



Valuation Perspectives

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Closely Held Business – Sometimes a “Forgotten” Asset

By: Hillary Stilwell

WHM Capital Advisors President and Chief Investment Officer, Bill McAfee, Jr., published “Heart and Soul” an article regarding the important topic of how a closely held business should be considered regarding long term financial planning. This article appeared in *Bloomberg Wealth Manager*. Many advisers focus on estate planning and benefit planning, but forget to factor in possibly the largest alternative investment held. Some advisers may overlook this investment and others may not have the proper tools to provide thorough advice on how to factor in such a large and variable asset.

McAfee’s article focuses on how the entrepreneur’s, “personal goals are inextricably linked to the vision for their businesses and should be examined carefully in light of that vision.” He also states that, “A key ingredient for providing comprehensive planning advice to a business owner is a business valuation.” In order to properly value a business, the person performing the valuation needs to know if the business is being valued for sale, for estate planning, or for transfer, as a few examples. Depending on what the goals are in beginning the valuation, they can affect the outcome of each valuation.

McAfee speaks to the importance of valuing the closely held company based on the true financial drivers of the company, not necessarily based on the value a client’s accountant calculates. In his article he states that financial planners and advisers, “should be equipped with risk-return models to analyze privately held companies as effectively as publicly traded stocks.” This means knowing what type of cash flow the business has and what it is providing to your client, knowing what the company’s financial trends are, determining the level of instability in the business and then use all of this information when planning for your client’s future. McAfee surmises, “It does no good to develop a financial plan that requires the client’s systematically investing over a period of time if that plan doesn’t account for the risk that the business may produce cash flow below expectations. One relatively simple way to measure risk is to determine the level of variance in the business financials year-over-year.”

The client and adviser need to have a clear understanding of the client’s expectation of return from their business. As the adviser asks the many questions and collects the documents to perform the valuation and to find out the expectations, he/she needs to be looking for the, “level of return”, that is needed to reach the client’s goals. McAfee finds that, “One tool that can be used effectively for examining a business’s return on equity (ROE) is a formula developed by the corporate finance office at DuPont.” This formula takes into consideration the leverage, net margin, and asset efficiency. This formula is used for publicly traded companies and also works remarkably well with privately held businesses. Overall, the formula, “breaks return on equity into various components that drive returns.”

$$\text{ROE} = \text{Net Income/Sales} \times \text{Sales/Assets} \times \text{Assets/Equity}$$

This formula helps in understanding what drives the returns for each company.

McAfee advises that, “Lastly, examine the external framework of the client’s business.” This should include industry health, competitors, impact of suppliers on pricing, and the industry growth or lack thereof, just to name a few variables. The answers to these questions may lead to insights into the future of the privately held company based on variables outside of the owner’s control.

While all of these issues are complicated and multi-faceted, any adviser that wants to offer sincerely comprehensive financial planning to entrepreneurs, this absolute approach is necessary. In summary McAfee states, “Although the required depth of knowledge and time commitment are daunting, the potential rewards are great for your planning practice as well as your clients’ financial well-being.”

For more information or to view the complete article, please go to our [website](http://www.whmca.com) (www.whmca.com).

Sidebar—Dissenting Shareholder Appraisal Action

By: John Barnes

Ryan v. Lyondell Chemical Co., 2008 WL 2941129 (Del. Ch. July 29, 2008), in this case the Delaware Court of Chancery found that the defendant’s board of directors failed to disclose the findings of a fairness opinion to shareholders on a proxy statement. The proxy devoted space to a discussion of the fairness opinion that valued the business using a discounted cash flow method combined with management’s projections and street projections. The investment bank did not use management’s projections to arrive at a discount rate, but rather used a range of discount rates based on comparable subject companies. The court found that the decision to not use management’s discount rate may have been material to shareholders using the proxy statement to arrive at a voting decision on a transaction involving the company.

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WHM Capital Advisors, LLC is a financial advisory and wealth strategies firm headquartered in Columbia, South Carolina, which specializes in valuing companies, designing exit strategies and managing portfolios for business owners.