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# Handbook of Advanced Business Valuation



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## Dedication

The editors dedicate this book to their colleague Shannon P. Pratt.

We dedicate this book to Shannon in recognition of his contribution to the literature that is advanced in this text. More important, we dedicate the book to Shannon because of his pioneering contribution to the business valuation profession during the last 30 years. Many have contributed to the field in many ways, but none have carried the business valuation flag the way he has. As much as any one individual, Shannon Pratt has helped convert the business valuation industry into a recognized profession and the business valuation art into a recognized science. As practitioner, author, educator, and entrepreneur, he has contributed more than anyone to the professional literature, the professional standards, and the professional societies and institutes of the business valuation discipline. We are grateful.

Robert F. Reilly  
Robert P. Schweih



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# Preface

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## Intent of the Book

The business of business valuation has been changing at a pace that is even more accelerated than the pace of change in the world's economy. At the start of the new millenium, we are experiencing a global transformation of financial markets and business procedures. The number of situations in which business valuation techniques apply is expanding exponentially. In this unsettled climate, conventional business valuation principles and procedures are proving to be robust and remarkably versatile. To keep abreast, this anthology of advanced business valuation wisdom provides a new benchmark of contemporary discussions of topics of interest to experienced business valuation practitioners.

As a profession, business valuation is the most rapidly growing of the major appraisal disciplines. There are many new entrants into the field. What they may not know is that there has been an entire generation of professional business analysts who have spent their careers in the field. Many of the new entrants consider complicated business valuation situations to be too infrequently encountered or too esoteric to be of interest.

On the contrary, we have found that the advanced business valuation matters are instructive because they shine a bright light on what many of the less experienced consider to be "gray areas." Studying the advanced business valuation situations like those covered in this book demystifies issues that the uninitiated might consider controversial. This book includes some of the leading ideas on advanced business valuation topics, contributed by prominent members of the business valuation community—ideas that will be instructive to both the beginner and the experienced business valuation practitioner.

There are several well-regarded books that provide a solid foundation for the general theory and application of business valuation. We have coauthored three: *Valuing a Business*, *Valuing Small Businesses and Professional Practices*, and *Valuing Intangible Assets*. *Handbook of Advanced Business Valuation* is intended to be the in-depth complement to these three popular valuation texts.

In fact, these four texts may be considered as a complementary collection that covers the spectrum of financial valuation. These texts present different levels of discussion of current financial valuation conceptual

development and practical application. We have found that when common terminology and notations are used, even complex financial valuation concepts become easy to absorb.

In addition to presenting advanced discussions of technical financial valuation applications, this book is intended to be—and to remain—contemporary. Accordingly, each chapter shares with the reader the current state of conceptual thinking, methodological applications, judicial precedent, and empirical data sources. It is the intention of the editors to update this book periodically with new topics and fresh ideas on these topics. Such periodic updates will allow the *Handbook of Advanced Business Valuation* to be a current and timely reference source to all valuation analysts.

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## Content of the Book

We explore and debunk controversial topics unlike any other book. *Handbook of Advanced Business Valuation* sheds light on critical issues such as:

- What is the best way to estimate the required return on an investment and how is that estimate different if the investment is not in the United States?
- How is the value of securities that are not traded on organized stock markets affected by their lack of liquidity?
- What business valuation opportunities exist for wealthy individuals?
- How are business valuation techniques used and abused in litigation over economic damages or the fair value of a minority shareholder's interest?
- What are the essential factors that drive the value of sports franchises?
- How can business valuation techniques be used to reduce property taxes?
- What are ESOPs and why are they valued differently from other business interests?
- Will my company be worth more if I make the S election?

This book is presented in four parts. The earlier parts include more general topics. The later chapters present more specific topics.

Part I presents general technical topics that may be applicable to most complex business valuations. These topics include estimating the appropriate cost of capital (for both domestic and international valuation analyses), estimating equity risk premiums, and quantifying various valuation discounts.

Part II presents examples of special applications of valuation methods. These special applications include S corporation valuations, family limited partnership valuations, and in-process research and development valuations.



Part III discusses the conceptualization and the conduct of business valuations for specific purposes. These specific purposes include estate planning and intergenerational wealth transfer, ESOP formation and financing, ad valorem taxation assessment, estimation of economic damages, fair value analyses in oppressed shareholder litigation, fairness and solvency analyses, and transaction planning and structuring.

Part IV presents special valuation issues related to specific industries. These chapters discuss advanced valuation issues in such diverse industries as sports franchises, automobile dealerships, radio broadcasting companies, health care, emerging and technology companies, and government contractors.

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## Audience for the Book

This book should be useful to a variety of constituencies who are interested in specialized business valuation topics, including:

1. Experienced business valuation analysts who want to remain current with the most up-to-date professional developments.
2. Less experienced valuation analysts who want to prepare for a specialized valuation assignment.
3. Investment bankers, business brokers, accountants, and other transactional intermediaries who participate in the valuations and sales of businesses and business interests.
4. Commercial bankers and merchant bankers who finance the purchases of businesses and business interests.
5. Lawyers, judges, regulators, and other members of the legal community who have to interpret business valuations.
6. Business owners, stockbrokers, chief financial officers, tax managers, and investors who rely upon business valuations for transactional, taxation, financing, and strategic planning purposes.

Each audience may have a different level of interest in the theoretical concepts, practical applications, and empirical data presented in this book. One word of caution is in order, however. Casual readers of a book like this may read only a few chapters and convince themselves that they have a rigorous comprehension of this complex subject. The valuation and economic analysis of businesses and business interests is an evolving discipline. Even the serious reader of the entire book will begin—but not complete—an exploration of this complex topic.

Robert F. Reilly  
Robert P. Schweih



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# Acknowledgments

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First and foremost, we would like to thank each of the chapter authors. We were able to assemble a remarkable group of nationally recognized valuation practitioners and legal experts to contribute to this book. Each of the chapter authors is a leading valuation or legal practitioner. And each of the chapter authors enjoys individual prominence and eminence in the professional community.

Readers should appreciate that the chapter authors can look forward to virtually no compensation for their efforts. In fact, they received only a complimentary copy of the book. Therefore, these authors did not expend their valuable time and considerable effort for personal gain. Rather, each wanted to make a significant contribution to the professional literature of the financial valuation profession. The editors are extremely appreciative of each author's significant contribution.

As is often the case with leading authorities in any profession, the positions espoused by the chapter authors are not necessarily those that have been adopted by the profession's societies and institutes. In fact, sometimes the chapter authors may not agree with one another. However, in each case, the chapter authors have presented the most advanced and the most contemporary discussions of their respective topics.

In particular, we would like to thank Charlene M. Blalock, a research associate in our Portland (Oregon) office, who served as the project manager for this undertaking. Charlene coordinated all aspects of the writing, editing, and publication of this book. She was responsible for obtaining permission to use material reprinted in this book from other sources. Charlene also prepared the index and edited and proofread the manuscript. As with all our recent publications, this book would simply not have been completed without Charlene's dedication and project management. Sally Martin also provided proofreading assistance.

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Mr. Reilly provides consulting services relating to business valuation, intangible asset appraisal, security analysis, and damages analysis. He has testified as an expert witness in federal, state, and international courts on numerous occasions, and he regularly provides clients with litigation support and dispute resolution services. Mr. Reilly has also served as a court-appointed arbitrator.

He is the coauthor of *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 3d ed. (McGraw-Hill, 1996), *Valuing Small Businesses and Professional Practices*, 3d ed. (McGraw-Hill, 1998), *Valuing Intangible Assets* (McGraw-Hill, 1999), and *Valuing Accounting Practices* (John Wiley & Sons, 1997).

He has authored chapters in numerous books related to specialized topics, such as ad valorem property taxation, matrimonial law and marital dissolution, and employee-owned corporations. He has also written over 200 articles on valuation-related topics that have been published in various professional journals.

Mr. Reilly is often called upon to speak at seminars and conferences of professional groups. He has also taught courses in business valuation both in the United States and abroad.

Prior to joining Willamette Management Associates, Mr. Reilly was a partner and national director of the Deloitte & Touche Valuation Group. Before that, he was vice president of Arthur D. Little Valuation, Inc., a national appraisal firm.

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## Willamette Management Associates

Founded in the 1960s, Willamette Management Associates is one of the oldest and largest independent valuation consulting, economic analysis, and financial advisory services firms in the country. In addition to valuation consulting services, Willamette Management Associates provides specialized capital market and investment banking services.

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