HANTZMON WIEBEL LLP
CPA and Advisory Services

Valuation Report

Business Valuation
Trends and Strategies

Spring 2023

Vexing Valuation Challenge

Valuing Personal Goodwill

The value of a business owner's personal goodwill is relevant in divorce or the sale of the company. One way to estimate the value of an owner's personal goodwill is to value the company with and without the owner's involvement, similar to the way a non-compete agreement is valued.

Advantageous Relationships

Non-compete agreements are used to allow advantageous personal relationships with certain customers and employees that a covenantor may have to be institutionalized.

The term of the agreement (e.g., one year, three years, five years) is a reasonable proxy for the time period the parties agree will be required to institutionalize these relationships. This term reflects the time during which the covenantor will have an advantage over the covenantee compared to competitors who do not have these advantageous relationships.

This advantage will be greatest on day one of the agreement and, by definition, gone by the end of the agreement. The advantage decreases over time either as the covenantee institutionalizes the advantageous relationships or the advantageous relationships atrophy.

At the end of the term, the covenantor, the covenantee, and the other competitors are all in the same competitive position: None have any advantageous relationships with any of the others' customers or employees.

During the term of the agreement, it is reasonable to expect the covenantee's remaining cash flows to grow at the same rate as they would in the absence of an agreement. There is no basis to expect they would grow faster in the absence of an agreement because this would require the covenantee to take more market share from the other competitors during the agreement term than what was expected without competition from the covenantor.

As a result, absent the covenantor's involvement, the business will, in perpetuity, be smaller at any given time than it would have been given the covenantor's involvement. Therefore, a terminal value is required to capture the value beyond the term of the non-compete agreement.

A Hypothetical Example

Suppose Brett, the owner of a dental practice, sells his practice without a non-compete agreement and opens a new practice around the corner. It's reasonable to assume that a significant percentage of Brett's patients will follow him to his new practice.

Let's be conservative and say that 20 percent of Brett's patients follow him to his new practice. Assuming the practice's annual revenue was

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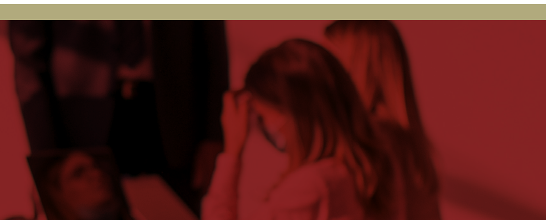

Rising Inflation and Interest Rates

How These Affect Business Valuations

Business valuations are based on many factors, including the environmental factors in which a business operates. Two environmental factors that had been relatively simple from a valuation perspective were inflation and interest rates. Not anymore.

After remaining below 3 percent for more than a decade, the annual inflation rate started rising in the spring of 2021, eventually peaking at over 9 percent in the summer of 2022. It has remained stubbornly high since. The Federal Funds Rate also started rising during the same time—from near zero to 4.75 percent in early 2023.

Rising inflation and interest rates can impact business valuations through their effects on discounted cash flow and the cost of capital. Understanding their impact will be crucial to accurate business valuations in the current environment.

Inflation and Earnings

When valuing a business using the discounted cash flow method, a professional valuator must determine whether the business can grow earnings at the rate of inflation or higher. For example, can the business raise prices high enough to cover its rising material and labor costs? If not, the business will experience negative growth, which will impact value.

The effects of inflation on revenue will vary based on how elastic demand is for its products and services. This, in turn, is affected by factors such as the level of competition in the marketplace and whether substitute products and services are available. It's also affected by whether customers consider the product or service to be a commodity and discretionary or non-discretionary.

Inflation's effects on business value will depend on the lifecycle stages of its products and services. For example, high inflation could have the least effect on value during the growth stage and the greatest effect during the maturity and decline stages, perhaps even shortening the length of these stages.

Inflation uncertainty is lower for improvements to existing products or services sold to existing customers. This is due to the impact of yield improvement or waste reduction being amplified in an inflationary environment. Meanwhile, inflation uncertainty is higher for new products and services sold to new customers. The uncertainty caused by inflation also affects the cost of capital.

Maximizing employee retention can pay off during periods of high inflation by reducing the costs of hiring new staff. At the same time, any cost savings realized from temporarily cutting back on staff training and development should be weighed against the potentially negative effects on employee morale and efficiency.

High levels of inflation will also affect financial considerations, including cash management strategies. For example, you might compare the holding cost of cash to using a line of credit, or reducing accounts receivable and extending accounts payable against the potential effects this might have on your relationships with customers and suppliers.

Interest Rates as an Input

Value is driven mainly by cash flow, so valuation experts typically use some sort of buildup method to determine the capitalization rate for valuing a business. Interest rates are one of the inputs to the formula. Therefore, if interest rates rise by two percentage points, what would have been an 18 percent discount rate becomes a 20 percent discount rate, thus lowering the value of the business using the discounted cash flow valuation method.

In other words, the higher the interest rate is as an input into the discount rate, the lower a business' value will be. This and the business' rate of growth factor into the capitalization rate, which capitalizes a measure of earnings or cash flow into today's dollars. The higher the capitalization rate, the lower a business' value will be.

An example below helps illustrate the effect of rising interest rates on business valuation. This example assumes the appraiser is using a buildup method to calculate the capitalization rate.

Understand the Impact

No one can predict where inflation and interest rates are headed, so it's important to understand how they affect valuations now and in the future. Doing so will help you arrive at more accurate business valuations.

Contact us if you have questions about the impact of rising inflation and interest rates on business valuations.

Earnings to be capitalized: $100,000

Risk-free interest rate	2.0	4.0
Equity risk premium	7.4	7.4
Size premium	7.9	7.9
Company-specific risk premium	3.0	3.0
Discount rate	**20.3**	**22.3**
Growth rate	-3.0	-3.0
Capitalization rate	17.3	19.3
Capitalization of earnings valuation	**$578,035**	**$518,135**

Pepperdine Private Capital Markets Report

Highlights from the 2022 Private Cost of Capital Survey

Since 2007, Pepperdine University has published the Private Capital Markets Report. The annual report summarizes the Pepperdine Private Cost of Capital (PCOC) survey, which is a comprehensive investigation of the major private capital market segments.

Labor availability was the most frequently cited current issue facing privately held businesses, according to the 2022 Private Capital Markets Report. Inflation, economic and political uncertainty, and access to capital were cited as emerging issues for privately held businesses.

The following are more takeaways for valuation professionals from the 2022 Private Capital Markets Report.

Required Rates of Return

The 2022 report segmented capital sources as follows: banks, asset-based lenders, mezzanine lenders, private equity groups, venture capitalists, and angel investors. The cost of capital for privately held businesses varies significantly based on capital size, size of the business, and level of risk assumed.

According to the report, these capital sources require the following median rates of return before investing in privately held businesses:

Banks: 4%–6%
Asset-based lenders: 3.8%–16%
Mezzanine lenders: 10%–15%
Private equity groups: 22%–30%
Venture capitalists: 30%–43%
Angel investors: 33%–43%

Valuation and Multiple Methods Used

Investment bankers indicated that they use various valuation methods when valuing privately held businesses. The most popular is the guideline company transaction method, which was listed by 31 percent of respondents. This was followed by the capitalization of earnings method (26 percent), the VC or discounted expected exit value method (17 percent), and "gut feel" (3 percent).

The recast (adjusted) multiple method is by far the most common multiple method used by investment bankers in business valuations—it was cited by 74 percent of the survey respondents. The revenue multiple method was cited by 12 percent of respondents, the EBITDA (unadjusted) multiple method was cited by 6 percent of respondents, and the cash flow multiple method was cited by 2 percent of respondents.

Median Deal Multiples

The Pepperdine Private Capital Markets Report also broke down median deal multiples by size of company and industry as measured by EBITDA. Not surprisingly, as the size of the company increases, so do the multiples.

For companies with EBITDA up to $1 million, the average multiple in 2022 was 4.3. This increased to 6.2 for companies with EBITDA between $1 million and $5 million, 7.2 for companies with EBITDA between $5 million and $10 million, 8.0 for companies with EBITDA between $10 million and $25 million, 8.6 for companies with EBITDA between $25 million and $50 million, and 9.3 for companies with EBITDA greater than $50 million.

These numbers were down slightly from 2021 when the average multiples for companies were as follows: 4.6 for companies with EBITDA up to $1 million, 6.8 for companies with EBITDA between $1 million and $5 million, 7.7 for companies with EBITDA between $5 million and $10 million, 8.3 for companies with EBITDA between $10 million and $25 million, 8.7 for companies with EBITDA between $25 million and $50 million, and 9.3 for companies with EBITDA greater than $50 million.

To Learn More

You can download the entire Pepperdine University 2022 Private Capital Markets Report by visiting https://digitalcommons.pepperdine.edu/gsbm_pcm_pcmr/15/.

Valuing Personal Goodwill

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$1 million before Brett sold it, this would lower revenue to $800,000 after Brett leaves. The new owners of the practice are now operating from a revenue starting point that's $200,000 lower than when they bought the practice.

This is likely to reduce or eliminate the amount of profits available for distribution, which will reduce or eliminate the value of the practice. The difference between the value of Brett's practice with his involvement and the value with him competing against it is a measure of his personal goodwill.

More Accurate Valuations

Valuing personal goodwill is one of the most vexing challenges valuation professionals face. Using methods similar to those used to value non-compete agreements provides a mechanism to address this challenge.

Give us a call if you have questions about valuing personal goodwill or non-compete agreements.

Comparing Business Valuation Glossaries

With the introduction of the *International Valuation Glossary–Business Valuation* in 2021, there are now at least two sets of glossaries for business valuation. This glossary joins the *International Glossary of Business Valuation Terms* that was introduced in 2001.

The 2001 glossary was adopted by the AICPA, ASA, CICBV, NACVA, and IBA to enhance and sustain the quality of business valuations for valuation professionals and clients. It was a major achievement for the valuation profession, clarifying many aspects of business valuation that had caused confusion. The 2001 glossary contains 123 terms and definitions that most valuation analysts are now comfortable and familiar with.

The 2021 glossary serves as an update to the 2001 glossary, eliminating 52 of its original terms to streamline the new glossary while adding many new terms. It was compiled and directed by the ASA, CBV Institute, RICS, and TAQEEM.

The AICPA has not adopted the 2021 glossary, and its members (including CPAs, ABVs, and CPA/ABVs) do not have to follow it, though they can if they choose. Remember, however, that many terms from the 2001 glossary have been removed from the new glossary and many new terms have been added. There are also many similar but not exact terms and definitions in the new glossary.

Auditors of fair value for financial reporting valuations may ask valuation analysts to use the 2021 glossary even though they aren't required to. This could create a scenario where analysts have to use both glossaries, which could create the potential for litigation.

The 2021 glossary states that it is designed to be "helpful, but neither authoritative nor prescriptive." If any term in the glossary conflicts with a published governmental, judicial, or accounting authority, the analyst should give precedence to the use and interpretation of terms as they appear in applicable published authoritative guidance.