation
  - Owner's discretionary expenses
- Multiple of Earnings
- SDE – Seller's Discretionary Earnings

For many small businesses running the company is a job. The income generated is primarily compensation for the work performed. All personal goodwill! THEY ARE NOT SALABLE!

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Frequent Appraisal Errors – Fix these before you file

1. Opinion. Opinions stated as fact. “The capitalization rate is 10%” is opinion stated as fact. Opinions may be necessary but require evidence that the opinion is reasonable.
2. Understand. Methodology inappropriately applied. Analysis that is difficult or impossible to follow. Logic breakdown.
3. Explain. Facts at odds with the conclusion. The industry is declining but the business is expected to double in size?
4. Identify. Appraisal of the wrong asset or entity. The IRS recently won a case on real estate being appraised but an interest in a holding company was transferred. These are two very different assets. Just how easy would this have been to fix before filing the return?

Frequent Appraisal Errors – Fix these before you file

5. Dictation. Allowing the client to dictate the scope of work. "I just need a letter not a full appraisal." What they really mean is they don't want to pay much. The appraiser has a reputation that they sell in the market. We never hear about a little audit or a short will. Appraisers line up like lemmings for the opportunity to do less than required to win.
6. Transaction. Not understanding prior transactions (gift, sale, etc.) Transactions occur for different reasons. Not all equivalent interest transactions will occur at the same value. Clarifying the different motivations among sellers and buyers can help the IRS make better decisions. The appraiser should tell the story about each transaction and any special circumstances like death, divorce, and disaster.
7. Filing. Relying on a poor appraisal puts all your god work at risk. Beware suspicions outcomes. Recall that getting an appraisal with a desirable result is not winning it may be the IRS audit trigger.

Frequent Appraisal Errors – Fix these before you file

8. Mismatch. The real estate appraiser opining on a fractional interest, real estate partnership discount, or ESOP.
9. Bankers. Investment banker opinions might be accurate but are not USPAP compliant. These banker opinions have a "trust me" element that is not well received by triers of fact.
10. USPAP. Many appraisals do not mention USPAP. Run away from these appraisals. More troubling are those appraisers that claim to be USPAP compliant but fail to follow USPAP standards. Use a checklist! Available at: http://adamscapital.com/education-center/reviewing-appraisals-for-non-appraisers
11. Disclosure. Just say what was done and be clear about it. Include all facts both positive and negative.
12. Distributions. Is income aligned with value of the assets? Is the income a partial liquidation? Liquidations related to prior assets will have no bearing on future distribution capacity.

Working with Appraisers – Reviewing Appraisals for Non Appraisers

1. Begin with a review of the scope of work and definition of value with the accountant, banker, or lawyer.
2. Use the Uniform Standards of Professional Appraisal Practice ("USPAP") Checklist included in the handout.
3. Verify that the legal name and appraisal value are consistent in the appraisal and other referring documents (If they do not match, make them).
4. Does the valuation date match the transaction date? If it does not, an explanation should be in the appraisal report or with a separate letter from the appraiser.
5. Verify that the appraisal's scope and the specific property interest are precisely defined.

Working with Appraisers – Reviewing Appraisals for Non Appraisers

6. Confirm that the appraisal definition of value is consistent with the intended user's definition of value (The appraiser should not rely on the client as the client is frequently unaware of the precise rules applicable to the appraisal situation).
7. The appraisal should be clear and easy to follow. If you do not fully understand the appraisal, the SEC, IRS, banking regulators, courts, etc. also may not understand.
8. Does the enterprise value fully capture fundamental risk of the specific business – such as key person, environmental, supply, customer vulnerability, technology obsolescence, historic low dividend policy, product liability, personnel issues, etc.?

Working with Appraisers – Reviewing Appraisals for Non Appraisers

9. If the appraisal conclusion or the marketability, control/minority, and other discounts, are unusual, the appraisal should tie the conclusion to the unusual facts that drive the conclusion.
10. The owner/operator/manager/general partner should read and question the appraisal.
11. The accountant should read, question, and check the math calculations and logic in the appraisal.

Characteristics of a Well Supported Valuation

- The inputs to the valuation agree to source documentation.
  - Information should be documented and supportable.
  - The starting point of any well-supported valuation starts with the source company documents.

- Calculations are easily understood by the reader.
  - No complex calculations buried in an excel file
  - Adjustments made from source documentation should be easily followed

Characteristics of a Well Supported Valuation

- All assumptions are clearly stated and supported
  - The sources of the assumptions should be appropriately cited
  - Assumptions have a significant impact on fair market value

- The subject interest agrees to the tax return or financial statement
  - The subject interest needs to be defined clearly to the reader

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Personal Goodwill – RR 59-60 sec. 4.02(b)

- "….**The loss of the manager of a so-called "one-man" business may have a depressing effect upon the value** of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. In valuing the stock of this type of business, therefore, the effect of the loss of the manager on the future expectancy of the business, and the absence of management-succession potentialities are pertinent factors to be taken into consideration….." **Emphasis added**

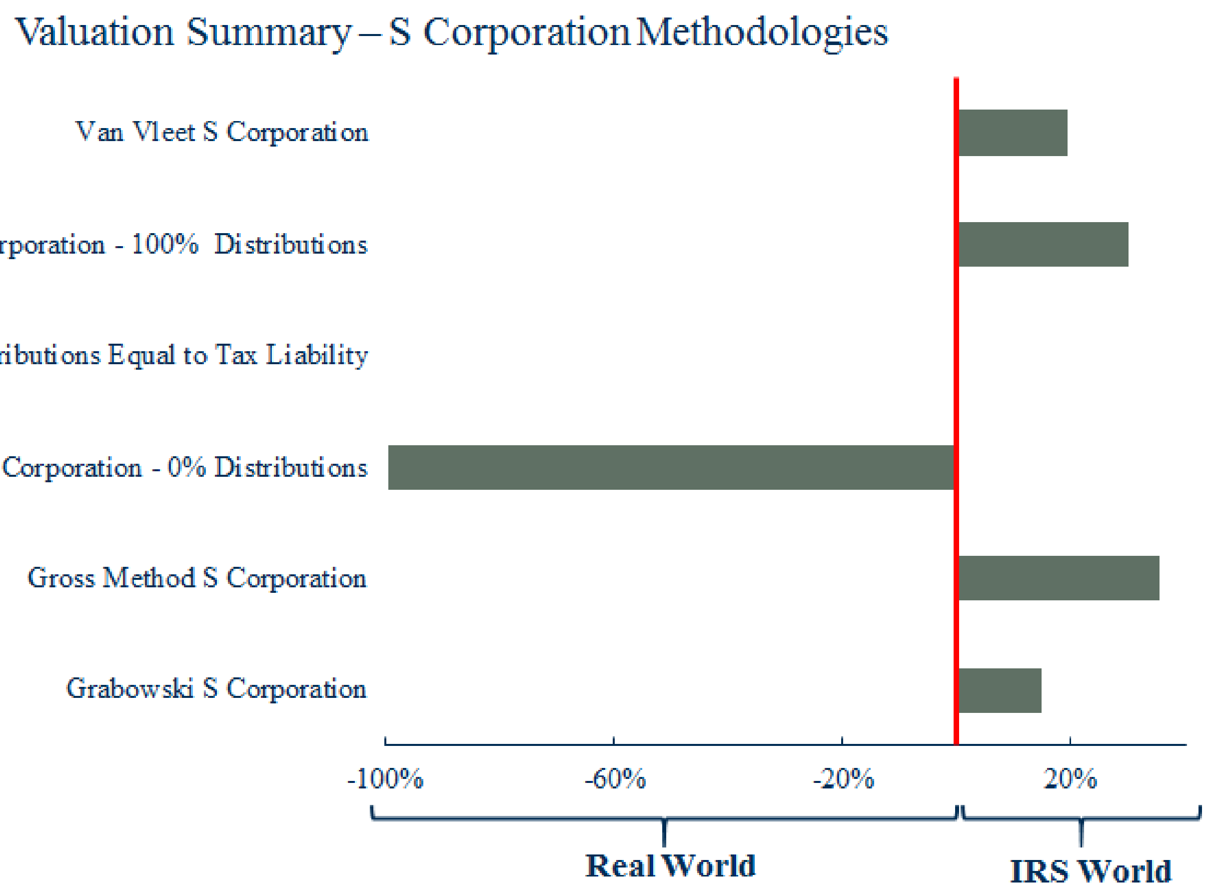
Cecil Family Gift of the Biltmore House and Gardens

Respect the Entity - Uniform Standards of Professional Appraisal Practice

Standards Rule 9 – 3:

- In developing an appraisal of an equity interest in a business enterprise ***with the ability to cause liquidation***, an appraiser must investigate the possibility that the business enterprise may have a higher value by liquidation of all or part of the enterprise than by continued operation as is. If liquidation of all or part of the enterprise is the indicated premise of value, an appraisal of any real property or personal property to be liquidated may be appropriate.

Never Pay an S Corporation Premium!



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A Dollar is only worth a Dollar

MAXIMIZING VALUE THROUGH KNOWLEDGE

Thanks!

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Questions or Comments?

600 Galleria Parkway, Suite 1850, Atlanta, GA 30339 www.adamscapital.com

Reviewing Appraisals for Non-Appraisers

http://adamscapital.com/education-center/reviewing-appraisals-for-non-appraisers

USPAP Standard	Issue	Adequate? Y	N	N/A
2-2	Reporting Option prominently stated?	☐	☐	☐
2-2(i), 1-2(a)	Client and intended users identified?	☐	☐	☐
2-2(ii), 1-2(b)	Is the Intended Use of the appraisal stated?	☐	☐	☐
2-2(iii), 1-2(e)(i)	Real estate adequately identified (including physical, legal, and economic attributes)?	☐	☐	☐
2-2(iii), 1-2(e)(iii), 1-4(g)	If personal property and / or intangibles are included in the appraisal, are they handled appropriately?	☐	☐	☐
2-2(iii), 1-2(e)(iv)	Are easements, restrictions, encumbrances, leases, reservations, covenants, contracts, declarations, special assessments, ordinances, or other items of similar nature handled appropriately?	☐	☐	☐
2-20(iv), 1-2(e)(ii)	Real Property Interst appraised stated and identified correctly?	☐	☐	☐
2-2(v), 1-2(c)	Purpose of the appraisal and definition of value included?	☐	☐	☐
2-2(vi), 1-2(d)	Effective date of report included?	☐	☐	☐
2-2(viii), 1-2(g)(h)	Assumptions, hypothetical conditions, and limiting conditions reported and accurate?	☐	☐	☐
2-2(ix)	Data, procedures, reasoning / analyses, opinions, and conclusions adequate for intended use and reporting option?	☐	☐	☐
2-2(x), 1-3(a)(b)	Highest and Best Use stated, and is the opinion adequately supported for the intended use and reporting option?	☐	☐	☐
2-3	Certification complete and signed?	☐	☐	☐
2-1(a)	Was the appraisal report clearly and accurately set forth in a manner that was not misleading?	☐	☐	☐
2-1(b)	Did the appraisal report contain sufficient information to enable the intended user to understand the report properly?	☐	☐	☐
2-1(c)	Were the extraordinary assumptions, hypothetical conditions, or limiting conditions clearly and accurately disclosed? Was the impact on value appropriately disclosed?	☐	☐	☐

USPAP Standard	Issue	Adequate? Y	N	N/A
1-4(a)	Sales comparison approach sufficiently analyzed (or reason for not using made)?	☐	☐	☐
1-4(b)(i)	Was the site valuation method appropriate (or reason for not using made)?	☐	☐	☐
1-4(b)(ii)	Was the cost approach adequate and supported (or reason for not using made)?	☐	☐	☐
1-4(b)(iii)	Were all sources of depreciation within the cost approach considered and appropriately analyzed?	☐	☐	☐
1-4(c)(i)	Within the Income Approach (check NA if not applicable), did the appraiser analyze appropriate rental data and reasonably estimate potential gross income?	☐	☐	☐
1-4(c)(ii)	Were the operating expenses adequately analyzed within the Income Approach?	☐	☐	☐
1-4(c)(iii)	Was the capitalization rate or discount rate appropriate within the Income Approach?	☐	☐	☐
1-4(c)(iv)	Was future income and expenses based on reasonably clear and appropriate evidence?	☐	☐	☐
1-4(d)	If leased fee interest was appraised, did the appraiser appropriately analyze the effect on value of the terms and condition of the lease?	☐	☐	☐
1-4(e)	If applicable, did the appraiser analyze the effect on value of the assemblage of the various estates or component parts of a property and refrain from valuing the whole solely by adding together the individual values of the various estates or component parts?	☐	☐	☐
1-4(f)	If applicable (or known to the reviewer), did the appraiser appropriately analyze the effect on value of anticipated public or private improvements, located on or off the site, to the extent that the market actions reflect such anticipated improvements as of the effective appraisal date?	☐	☐	☐
1-5(a)	Did the appraiser analyze the current agreement of sale option, or listing of the property?	☐	☐	☐
1-5(b)	Did the appraiser analyze and report the sales history of the property (1 year for one-to-four family residential properties, and 3 years for all other property types)?	☐	☐	☐
1-5(c)	Did the appraiser appropriately reconcile the approaches and analyses?	☐	☐	☐
1-1(a)	Was the appraiser aware of, understand, and correctly employ those recognized methods and techniques that are necessary to produce a credible appraisal?	☐	☐	☐
1-1(b)	Does it appear that the appraiser did not commit a substantial error of omission or commission that significantly affects the appraisal?	☐	☐	☐
1-1(c)	Does it appear that the appraiser did not render appraisal services in a careless or negligent manner, such as by making a series of errors that, although individually might not significantly affect the results of an appraisal, but in aggregate would affect the credibility of those results?	☐	☐	☐

DAVID P. ADAMS III, CPA, ABV, ASA

President of Adams Capital, a leading National provider of strategic business valuation and financial advisory services. Prior to forming Adams Capital, Mr. Adams practiced business valuation with Coopers & Lybrand and KPMG Peat Marwick. Mr. Adams received a BS degree in Mechanical Engineering from Georgia Tech and an MBA with a concentration in finance from Georgia State. He is an Accredited Senior Appraiser with the American Society of Appraisers, and the past president of the society's Atlanta Chapter. Mr. Adams is a Certified Public Accountant, Accredited in Business Valuation and a member of the American Institute of Certified Public Accountants. Mr. Adams is also a member and past management committee member of the Georgia Society of Certified Public Accountants where he previously served on the board, estate gift and trust committee and personal finance committee. He is past president of the Buckhead chapter of the Georgia Society of Certified Public Accountants. Immediate past president of the Atlanta Estate Planning Council. Mr. Adams is recognized as a qualified expert witness and has provided expert testimony in Tax Court, Alabama, California, Florida, Georgia, New York, Pennsylvania and Tennessee.