

Business Valuation Notes

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Machinery & Equipment issues.....

FAIR VALUE FOR PERSONAL PROPERTY

...Is it really fair?

Fair value measures applied to machinery and equipment appraisals have raised the price of doing those valuations. Fair value is now required for most accounting applications. This measure is not used for most other applications, such as for gifting, estate, or employee stock ownership plans.

During a presentation for the national conference of the National Equipment and Business Builders Institute (NEBB Institute) in Minneapolis, Minnesota September 25, 2009, Minnesota Business Valuation Group President Randall Schostag will briefly address some of the nuances of using fair value as the standard of value when used for appraising machinery and equipment.

MBVG's expertise for machinery and equipment appraisals comes from Ron Bruzek who has been affiliated with MBVG for the past eight years. He is accredited for this work by the American Society of Appraisers to do the equipment appraisals, and worked for Marshall & Stevens for 24 years before joining MBVG in 2001.



Schostag

The NEBB Institute (<http://www.nebbi.org>) is a national organization which provides initial and monthly comprehensive education, on-going support, an international network, and certifies professionals in the art of ma-

chinery/equipment appraisal and brokerage.

Schostag, who is a nationally recognized expert on fair value, will discuss the fair value standard generally, and more specifically how it is used in business valuation, from an operating company and intangible asset value perspective. However, because attendees to the national conference are primarily equipment appraisers, he will also discuss some aspects of how this relatively new standard of value has had an impact on valuing machinery and equipment, the greatest interest to this group.

Fair value was formally adopted effective November 15, 2007, by the American Institute of Certified Public Accountants in the Statement of Financial Accounting Standard (SFAS) 157. FASB has long indicated a preference for fair-value measurements, which have been making inroads into accounting standards for the past 15 years.



Bruzek

The new, single measure to be used for generally accepted accounting principles (GAAP) now defines fair value and deals with measurement protocols and techniques, and financial statement disclosure.

In developing the statement, the FASB and the AICPA created a single definition of fair value by amending 28 opinions, statements, interpretations and other pronouncements, and integrated

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M&A Heating Up...

DO YOUR HOMEWORK

Buying and selling businesses is gaining some momentum, following a drought in activity after the market nose-dive in late 2008, Randall Schostag, President of the Minnesota Business Valuation Group believes.

Schostag addressed the Minnesota chapter of the Alliance of Mergers & Acquisition Advisors in Minneapolis, Minnesota, on September 15. The Minnesota AM&AA chapter is part of the national AM&AA headquartered in Chicago, Illinois, and consists of private equity investors, financiers of mezzanine debt, asset-based lenders, fund-less sponsors, and professional service organizations which offer support services for buying and selling businesses.

"It's too early to be sure," Schostag said. "But we're seeing more inquiries and the beginning of activity. That's consistent with national data which shows record high cash at private equity firms, mezzanine lenders, and asset-based lenders."

Transaction terms will differ from a year ago, with valuation ratios for equity down to 4 to 6 times earnings before interest, depreciation, and amortization compared to 8 to 10 times before the late 2008 melt-down.

"Sellers must be familiar with the value of what they're selling, and prepare a due diligence book in advance," Schostag said. "Although there's more buyer interest, reduced pricing means sellers must be conscious of the true value of their business and not to sell

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M&E Appraisal

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another 39 pieces of accounting literature which had been issued previously and was spread over numerous places.

As MBVG has written in past issues of *Business Valuation Notes*, the standard of value prescribed for use by accountants has been widely discussed and criticized by many in the business appraisal community, mostly due to the standard's heavy reliance on the market approach.

In a two-part series published by the National Association of Certified Valuation Analysts in *Value Examiner* in 2008, Schostag reasoned why the AICPA and FASB focus so much on using the market approach, and why in most cases when dealing with small companies that measure may be both difficult and in error to apply. After the market melt-down in late 2008, FASB introduced some changes to SFAS 157, but the changes mostly relate to loan portfolios and do not answer the concerns of holdings other than loans.

"In our opinion, the epicenter of the debate over fair value is the demand to concentrate on the market approach," Schostag said. "For business valuers this has been translated into identifying transactions of similar companies, especially ones which are publicly traded. Trying to find publicly traded companies which are reasonably similar to those which are private is problematic. Most public companies have better access to capital, are larger, and have more and / or different product offerings and different markets.

"Furthermore, the public companies may have different capital structures or other unique aspects which make them difficult to compare to another private company. This means the business appraiser may end up with only a very few companies to use for comparison and therefore not be reflective of the broader market. The most discouraging aspect of SFAS 157 is

that it actively discourages the use of the income approach whereby the analyst is able to capture the unique attributes of the company analyzed."

Bruzek said that most equipment appraisers have typically relied heavily on the cost approach to value personal property, but that with the new focus on the market approach the work product is much more time intensive and may not always produce a realistic value.

"Most equipment appraisers call the cost approach 'trend and bend'" Bruzek said. "Essentially we look at the original cost basis of the equipment, examine the depreciation used, and bring it to present value, and then make adjustments to that value by deducting for physical, economic, and functional obsolescence.

"With the additional requirement to seek out dealers, obtain a quote, assess the reliability of such quotes, and then theorize about transporting the equipment to the site and installing it requires a lot more time and effort." Bruzek said that in his experience using the market approach for these engagements has produced values which are lower than they would have been using the "trend and bend" models.

"The greatest problem with the market approach is that it fails to capture the unique improvements which may have been made to equipment at a company. Think of that added hard drive on a computer, software designed or fitted to the computer, and other similar changes. Using 'trend and bend' we're able to approximate present value quite closely. The market approach simply does not get us there."

Schostag added to Bruzek's comments saying, "Property, plant, and equipment or PP&E appraisers have been using 'Value-in-Use' methods for 35 years. But the FASB has now switched to requiring a 'Value-in-Exchange' method which often results in lower values for tangible assets. This means that the remaining difference between adjusted book value and going concern value displays more in-

tangible value. Assuming that the business appraiser is consistent with respect to identifying and valuing transferable intangible assets, this means that the amount of remaining goodwill will be larger."

Used News, a publication of Iron Solutions, Equipment Market Intelligence, notes a five-step appraisal process by dealerships to determine appropriate trade-in value when a quote is given. Often the value is based on trade-in and not an outright purchase. The value given by different salesmen can vary widely, depending on their individual "feel" for the used market, deciding how much it may cost to recondition the equipment, get the trade-in ready for resale, and the eventual profit margin required from a resale. "All of these factors rely on considerable judgment from the source," Schostag said, "and the source may have circumstances where he or she needs or has a surplus of similar equipment, does not actually see the equipment, or doesn't take sufficient time to evaluate the specific piece."

Because the market approach alone doesn't reflect many of the nuances captured using the cost approach model, the appraiser should still use a combination of the cost and the market approach. Schostag points out that in conventional valuations conducted for business appraisals, the evaluator will examine values from the perspectives of the income approach, the market approach, and the asset-based approach. This three-legged system helps identify potential blind-spots in deriving a value.

"In most instances of going concern valuation," Schostag said, "the asset approach is only used to corroborate the findings using the income approach and the market approach. This is done at the end of the analysis in a section on reconciliation." Bruzek explained that it's similar for equipment appraisal. "For fair value we generally do both a method for the cost approach and another method for the market approach. These are then reconciled to ascertain value."

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M&E Appraisal

(Continued from page 2)

Of course if there is no market-based evidence of fair value because of the specialized nature of the item, the appraiser may need to estimate fair value using an income or depreciated replacement cost method, Bruzek said. Trying to slice out the appropriate income stream for a specific asset is generally problematic, so the default is using a depreciated replacement cost method – trend and bend.

Robert H. Herz, who became FASB chairman in July 2002, was quoted by CFO.com in 2003 as saying that he is aware of the problems associated with applying a market approach model to assets where active markets don't exist, but that he would make sure that the ability to value wouldn't "outstrip" the ability of analysts to implement the concept.

"Seven years later, however, FASB and the AICPA pay more attention to the holdings of publicly traded companies," Schostag said, "with only minor attention to the effect on small companies and related issues, such as equipment."

The presentation by Schostag will be at 11:00 a.m., Friday, September 25, at the Airport Embassy Suites, Minneapolis, Minnesota, at the national conference of the National Equipment and Business Builders Institute (NEBB Institute). The topic will be: *Fair Value: Is it Really Fair? Working with your Accountants for Reporting.*

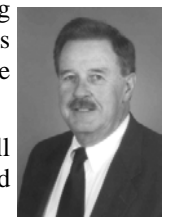
The NEBB Institute Conference will be at the Embassy Suites in Minneapolis, Minnesota September 24 through September 25, 2009.

For more information contact either Richard Thorsen at dick-thorsen@msn.com who is a committee member or Bud Sandberg at wals@pro-ns.net who is in charge of the conference planning.

The conference will have a full agenda, planned for M&E Appraisers.



Sandberg



Thorsen

M&A Homework (Continued from page 1)

too cheap."

In working with owners, MBVG uses a multi-step process. The business is analyzed as a stand-alone operation, presumed to continue as is into the foreseeable future, with only minimal changes, and assuming it is prudently managed, though not optimized. The analyst assumes the business is sold for cash, without seller's notes or taking stock or similar terms. Finally forecasts are made to ascertain what can reasonably be expected over the near term, say five years, for business operating returns, given what is known or knowable at the present time.

"This manner of evaluating the business uses a standard of value called Fair Market Value," Schostag said. "That's the standard of value required, for example, for valuations for gift and estate appraisals by the Internal Revenue Service and for Employee Stock Ownership Plans or ESOPs by the Department of Labor. At MBVG we consider the value obtained using fair market value to be a base value, a kind of floor on the price which the owner should accept.

"This exercise to value the business using this standard of value is very good because it not only gives the seller a base-line, but it also surfaces important value drivers for the business and permits a sensitivity analysis to determine what factors may give the business the largest and smallest range in values if underlying assumptions change."

MBVG uses a work sheet to estimate future changes in balance sheet and income statement factors which reveal operating assumptions, including: profitability, financial leverage, reinvestment and working capital requirements, growth, and asset-handling efficiency. Such factors can be tested for sensitivity so that during negotiations with a prospective buyer, the seller can better understand the effect of assumptions made by the other party and how it may affect a buyer's point of

view of value.

"Unless the seller is armed with that understanding," Schostag said, "the seller is at a disadvantage in truly communicating with a buyer or knowing what should be treated as important during negotiations."

After developing an estimate of value using the fair market value standard, and as negotiations with a buyer progress, MBVG then analyzes the prospective buyer. "What we're looking for in the buyer, particularly when it is another business, is how combining the two firms can produce better growth, better margins, or cheaper capital," Schostag said. This analysis uses a different standard of value: strategic, synergistic, or investment value. "This standard of value pertains only to a specific buyer," Schostag said. "For example a new buyer may already have distribution channels for product which the seller does not have and should provide a rapid increase in sales. Or the buyer may have employees who can be leveraged, reducing the need for some overhead at the seller. Perhaps the buyer can purchase insurance or some raw materials cheaper, or can attain better transportation costs. All of these factors would mean that the selling company has more value to the buyer than simply fair market value."

In this exercise, MBVG is trying to assist the seller in understanding what the possible value to a corporate buyer may be, according to Schostag. This gives the seller solid information during negotiations, assisting in moving the price higher than fair market value.

Schostag reminded the AM&AA attendees that although the cost of doing the analyses for sellers (and buyers) for this work is not cheap, ultimately the work must be done if the buyer has audited financial statements. "With the adoption of the Statement of Financial Standard 141, buyers must now obtain a purchase price allocation after a purchase, identifying the value of asset groups transferred, including the value of intangible assets and goodwill. Furthermore, the way assets are allocated on a sale can have significant ramifications for taxes for both buyer and seller. Waiting until closing to begin understanding those impacts can result in a failed deal at the last minute."

Professional Business Appraisals

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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.