

BUSINESS VALUATION NEWSLETTER

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Valuation Takes Front Row Seat In ABC's Shark Tank

The Emmy Award winning business-themed reality show, Shark Tank, is entering its sixth consecutive season. For the 6 million weekly viewers, the value of a business has taken on a new meaning.

As the entrepreneurs discuss their business plan, a key element for the investors (aka Sharks) is the valuation of the business. The entrepreneurs present their desired investment and the Sharks generally offer a different amount. While this might seem to be all negotiation, it is much more about value. The Sharks are knowledgeable business people who are putting their own money up for the investment. They understand risk and know that 80% of start-up companies fail.

Let's say that an entrepreneur comes on the show and asks for \$200,000 for a 10% stake in their business. What they are essentially saying is that they are valuing their business at \$2,000,000 ($\$200,000 \div 10\%$). The Sharks, on the other hand, may see much more risk than the entrepreneur and offer \$200,000 for 25% which values the company at \$800,000 ($\$200,000 \div 25\%$).

As the show continues, it appears the Sharks are able to make impromptu investment decisions. In reality, they are applying their knowledge of business to determine a value using two or three methodologies. The most conventional method is the discounted cash flow methodology which is a version of the Income Approach. Investors frequently use this methodology to value business interests, including privately-held interests, by determining their required rate of return and a future cash flow. This is one reason that you see the Sharks asking questions about sales, growth, profitability, customer acquisition costs, etc. The Sharks are estimating the future return of the business

over the next several years and converting it to a current value using a calculation method called discounting. The discounting of the future returns is accomplished using a required rate of return (or discount rate) that reflects the risk of the realizing those returns in the future.

The rate of return is based on a comparison to alternative investments in the public market. For

example, an investor would not purchase an interest in a small, privately-held interest for the same return that they could get by investing in Exxon/Mobil. A publicly-traded company is generally much more stable, diversified and has a longer history of operation.

The Sharks may also use the Market Approach to value a business by multiplying the current earnings or sales times a pricing multiple. The most common multiple

is the MVIC-to-EBITDA multiple which stands for the market value of invested capital (MVIC) to earnings before interest, taxes, depreciation and amortization (EBITDA). This method is typically used in M&A transactions.

Regardless of the methodology used, what is important to know is that the Sharks expect a return on their investment and, therefore, they are following the established principle that value is based on the present worth of the expected future earnings. Investors look at past performance and trends to gain an understanding as to what is likely to occur in the future. However, value is not based on what has happened in the past. It is based on what is expected to happen in the future. While value varies among investors as a result of different perspectives, it is all based on the same principles of valuation.

But the Sharks have a goal, too -- to get a return on their investment and own a piece of the next big business idea.

American Broadcasting Company

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Alternative Accounting for Purchase Price Allocation

The Financial Accounting Standards Board (FASB) issued a new accounting alternative for privately-held companies related to recognizing intangible assets in the accounting for a business combination (Accounting Standards Codification (“ASC”) 805, *Business Combinations*). The new alternative allows a privately-held company to elect an accounting policy under which it would *not* separately recognize noncompete agreements or customer-related intangible assets that cannot be separately sold or licensed in the accounting for a business combination. The value of these intangible assets is included in goodwill. The alternative accounting may only be elected if the company elects the private company goodwill accounting alternative.

The alternative guidance for ASC 805 is effective the first annual period beginning after December 15, 2015. (Early adoption is permitted.) The change significantly affects the accounting for business combinations for privately-held companies. Below are key points to the alternative accounting.

- 1. Customer-related intangible assets.** For each business combination, a company must determine if a customer-related intangible asset can be separately sold or licensed, if so, an intangible asset must be recognized. Examples of assets that may meet this threshold are: core deposit intangibles, mortgage servicing rights, commodity supply contracts, and customer information (e.g. customer lists). When determining whether a customer-related intangible asset can be sold or licensed separate from other assets of the business, the company should evaluate whether the customer-related intangible assets could benefit another party without other assets of the business.
- 2. Favorable and unfavorable contracts.** A favorable customer contract is not recognized under the alternative method unless that contract could be separately sold or licensed. However, a liability must be recognized for an unfavorable customer contract regardless if it could be sold.
- 3. Other intangible assets.** A company still needs to identify and measure all of the other intangible assets acquired in the business combination that do not fall within the scope of the alternative. The following are examples of other intangible assets that may need to be recognized in a business combination. The list is not all-inclusive as there are many other possible intangible assets.

Trademarks and trade names	Patents
Proprietary technology	In process R&D
Engineering drawings	FCC licenses
Drilling rights	Franchise agreements
Favorable leases	Air, water, land use rights
Documents under copyright	Trade secrets

Adoption may not be appropriate for companies considering a public offering in the future. If a company goes public they may need to go back and restate the financial statements with all the intangible assets. In addition, a privately-held company should consider whether the users of its financial statements will accept the alternative accounting.

Historical Venture Capital Returns Exceed Publicly-Traded Stock Returns

When appraising a business interest, the rate of return required by an investor is an important component in the calculation of value. The following table compares privately-held company returns to publicly-traded stock returns.

	Long-Term Return	
	Privately-Held Companies	Publicly-Traded Large Stocks
20 Years	34.1%	11.7%
25 Years	21.7%	11.3%
30 Years	17.5%	12.8%

As reflected, investors in private equities have earned a higher rate of return over a long term horizon when compared to publicly-traded equities.

The historical returns for privately-held equity investments were measured using the Cambridge Associates LLC U.S. Venture Capital Index®.¹ This index is the official performance benchmark of the National Venture Capital Association. For the publicly-traded equity investments, the historical returns were measured using information published by Morningstar, Inc. in *Ibbotson SBBI 2015 Classic Yearbook*.²

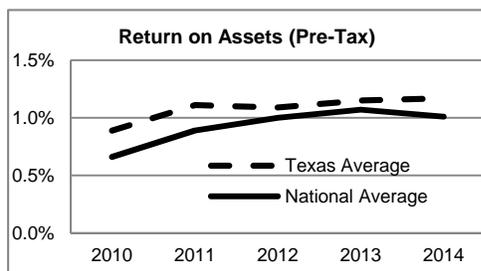
¹ Cambridge Associates LLC, *U.S. Venture Capital Index® and Selected Benchmark Statistics*, (Boston, MA: Cambridge Associates, Inc., 9/30/2014), 3.

² Morningstar, Inc., *Ibbotson SBBI 2015 Classic Yearbook*, (Chicago, IL: Morningstar, Inc., 2015).

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2014 Was Another Good Year for the Banking Industry

In 2014, Texas banks continued to be more profitable than other national banks. Two common measures of profitability are return on average assets (ROAA) and return on average equity (ROAE). In recent years, the average Texas bank ROAA generally has been higher than the national average. The following chart compares the average pre-tax ROAA of Texas banks to national averages for the past five years.



A company's ROAE depends on its ROAA and the amount of leverage in its capital structure. (Higher leverage magnifies a company's ROAE.) In recent years, the average ROAE of Texas banks has been slightly higher than the national average.

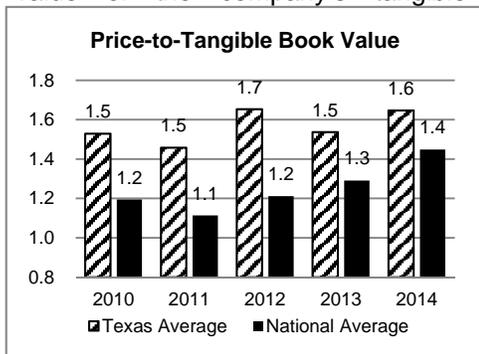
Return on Average Equity

As of the year ended December 31,

	2010	2011	2012	2013	2014
Texas Avg	8.0%	9.4%	9.7%	10.2%	10.2%
Nat'l Avg	5.8%	7.7%	8.7%	9.4%	8.7%

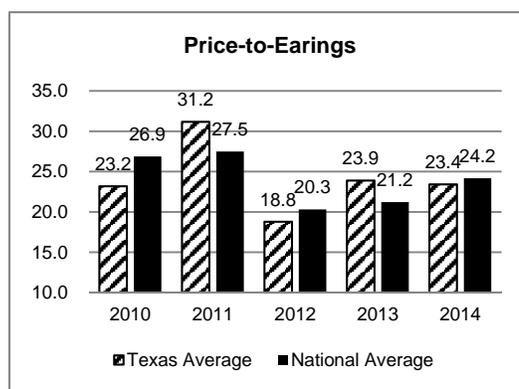
A valuation multiple is a ratio in which the numerator is a measure of a company's market value, and the denominator is a balance from a company's financial statements. Two valuation multiples are commonly used in appraisals of banks and bank holding companies:

P/TBV ratio - The numerator of this ratio is the market price of a company's common stock. The denominator is the book value of the company's tangible stockholders' equity. This ratio is commonly referred to as the "price-to-tangible book value ratio." Historically, the average Texas bank P/TBV ratio has been higher than the national average. The



accompanying chart compares the Texas average P/TBV to the national averages for the past five years.

P/E ratio - The numerator of this ratio is the market price of a company's common stock. The denominator is the company's net income for the most recent year. This ratio is commonly referred to as the "price-to-earnings ratio." In 2014, the average Texas bank P/E ratio was slightly lower than the national average. The following chart compares the Texas average P/E to the national averages for the past five years.



2015 Economic Outlook

The *Livingston Survey* is the oldest continuous survey of economists' expectations and is conducted by the Federal Reserve of Philadelphia. According to the survey released in December 2014, economic growth was forecast to increase at an annual rate of 2.9% in the first half of 2015 and to increase at an annual rate of 2.7% in the second half of 2015. The panelists believed that the real gross domestic product would grow 2.5% on average over the next 10 years.³

As reported by the *Livingston Survey*, the estimated unemployment rate decreased from an average of 7.9% in 2012 to an average of 7.3% in 2013. December forecasts were for the average unemployment rate to decline to 5.7% through December 2014. Forecasts were for the average annual unemployment rate to fall slightly to 5.4% by December 2015.

(continued – page 4)

³ The Livingston Survey, [Online] December 2014, The Federal Reserve of Philadelphia, <http://www.phil.frb.org/research-and-data/real-time-center/livingston-survey/2014/livdec14.pdf>.

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The Consumer Price Index for all Urban Consumers (CPI-U) is one of the most widely used measures of inflation. It measures the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services and represents about 87% of the total U.S. population. The annual rate of inflation over the past ten years as measured by the CPI-U ranged from a high of 4.1% in 2007 to a low of 0.1% in 2008. Over the ten-year period ending in 2014, inflation as measured by the CPI-U averaged 2.3%. According to the *Livingston Survey*, economists expected inflation to average 2.25% over the next ten years

The S&P 500 is a stock index made up of the 500 leading U.S. companies. It is regarded as one of the best gauges of the large cap U.S. equities market. According to the *Livingston Survey*, the S&P 500 is expected to deliver a 4.6% return for 2015 as compared to 11.4% in 2014.

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The firm focuses on providing consulting in the areas of business valuation and acquisitions.

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