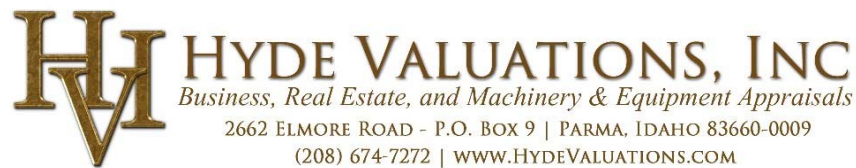




PAUL R. HYDE
ASA-BV, ASA-M&E,
ASA-RP, MAI



APPRAISERS:
PAUL R. HYDE
BRIAN D. HYDE
JOSEPH PHELON

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Too Much Cash?

An appraiser friend asked me a very interesting question based on the following scenario:

A client owns a company operating a profitable Convenience Store/Gas Station and wishes to gift 10% interests each in the stock to two children. A related entity owns the real estate and market rent is being paid to that entity. The owner/operator is being paid reasonable compensation as well. The operating business is valued at \$3.6 million – HOWEVER – the Company has built up a pile of \$4 million in cash held in the business. The thought is that someday another store may be built or acquired, but no plans are in place.

THE QUESTION: Do I have to consider the \$4 million in cash to be Excess Cash, i.e. a non-operating asset or can I simply impute an interest income to the forecast using negligible interest since a minority interest cannot force the control interest to distribute cash or sell the Company?

ANALYSIS: If an appraisal of a 10% minority interest were completed using the suggested/desired methodology, the \$4 million of cash held in the business would have very little value as cash in a bank account is paid very little interest. It is true that a minority interest holder cannot force the control shareholder(s) to disburse cash or sell the Company, however, a benefit will eventually be received from either receipt of their pro rata portion of the cash someday or profit from its future use in generating additional income.

RECOMMENDATION: I recommended that the \$4 million in cash be treated as Excess Cash, which is a non-operating asset, i.e. an asset not needed in the operation of the business. The proper treatment of a non-operating asset, such as Excess Cash, is to value the operating entity, then add the value of the non-operating asset, in this case \$4 million of cash, to arrive at the value of the equity in the Company. In this case, the \$3.6 million value for the Convenience Store/Gas Station plus \$4 million for the Excess Cash – total value of \$7.6 million for the equity in the Company. In order to arrive at the value of a ten percent non-controlling, non-marketable value, discounts for both lack of control and lack of marketability need to be determined, supported, and properly applied.

Valuation discounts and premiums are a complex area with many rules and exceptions to those rules. The complexity and varied circumstances are what makes this area of business valuation particularly interesting and fun for practitioners such as myself. Many times serious thought and analysis must go into determining what discounts or premiums are actually applicable and then further thought and analysis goes into arriving at the appropriate magnitude of the discounts and/or premiums including a thorough explanation in sufficient detail to satisfy the IRS and any other interested party.

First, it should be noted that businesses are not bought and sold after applying discounts and premiums. Instead, discounts and premiums are the result of using less-than-perfect data to measure value.¹ It is critical to identify the base or level of value for each indicated value before discussing valuation discounts or premiums.² This is necessary as some appraisal methods generate a level of value with characteristics

¹ Shannon P. Pratt. Business Valuation Discounts and Premiums. (New York: John Wiley & Sons, Inc., 2001), p. xxi.

² Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs. Valuing a Business: The Analysis and Appraisal of Closely Held Companies. Fourth Edition. (New York: McGraw-Hill, 2000), p. 346.

different from the base or level of value needed for the valuation. In cases such as this, a discount or premium must be applied to move the indicated value to the desired base or level of value.³

The standard of value used in the valuation has a very large impact on the magnitude of any applicable discounts and premiums or on whether or not discounts and premiums should be applied at all. Using the fair market value standard of value, the specific ownership interest being valued is being valued “as is,” including any control or marketability characteristics of the ownership interest. Because of this, minority interests in closely-held companies are valued to reflect their lack of control and lack of marketability characteristics.⁴ In some states, family law courts use the investment value standard of value. In these cases, the attempt is to identify what is called “value to the owner” or the marital community instead of value in exchange as is the case in a fair market value standard of value. In cases such as this, when the company is family owned, there may be no minority discount for a minority owner because through family attribution, the owner is assumed to be part of a control group.⁵

Some discounts and premiums apply to an entire entity, others apply only to specific blocks of ownership. These are typically distinguished as entity level discounts and premiums versus “shareholder” level discounts and premiums.⁶ “Shareholder” level discounts and premiums often apply to partnerships, limited liability companies, and other entities that do not issue “stock.” Examples of entity level discounts and premiums are key person and environmental liability discounts. Shareholder level discounts and premiums are most commonly encountered in business appraisals. The most often encountered are control premiums, minority interest discounts (perhaps more clearly referred to as discounts for lack of control), and marketability discounts (also known as discounts for lack of marketability).⁷ Some marketability discounts are taken from control level values, others from minority ownership levels.

The asset mix held in the Company also can affect the magnitude of applicable discounts – in the example used, a Company with \$4 million in cash along with the operating company valued at \$3.6 million will likely warrant lower overall discounts than would a similar company without the excess cash.

Valuations play a part in all strategic transactions, tax, and many litigation matters. For additional information or advice on a current situation, please do not hesitate to call. **We value real estate, businesses, and personal property including livestock and machinery & equipment.**



Paul R. Hyde, ASA-BV, ASA-M&E, ASA-RP, MAI

Accredited Senior Appraiser – Business Valuation
Accredited Senior Appraiser – Machinery & Equipment
Accredited Senior Appraiser – Real Property
MAI – Real Estate Appraiser



³ Shannon P. Pratt. Business Valuation Discounts and Premiums. (New York: John Wiley & Sons, Inc., 2001), p. 2.

⁴ Ibid, p. 14.

⁵ Ibid, p. 14.

⁶ Ibid, p. 3.

⁷ Jay E. Fishman, Shannon P. Pratt, J. Clifford Griffith, and D. Keith Wilson. Guide to Business Valuations. (Fort Worth: Practitioners Publishing Company, 1999) Ninth Edition, Volume 2, p. 8-14, paragraph 803.3.