

Business Valuation Notes

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ASSET APPROACH FOR DISSOLUTION

DEFAULT PROBABILITY STUDIES

Goodwill not valued

Risk Judgment

An appeals court has accepted a liquidation method to determine a company's value, disallowing the value of goodwill. The plaintiff had argued the company was still a going concern and should have been valued as such. The court, however, determined that the plaintiff was personally responsible for the outcome.

MBVG President Randall Schostag said the case is worth reviewing for those instances when a principal's departure may critically harm a business.

The facts are unique. The business had two partners, one with a clear majority and

another with a minority. The minority partner abused his interest, using the company's assets to create a competing business.

When the majority partner discovered the abuse, he removed the minority partner. He accepted dissolution of the business, declining to purchase the minority partner's interest to avoid liquidation.

The case is *Catalino Olaires, Jr. v. Technical Cable Concepts, et al.*, No. G026221 (Cal. App. 4 Dist. January 3, 2003),

The minority partner held 24.5% of Technical Cable Concepts

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The Risk Management Association (RMA) has started publishing "Industry Default Probabilities and Cash Flow Measures". The studies are an extension of RMA's familiar "Financial Ratio Benchmarks", used by bankers, appraisers, and others in corporate finance since 1914.

MBVG President Randall Schostag said that the studies will help appraisers better understand a subject company's risk than was previously ascertainable.

"I don't think that appraisers will start incorporating this information immediately,"

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DISSOLUTION

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(TCC). The majority partner thus held 75.5%.

In 1997, the minority partner helped his nephew establish a competing business, CCIS, using TCC's equipment, supplies, and employees. The minority shareholder filed for dissolution under California Code 2000. The majority interest, however, declined to purchase the interest to avoid dissolution. The lower court then ordered the business into involuntary dissolution under Corp. Code sec. 1800.

The court appointed an accountant to value the business for the involuntary dissolution. The accountant determined that the business had a net asset value of \$2.69 million. He did not determine the value of any goodwill the company may have had, determining that the value of any goodwill would be speculative in light of the minority partner's setting up a competing company and then

forcing an involuntary dissolution. The lower court awarded the minority shareholder 24.5% of the net asset value. In doing so, the court permitted the majority shareholder to purchase the minority interest for that amount.

On appeal, the minority shareholder argued that the lower court erred in failing to value the business in accordance with Corp. Code sec. 2000, which required the lower court to appoint a panel of three appraisers to determine the fair value of the business in liquidation, considering the possibility of a sale of the business as a going concern. He also argued the lower court erred in failing to value TCC's goodwill.

The appellate court rejected both arguments. It noted that a determination of fair value as set forth in Corp. Code sec. 2000 is only required when the majority shareholder or the company elects to

purchase the minority shareholder's interest in order to avoid dissolution. The appellate court stated, "Absent such invocation, we are not persuaded the court was prohibited from determining the fair value of ...(the minority interest) ... shares by an alternative method." Moreover, it noted the net asset value method is one of three approaches generally used to determine the value of a closely held company. Thus, it rejected the argument.

The appellate court next noted that the lower court found that "Consideration for any goodwill would have produced an inequitable result by permitting a minority shareholder who was involved in setting up a competing business and soliciting the corporation's business for himself to force the corporation into involuntary dissolution." Thus, it affirmed the lower court's valuation.

NEW RMA RISK MEASURE BY INDUSTRY

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Schostag said. “It will take us some time to develop a learning curve—to assess how the information is best used.”

RMA was previously known as Robert Morris Associates. The company’s “Annual Statement Studies—Financial Ratio Benchmarks” is published annually and provides a commonly used reference point for analysts to use to compare a subject company’s performance. The information is displayed for companies by Standard Industrial Classification Code (SIC) or the North American Industrial Classification System (NAICS).

Pratt, Reilly, and Schweih in “Valuing a Business” (4th Edition, McGraw Hill, 2000) notes that RMA’s annual statement studies are “probably the most popular source of composite company data, including privately owned company data...”

The financial statement

information RMA uses is obtained by RMA member institutions (banks) and represent the financials on their commercial customers and prospects. It provides financial ratio benchmarks derived directly from more than 150,000 statements of financial institution borrowers and prospects.

The RMA financial ratio benchmarks include common size balance sheets and income statements that allows the analyst to compare the subject company performance to its peers, and standard ratios for profits, asset efficiency, solvency, and financial leverage.

“The financial analyst review these comparative data within a company from year to year,” Schostag said, “but it is also important to see how the company compares to other similar companies.”

In the new publication, RMA uses the extensive database it already has, focusing on the cash flow characteristics.

These measures provide a method for RMA to obtain an indication for the probability of default in an industry, using one and five-year horizons. The information also provides a “Z-Score”, another measure of potential bankruptcy.

The probabilities for default used in the new publication are generated using Moody’s RiskCalc™ model.

RiskCalc™ uses Moody’s unique and proprietary middle-market private-firm financial statement and default database, consisting of 28,104 companies and 1,604 defaults. The algorithm uses 10 financial ratios, targeting middle-class borrowers. It is for firms too large to be considered a simple extension of an individual, yet not publicly traded. “We’re not sure exactly how we will apply this new tool,” Schostag admitted. “We want our clients to know about its availability and to not be surprised when it is used.”

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BUSINESS VALUATION

Goodwill Impairment Analysis (141/142)

Businesses

Intellectual Property

Intangible Assets

Options

Strategic Planning

ESOP

Divorce

Shareholder Oppression / Dissenting Rights

Buy/Sell Agreements

Merger / Acquisitions

Fairness Opinions /Purchase Allocation

Planning

BUSINESS ASSET VALUATION

Experts or Consultants

Sale / Purchase

Insurance

Fair Rental Rates

Financing

Ad Valorem Taxes

Condemnation

Feasibility

Purchase Price Allocation

Property Records

Fiduciary Review

Sale / Leaseback Structuring

Business Planning

WE ARE AVAILABLE FOR PRESENTATIONS FOR ESOP IMPLEMENTATION, MERGER & ACQUISITION CONSIDERATIONS, EXPERT TESTIMONY PREPARATION, GENERAL BUSINESS VALUATION, AND MANY OTHER TOPICS.

OUR FORMAT IS POWER POINT - BASED.

WE REQUEST THAT YOU SUPPLY THE SOUND SYSTEM AND APPROPRIATE DISPLAY INSTRUMENT.

WE WILL CONNECT OUR COMPUTER.

PLEASE ALLOW AT LEAST 30 DAYS FOR SCHEDULING.