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Watch for Painful Provisions in Shareholder Agreements

I recently encountered the following instructions in a Shareholder Purchase Agreement for a Company that I was asked to appraise. If this provision is ever followed, it will very likely result in some very painful results. Here is a summary of the instructions relating to the business appraisal in the agreement:

First, both the decedent's representative and the Company shall each select a Certified Public Accountant. Further, instructions to the appraisers are that primary reliance should be on the income approach and on comparable sales of comparable businesses within the geographic area that includes Ada County, Idaho. The value of the Corporation shall be considered in place, in use, and as a going concern. The income approach, to the extent used, shall give major consideration to normal current net operating income capitalized using a level perpetuity formula at the prime (base) rate on corporate loans at large U.S. money center commercial banks as published in the Western Edition of the Wall Street Journal (or successor publication) most recently preceding the date of withdrawal. No discount or premium shall be made based on the fact that the Decedent Shareholder's Interest in the Company may be a minority or majority interest.

Here are the problems that will likely produce those painful results referenced above, as I see them:

1. The selection of a CPA to do the appraisal. Very few CPAs are trained as business appraisers and even fewer are experienced in appraising companies. There are a number of professional designations for business appraisers, however many of those are very "light weight." The Accredited Senior Appraiser designation issued by the American Society of Appraisers is the most difficult to obtain and generally provides the best indication of competency for a business appraiser.
2. Giving primary emphasis to the income approach makes sense for a profitable operating company. However, the use of current net operating income, a pretax income stream is a big mistake. Competent business appraisers generally use net cash flow, usually net cash flow to equity, which is an after-tax, income stream which approximates the amount of cash that could be withdrawn from a company without hurting it each year.
3. The capitalization rate instructed to be used based on the Prime rate on large corporate loans is another serious mistake which will result in a massive overvaluation of any company. A capitalization rate used for valuing a privately held company is typically built up using a risk free rate – now about 3%, an equity risk premium (representing the returns to the overall large equity stock market over time – now about 7%, a small stock premium – now about 4% and on top of that, a specific company risk premium comprised of things like the industry risk, the financial position of the company, the level of diversification, the depth of management, competition, barrier to funds, and the expected growth or decline of the business's revenue and earnings. Currently, the Prime rate is about 4%. The lower the capitalization, rate the higher the value.
4. The CPA is also instructed to use sales of comparable businesses within the County in which the business headquarters is located. This is a big problem for several reasons. One, there are no

similar companies of which I am aware in the County and two, even if there were, it is highly unlikely that the terms of any sale would be publicly disclosed or even shared with an outside party. The Market Approach is and should be used, however, data bases and other methodology commonly employed by a competent and experienced business appraiser are required.

5. No discount or premium shall be made based on the fact that the descendent shareholder may have held a minority interest. This provision makes sense for this type of agreement.

Here is a simple example to illustrate what would happen based on the following assumptions if the instructions to the appraiser were actually followed – I did not make these number up; I simply adjusted the net operating income to $1,000,000 and the net cash flow to equity accordingly:

Assumptions:

Net Operating Income	$1,000,000
Net Cash Flow to Equity	$ 488,000
Prime Rate	4%
Built-Up Capitalization Rate	15%

"Appraised Value as Instructed"

Net Operating Income	$1,000,000	=	$25,000,000
Prime Rate - Capitalization Rate	4%		

"Typical Appraised Value"

Net Cash Flow to Equity	$488,000	=	$3,253,333
Build-Up Method Capitalization Rate	15%		

As can be easily seen, the value determined by following the instructions to the CPA would result in a value 7.7 times the size of what it should be – which would likely result in serious problems to the Company which would be required to pay this amount to the decedent's estate. Such an amount could very well put the Company out of business without getting the decedent's estate the money it deserves.

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.**

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