VIEWPOINT ON VALUE

MARCH/APRIL 2017

Discounted cash flow vs. capitalization of earnings
How two methods measure up

Business valuation pitfalls
3 reasons earnings may not equal cash flow

Consider the cost approach in M&A

What's the outlook for FLPs?

Discounted cash flow vs. capitalization of earnings

How two methods measure up

Future cash flow drives value under the income approach. That sounds simple, but there are several methods — including discounted cash flow and capitalization of earnings — that fall under the income approach. How do these two commonly used methods compare and which one is appropriate for a specific investment? Here are some answers to help clarify matters.

Discounting basics

The *International Glossary of Business Valuation Terms* defines discounted cash flow as “a method within the income approach whereby the present value of future expected net cash flows is calculated using a discount rate.” In other words, this method entails these basic steps:

Compute future cash flows. Potential investors are generally trying to determine what’s in it for them in terms of cash flow and an acceptable return on investment. Historical earnings are often the starting point for estimating expected cash flow over a discrete discounting period of, say, five or seven years. Then, the valuation expert calculates a terminal (or residual) value, which, in theory, represents how much the business could be sold for after the discrete discount period. (In reality, the business probably won’t be sold at that time, however.)

Discount future cash flows to present value. Once cash flows have been forecast, the expert adjusts them to present value using a discount rate based on the risk of the investment. If equity cash flows are computed in the first step, they’re discounted using the cost of equity. Conversely, if cash flows to both equity and debt investors are computed, they’re discounted using the weighted average cost of capital.

The sum of those present values represents the value of the business. Depending on the nature of the expected cash flows that are discounted, the valuation professional may also need to subtract interest-bearing debt to arrive at the value of equity.

Fundamentals of capitalization

The same valuation glossary defines capitalization of earnings as “a method within the income approach whereby economic benefits for a representative single period are converted to value through division by a capitalization rate." This sounds similar to the discounted cash flow method, but it's simpler. (Note: The term "earnings" typically refers to cash flow when valuation experts use this method, because capitalization rates are based on discount rates used in the discounted cash flow method.)

Instead of calculating cash flows over a discrete discount period based on varying growth and performance assumptions, this method assumes that future cash flow will grow at a slow, steady pace into perpetuity. The method is based on the assumption that a single period (with modest adjustments for growth) provides a reliable estimate of what the business will generate for investors in the future.

As such, this method requires two simplified steps:

1. Compute expected cash flow for a single period.
2. Divide cash flow from the single period by a capitalization rate.

The long-term sustainable growth rate is a critical component of this method. Under the Gordon Growth Model — which is often used to value perpetuities — cash flow from a single period is multiplied by one plus the long-term growth rate. Then, the long-term growth rate is subtracted from the discount rate to arrive at a capitalization rate. Again, depending on the nature of the expected cash flow, the valuation professional may also need to subtract interest-bearing debt to arrive at the value of equity.

The big decision

So, which method is more appropriate for a particular investment? In general, the discounted cash flow method provides greater flexibility if management expects short-term fluctuations in growth, revenue and expenses, leverage, working capital needs and capital expenditures. It's particularly useful for high-growth businesses and start-ups that aren't yet profitable — or when calculating damages over a finite period.

On the other hand, established businesses with stable earnings may generally find it easier and equally reliable to apply the capitalization of earnings method. This method is also convenient when valuing a business for litigation purposes because it's easier to explain to a judge or jury than a sophisticated discounted cash flow model. However, the discounted cash flow method is widely accepted in more sophisticated courts, such as the U.S. Tax Court or federal courts.

Expertise essential

For more information on how these methods work, contact a credentialed valuation professional. He or she can help you decide whether these methods are right for a particular investment. ■

Understanding terminal value

Terminal (or residual) value is "the value as of the end of the discrete projection period in a discounted future earnings model," according to the *International Glossary of Business Valuation Terms*.

Ironically, though it's part of the discounted cash flow method, terminal value is usually calculated using the capitalization of earnings method. The theory is that cash flows eventually stabilize once a business matures. In theory, terminal value may also be computed using the cost or market approach, however.

In many cases, terminal value represents a large chunk of the cash flows that are discounted to present value under the discounted cash flow method. So, it's important to compare terminal value to the results of other valuation approaches to gauge whether it seems reasonable.

3 reasons earnings may not equal cash flow

Business owners and business brokers may share price-to-earnings multiples by word of mouth in certain industries. However, valuations based solely on these oversimplified rules of thumb won't pass muster in court. And they shouldn't be used as a sole method of valuation, especially when pricing a business for sale.

Instead, a formal cash flow analysis can provide a more reliable estimate. Here are some important considerations that may be missing if you use the terms "earnings" and "cash flow" interchangeably.

1. Depreciation expense vs. capital investments

Depreciation is a noncash expense that's subtracted from revenue when calculating earnings. In theory, depreciation expense is taken against fixed assets (such as vehicles, equipment and leasehold improvement) over their useful lives. The reason is that these assets are used to generate revenue over many years, and, under accounting principles, expenses from an asset are "matched" to the period in which the asset generates revenue.

In reality, however, many companies use accelerated depreciation methods, which overstate depreciation expense in the early years that an asset is owned. Depending on the age of a company's assets, depreciation expense may under- or overstate the need for capital investments — which is what valuation experts really want to capture when estimating future cash flow.

Moreover, past capital expenditures may be higher (or lower) than what will be needed in the future. For example, a company that's at full capacity may need additional equipment or a plant expansion to achieve its growth forecasts. Alternatively, a start-up that has invested heavily in fixed assets in recent years may not need to make any major purchases for several more years.

2. Changes in working capital

Earnings estimates don't include changes in working capital, but cash flow estimates do. A company needs to invest working capital to fund its cash flow cycle as it grows. That is, management needs to purchase inventory and pay salaries, rent and other operating expenses. There's a lag between billings and collections on both the receivables and payables sides of the business.

The faster a business grows and the more unexpected obstacles it experiences, the more working capital it needs to stay afloat.

Cash flow shortages are a common frustration for entrepreneurs and other investors in private businesses. The faster a business grows and the more unexpected obstacles it experiences, the more working capital it needs to stay afloat. Established businesses tend to generate sufficient cash — and stockpile it — so they generally experience fewer cash flow shortages than high-growth ones.

3. Debt service or proceeds

Some companies choose to finance fixed asset purchases and changes in working capital with loans, rather than additional capital contributions from owners. Proceeds from debt are cash inflows — but, eventually, loans need to be repaid (cash outflows). The increase or decrease in cash from debt financings is relevant to investors, but it's not accounted for in earnings.

Here's where things get complicated: Cash flow may be calculated for equity or invested capital (debt and equity) investors. When calculating equity cash flows, interest expense, debt service and debt proceeds are factored in. This approximates the cash flow that's available to pay equity investors each period.

Conversely, when calculating invested capital cash flows, interest expense (net of the tax benefit) is added back and no adjustment is made for changes in debt. This approximates the cash flow that's available to pay both equity and debt investors. When using invested capital cash flows to value a business, interest-bearing debt must be subtracted from the preliminary estimate of value to arrive at the value of equity.

Cash is king

A company's income statement casts light on its earnings — but that's only part of the story. Investors are typically more interested in how much cash it will generate in the future than its earnings reports. Contact a valuation professional for help converting earnings to cash flow. Doing so can provide a reliable estimate of value. ■

Consider the cost approach in M&A

The cost approach has intuitive appeal: A company's value equals the difference between its combined assets and liabilities. A cost approach analysis is laid out similar to a balance sheet, a document that most business owners are familiar with. However, it requires a substantial amount of work to convert a cost-basis balance sheet to the required standard of value.

Despite the extra effort, buyers and sellers are increasingly using this approach in mergers and acquisitions (M&As) to help break down the components of value, facilitate deal structure discussions and prepare for postsale purchase price allocations. Here are the basics of this valuation approach.

Retooling the balance sheet

Under the cost approach, valuation experts identify all of the subject company's assets and liabilities, including those that aren't recorded on the balance sheet. Next, they assign a value to each item, based on the appropriate standard of value (typically, fair market value).

The book value of equity may not be a reasonable proxy of its fair market value for many reasons. For example, assets are recorded at historic cost under Generally Accepted Accounting Principles (GAAP). Over time, historic cost may understate market value for appreciable assets, such as marketable securities and real estate. In addition, some intangible assets — such as customer lists, brands and goodwill — are excluded from balance sheets prepared in accordance with GAAP, unless they were acquired from other companies. Balance sheets also might not include contingent liabilities, such as pending litigation or an IRS audit.

Companies that use cash- or tax-basis accounting methods present additional valuation challenges. A valuation analyst will usually convert the financial statements to an accrual basis. Their balance sheets may exclude accruals (such as accounts receivable and payable) and rely on accelerated depreciation methods that understate the market value of fixed assets. This process results in the creation of a market-based balance sheet. Revaluing certain assets — such as machinery, equipment and real estate — may require separate appraisals by outside specialists.

Understanding the advantages

Courts often appreciate the perceived simplicity of the cost approach, especially when it's used for asset holding companies and small manufacturers that rely heavily on their "hard" assets. It may also be useful when the parties present conflicting appraisal evidence.

In some cases, the cost approach provides a useful "floor" for a company's value that serves as a sanity check for the other valuation approaches. After all, reasonable sellers typically won't accept less than net asset value in M&A unless they're under duress to sell.

In addition, many buyers and sellers turn to the cost approach in M&A, because it assigns a specific value to the individual assets and liabilities that are owned by the business. That's different from either the income or market approach, which may indicate that a business is worth, say, 1.5 times annual revenues, but doesn't assign value to assets and liabilities.

With a cost approach analysis, the buyer and seller can negotiate exactly which assets and liabilities to include (or exclude), allowing them to more effectively bridge gaps between the asking and offer prices. Then, after the deal is closed, a cost approach analysis can be used to allocate the company's purchase price for tax and accounting purposes.

Weighing the pros and cons

Although the cost approach can provide valuable insight, it often requires significant time and effort to identify and revalue everything separately. In some cases, it's easier and more cost-effective to apply the income or market approach — even though these methods may seem more complicated on the surface. ■

What’s the outlook for FLPs?

The viability of family limited partnerships (FLPs) and other family-controlled entities is uncertain. In August 2016, the IRS proposed changes to the tax code intended to curb what the IRS considers abusive estate planning practices involving these entities.

Business owners, practitioners and even the American Institute of Certified Public Accountants (AICPA) have widely criticized the proposal for being too broad and general, however. Critics are especially surprised that the proposal appears to 1) extend to operating businesses, and 2) eliminate valuation discounts for lack of control or marketability for family-controlled entities.

Critics say rewrite or withdraw

When the Treasury Department met on December 1 to discuss this proposal, it was the most highly attended IRS public hearing ever. Although 36 people testified during the full-day session, only one argued in favor of the proposal as it’s currently written.

As of this writing, the IRS must decide whether to proceed with the proposal — despite widespread criticism — or abandon it. If the IRS moves forward, it’s likely to issue another proposal, rather than finalize the existing proposal, to help clarify its intentions.

The current version of the proposal calls for changes to IRC Section 2704 that address the treatment of certain lapsing rights and restrictions on liquidations in determining the value of transferred interests in family-controlled entities. More specifically, it includes provisions to:

- Amend existing rules on what constitutes control of a limited liability company or other entity or arrangement that isn’t a corporation, partnership or limited partnership,
- Address deathbed transfers (made within three years of the transferor’s death),
- Modify what’s considered an “applicable restriction” by eliminating a comparison to the liquidation limitations of state law, and
- Add a new class of “disregarded restrictions” that would be ignored when quantifying valuation discounts.

Additionally, the proposed regs address FLPs that include charities and other unrelated parties as partners in an effort to preserve valuation discounts.

Future is unclear

During the hearing, Catherine Veihmeyer Hughes, estate and gift tax attorney-advisor in the Treasury’s Office of Tax Policy, assured that: 1) valuation discounts won’t be completely eliminated under the new regulations, 2) the regs aren’t intended to impose a deemed put right, and 3) the three-year look-back provision won’t be retroactive.

Despite IRS enthusiasm for this proposal, Republican tax reform proposals are calling for repeal of the estate tax. Depending on if, when and how the estate tax rules are changed, the IRS proposal targeting family-controlled entities may not be a priority under the new administration.

Check with your valuation advisor for the latest information — it’s possible tax reform legislation may be enacted by the time you’re reading this. ■