



**VALUATION ENGAGEMENT AND CONCLUSION OF VALUE**

**SUMMARY REPORT**

**ONE PERCENT OF THE OUTSTANDING SHARES  
OF COMMON STOCK OF**

**ABC CORP Co.**

**AS OF**

**SEPTEMBER 30, 2008**

***Presented by***

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December 22, 2008

Mr. Bob Smith, CEO  
ABC Corp Company  
1295 Johnson Street NE  
Salem, Oregon 97303

Dear Bill:

You requested that I prepare a valuation analysis and summary report to estimate the *fair market value* of one percent of the outstanding shares of stock in ABC Corp Co. (ABC CO.), an S Corporation, for gift tax purposes. This valuation should not be used for any other purpose or by any other party without my written consent.

The valuation engagement was conducted in accordance with the Statement on Standards for Valuation Services (SSVS1) of the American Institute of Certified Public Accountants of which I am a member. In addition, the analysis is in conformance with Revenue Ruling 59-60, which outlines the approaches, methods and factors to be considered in valuing shares of capital stock in a closely held company for federal tax purposes.

**Based on my analysis, I estimate that the value of one percent of the outstanding stock in ABC CO. was \$8,950 at September 30, 2008.**

This conclusion is subject to the Statement of Assumptions and Limiting Conditions found on page 3 and the Valuation Analyst's Certifications found on the page immediately following this letter.

Sincerely,

A handwritten signature in black ink that reads "Stuart Weiss". The signature is written in a cursive, flowing style with a long horizontal line extending from the end.

Stuart Weiss, CPA/ABV

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## **Valuation of One Percent of**

**ABC CO.**

### **Opinion of Value**

In my opinion, the Fair Market Value of One Percent of the Outstanding Common Shares of ABC CO. as of September 30, 2008, was:

**\$8,950**

### **Valuation Analyst's Certification**

- 1) The statements of fact contained in this report are true and correct.
  - 2) The reported analyses, opinions, and conclusions are my personal, impartial, and unbiased professional analyses, opinions, and conclusions.
  - 3) I have no present or prospective interest in the property that is the subject of this report, and I have no personal interest with respect to the parties involved which would impair a fair and unbiased appraisal.
  - 4) My compensation for completing this assignment is independent and not contingent upon the value reported or direction in value that favors the cause of the client, the amount of the value opinion, the attainment of a stipulated result, or the occurrence of a subsequent event directly related to the intended use of this appraisal.
  - 5) I have personally interviewed management and physically inspected the Subject Company.
  - 6) The valuation engagement was performed in accordance with the AICPA Statement on Standards for Valuation Services in effect at the date this report was issued.
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## **1. Introduction**

### **1.1. Subject of the Valuation**

The subject of this valuation is one percent of the issued and outstanding common stock of ABC CO.

### **1.2. Purpose of the Valuation**

The purpose of the valuation is to establish a value for the gift tax compliance requirements of the Internal Revenue Service. A copy of this report will be filed with Form 709, the United States Gift (and Generation-Skipping Transfer) Tax Return.

### **1.3. Intended Users**

This report is intended for the Loch family, the owners of the subject company, and their legal and accounting advisors for the sole purpose of filing the gift tax return. I hereby disclaim liability to anyone else or for any other use.

### **1.4. Description of the Company**

ABC CO. transports petroleum products by truck to customers in Oregon and Southwest Washington. The Company's headquarters offices are located at 1295 Johnson Street NE, Salem, Oregon 97303.

### **1.5. Ownership**

The company's shares are owned by William Loch, through a revocable living trust, and his son David Loch. As of the date of valuation, September 30, 2008, William Loch owned 10,000 shares of voting common stock and 725,162 shares of non-voting common stock for a total of 735,162 shares of 73.52%. David Loch owned 264,838 shares of non-voting common stock, or 26.48%. The total shares outstanding: 1 million shares.

It is Mr. William Loch's intention to gift half of his remaining shares, or 36.76% of the outstanding shares, to David Loch in 2008 and the balance in 2009. Thus, the gifts represent minority interests in the business.

### **1.6. Valuation Date**

The subject is valued as of September 30, 2008. The report was issued on December 22, 2008.

### **1.7. Type of Report**

The valuation result is reported here as a Summary Report, as permitted by paragraph 71 of the SSVS1. A Summary Report is permitted when there are limitations on the scope of analysis. In this case, management does not make budget forecasts, which limits the scope of the work. In addition, per paragraph 48B

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of SVSS 1, Mr. Loch and I agreed that a Summary Report would provide sufficient reporting detail for this engagement.

### **1.8. Standard of Value**

The standard of value is *fair market value*, which is defined in IRS Revenue Ruling 59-60 as “the price amount at which property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, when both parties having reasonable knowledge of relevant facts.”

The following factors are outlined in Revenue Ruling 59-60 and will be considered:

- The nature of the business and the history of the enterprise from its inception.
- The economic outlook in general and the outlook of the specific industry in particular.
- The book value of the stock and the financial condition of the business.
- The earning capacity of the company.
- The dividend-paying capacity of the company.
- Whether or not the enterprise has goodwill or other intangible value.
- Prior sales of the stock and the size of the block of stock to be valued.
- The market prices of stock of corporations engaged in the same or similar line of business having their stocks actively traded in a free and open market.

### **1.9. Premise of Value**

The premise of value is *going concern*. The liquidation premise of value was considered and rejected as not applicable.

### **1.10. Scope of the Assignment**

The procedures employed in valuing the subject interest included such steps as an analysis of ABC CO.'s financial statements, discussions with management, a visit to the Company's headquarters, an analysis of the general economic and industry environment as of the valuation date, and an analysis of applicable discounts, such as the discount for lack of control and lack of marketability.

I have relied on management's representations without independent investigation or corroboration. I am also relying on the work of Boldt, Carlisle & Smith LLC, CPAs, which compiled ABC CO.'s financial statements.

The scope of this assignment does not include an examination or attest service in accordance with generally accepted accounting principles. I do not express an opinion nor do I accept responsibility for the accuracy and completeness of the financial information or other data provided to me by others, and I have not verified such information. The scope of this assignment does not include uncovering any misrepresentation, fraud, errors or other irregularities. I have no knowledge of issues related to potential litigation, lack of regulatory compliance, environmental hazards or other agreements among the owners and third parties which could have a negative impact on the value of the shares.

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## 1.11. Sources of Information

- CPA-compiled financial statements from 2002 through September 2008
- On premises interviews with William Loch, the Company's CEO
- Truck values by Beall Corporation, a local truck dealer.
- Ibbotson Stocks, Bonds, Bills & Inflation 2008 Valuation Yearbook
- Duff & Phelps 2008 Risk Premium Report
- Risk Management Association Annual Statement Studies, 2007-2008.
- Economic statistics published by the U.S. government, the State of Oregon, the University of Oregon, the City of Portland as well as publications such as The Oregonian, Oregon Business Magazine.
- CCH Business Valuation Guide, 2007 Edition
- Energy Information Administration
- Milliman Executive Compensation Survey
- Economic Outlook Update™ a publication of BV Resources in Portland, Oregon
- Various texts by authors Gary Trugman, Shannon Pratt and James Hitchner, all of whom are business valuation authorities.

## 1.12. Assumptions & Limiting Conditions

- 1) The valuation process is not a finding of fact. It is a good faith finding of opinion. The opinion is supported by a reasonable amount of research and analysis, but is ultimately only the informed and unbiased judgment of the appraiser.
- 2) A valuation is not a legal or tax opinion. Its purpose is to estimate value according to the applicable standard of value. I assume no responsibility whatsoever for legal or tax matters relative to its finding. Values are stated without reference to applicable legal or tax claims unless so noted.
- 3) I have relied on management's representations without independent investigation or corroboration as though they fairly and accurately represent the financial condition and activities of the Company. In addition, I do not provide assurance on the achievability of the results forecasted by the Company because events and circumstances frequently do not occur as expected. If prospective financial information approved by management has been used in my work, I have not examined or compiled the prospective financial information and do not express an audit opinion or it.
- 4) I have relied on the representations of the owners, management, and other third parties concerning the value and useful condition of all equipment, real estate, investments used in the business, and any other assets or liabilities. I have not attempted to confirm whether or not all assets of the business are free and clear of liens and encumbrances or that the entity has good title to all assets.
- 5) The estimate of *fair market value* established by this report may rely on estimated values for some assets of the subject firm if independent appraisals for these assets are not available. Where such values are used in this appraisal, no warranty is made with respect to these values. If these

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values are incorrect, the resulting estimate of the value of the subject ownership interest may be affected.

- 6) Financial statements and other related information provided by the Company have been accepted without any verification as fully and correctly reflecting the enterprise's business conditions and operation results. I have not audited, reviewed or compiled the financial information provided to me and express no audit opinion or any other form of assurance and assume no responsibility for that information.
- 7) Public economic and industry information has been obtained from sources that I believe to be reliable. However, I make no representation as to the accuracy or completeness of such information and have performed no procedures to corroborate it.
- 8) Neither my engagement nor this report can be relied upon to disclose any fraud, misrepresentation, deviations from generally accepted accounting principles, or other errors or irregularities.
- 9) The conclusion of value arrived at in this report is valid only for the stated purpose as of the date of valuation. Subsequent events have not been considered, and I have no obligation to update my report for such events and conditions.
- 10) This report and the conclusion of value are for the exclusive use of the Loch family and their legal and accounting advisors. I hereby disclaim liability to any other person or for any other use. In addition, this report is not be disseminated to the public through the advertising media, public relations, news media, sales media, mail, direct transmittal, or any other means of communication without my permission.
- 11) No future services regarding the subject matter of this report, including testimony or attendance in court shall be required of me unless previous arrangements have been made in writing.
- 12) I am not an environmental consultant and take no responsibility for any actual or potential environmental liabilities. I have not determined independently whether the Company is subject to any present or future liability relating to environmental matters. I have not taken such liabilities into account, except as they have been reported to me by the Company, in which case I have relied on such a report without verification and cannot offer a warranty as to its accuracy or completeness.
- 13) I am not an American Disabilities Act consultant. I have not made a compliance survey or analysis of the subject Company to determine whether it is subject to or in compliance with the American Disabilities Act of 1990. This valuation does not consider the effect, if any, of noncompliance.
- 14) No change of any item in this appraisal report shall be made by anyone other than me, and I am not responsible for any unauthorized change.

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## **2. The Subject Company**

Revenue Ruling 59-60, the “bible” of business valuation written in 1959, requires that I examine “the nature of the business and the history of the enterprise from its inception.”

### **2.1. Background and History**

A predecessor moving and storage company was founded in 1906. Mr. Loch joined in 1958 after graduating from the University of Oregon and serving in the military. He started the petroleum transport division in 1960, becoming president in 1971. Mr. Loch bought the company in 1972, which also included separate warehouse and distribution divisions. Today, ABC CO. is a distinct company from Capital Warehouse Co. and Capital City Companies, also owned by Mr. Loch.

### **2.2. Facilities**

The company operates 24 trucks averaging anywhere from about 550 to 800 loads of gasoline and diesel per month. During the first nine months of 2008, the total gallons hauled ranged from a low of 7,150,760 in January to 8,939,127 in August.

### **2.3. Organizational Structure**

The company currently employs 24 drivers, two dispatchers, one operations manager, and one mechanic. It shares three administrative people with the other two companies. David Loch, William Loch’s son, is the president.

### **2.4. Products & Services**

The company’s primary activity is to haul gasoline and diesel fuel to service stations.

### **2.5. Geographic Markets**

ABC CO.’s customers are located throughout Oregon and Southwest Washington.

### **2.6. Competition**

There are several strong competitors including Harris Transportation Company, Lee & Estes Tank Lines as well as many who haul their own product. The significant barrier to entry is the cost of the truck, which can be as high as \$300,000. In addition, the industry is regulated heavily.

### **2.7. Business Risks**

First, predatory freight rates limit the company’s ability to grow. Management will not cut freight rates and operate the trucks without adequate revenue. Second, industry consolidation threatens business. For example, if a customer sells out to a large distributorship which is also capable of hauling the product, then ABC CO. would lose that hauling business. Third, a state-wide recession reduces demand for fuel, which in turn reduces volume and the number of loads. Fourth, there is a perpetual market for small jobbers with one or two trucks which limits the company’s growth.

### **2.8. Strategy/Future Plans**

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ABC CO.'s primary business strategy is to retain its current business as well as convince other petroleum distributors to abandon their trucking operations, particularly those with trucks that are sitting idle.

### **3. Business Environment**

Revenue Ruling 59-60 requires consideration of "the economic outlook in general and the condition and outlook of the specific industry in particular."

#### **3.1. Economy**

##### **3.1.1. National**

The following discussion is an excerpt from Economic Outlook Update<sup>™</sup> which is a publication of BV Resources in Portland, Oregon. BV Resources, founded by Shannon Pratt, is the valuation profession's leading publishing and data source. I am a frequent contributor to many of its products, including BV Update<sup>™</sup>, BV Teleconferences and BV Guides.

The U.S. Department of Commerce reported that the nation's economy decreased at an annual rate of 0.3% during the third quarter of 2008. This represents the largest decline in Gross Domestic Product in seven years. It is also the second decrease in the prior four quarters, as the fourth quarter 2007 GDP decreased by 0.2%. Meanwhile, the National Bureau of Economic Research declared that a recession began in December 2007.

Consumer spending, which accounts for two-thirds of all economic activity in the United States, fell by 3.1% during the third quarter of 2008 – the first time since 1991. The Consumer Price Index rose 4.8% during the quarter.

As reported by the Energy Information Administration (EIA), the United States spot price for a barrel of crude oil was \$97.90 at the end of the third quarter of 2008, down from \$128.02 per barrel at the end of the prior quarter. The average retail gas price was \$3.64 per gallon at the end of the third quarter, a decrease from \$4.03 per gallon at the end of the second quarter. The price of diesel fuel was a low of \$1.42 per gallon in 2003. It reached \$3.35 at the end of 2007, topping out at \$4.64 in June 2008 before easing to \$3.96 in September 2008.

The Federal Open Market Committee (FOMC) kept the target for the federal funds rate unchanged at 2.0% in the third quarter of 2008. The target for the federal funds rate was reduced three times in the first quarter of 2008 by a total of 200 basis points and then reduced once in the second quarter by 25 basis points. The federal funds rate is the interest rate at which a commercial bank lends immediately available funds in balances at the Federal Reserve to another commercial bank.

The national unemployment rate jumped to 6.0% during the third quarter of 2008, up from 5.3% posted in the previous quarter. While employment in most job sectors was hit hard during the third quarter, only jobs in education and health services, as well as in the government, saw gains over the quarter.

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The third quarter of 2008 marked the fourth consecutive quarterly decline for both the Dow Jones Industrial Average and the S&P 500. The market experienced much volatility as worries grew over shares of financial companies, the government's rescue of Fannie Mae and Freddie Mac, the collapse of Lehman Brothers, the AIG rescue, etc.

### **3.1.1. Oregon**

According to the Oregon Employment Department, unemployment in Oregon reached 6.4% in September 2008, up from 5.4% a year earlier. The third quarter job loss was spread across most employment sectors. "The housing market slump continued to impact employment sectors. Construction, wood products, and financial activities lost jobs. Consumer spending has slowed considerably impacting retail and wholesale employment sectors. Further detrimental employment impacts will likely stem from the turmoil in the financial markets. The economic environment is increasingly taking on the characteristics of a recession."

In addition, the University of Oregon Department of Economics reports that initial unemployment claims jumped to a weekly average of 9,641, up from 8,005 in April and the highest since December 2001. The population of the state grew 1.2% from July 1, 2007 to July 1, 2008, to 3.79 million, up from 3.75 million.

### **3.2. Impact on Subject**

The combination of still-high gasoline prices and a recessionary economy is a clearly negative backdrop for a company that hauls gasoline.

### **3.3. Industry Conditions**

It is difficult to talk about the trucking industry without focusing on the product that is being transported. According to the Oregon Trucking Association president Bob Russell, companies hauling fuel have fared better than other segments.

Another way to analyze the industry is to look at publicly traded companies. For the most part, these companies are not truly comparable to the subject because they operate in other parts of the U.S. and they haul different cargo. Nevertheless, it is noteworthy that many of these companies are performing well (see [Schedule 1](#)). Nine of 18 companies showed earnings growth from the year-ago quarter.

However, according to the Oregon Department of Transportation, weight-distance tax revenues declined in 2008 for the first time since 2000. Weight mile taxes are a type of highway user fee assessed on trucks. Its main purpose is to assess road wear. Oregon has collected some form of weight-distance tax on trucks since 1925.

### **3.4. Impact on Subject**

Industry conditions are generally negative for ABC CO. given Oregon's weakening economy and then sensitivity of its cargo to business conditions. A somewhat mitigating factor is the relative strength of the publicly traded companies.

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## 4. Financial Information & Analysis

The following presents ABC CO.'s financial information as well as an analysis of the company over time.

### 4.1 The Balance Sheet

Revenue Ruling 59-60 requires that I examine "the book value of the stock and the financial condition of the business." Schedule 2 presents balance sheets in dollars and as a percentage of total assets from 2003-2008.

The most noticeable trend is the relative stability of shareholders equity as a percent of total assets, reaching a peak of 50% at the valuation date. In comparison, the average company in its industry only has equity of 26% of total assets. Industry comparisons are from Annual Statement Studies 2007/2008, published by Risk Management Association (RMA), a leading provider of financial statistics. The averages shown are for Standard Industrial Classification (SIC) 4212, *General Freight Trucking*.

In addition, Schedule 5 indicates that ABC CO. has a stronger balance sheet than the RMA average, posting a higher current ratio, a lower debt-to-equity ratio and stronger interest coverage ratio.

### 4.2 The Income Statement

Revenue Ruling 59-60 requires that I examine "the earning capacity of the company." Schedule 3 presents income statements in dollars and as a percentage of total revenues from 2003-2008.

One can see that fuel expense ranged from a low of 12.4% of revenues in 2003 to a high of 27.1% in 2008; but that driver payroll stayed steady between 30% and 32% during the same time period. Fuel costs soared in 2008, up about \$300,000, although some of this increase can be passed on to customers in the form of a surcharge. Other increases include outside maintenance, truck washing and tires.

Although revenues have grown at a compound annual rate of nearly 12%, operating expenses have grown at nearly 14% during the five-year time period.

Compared to its industry, ABC CO. outperforms the RMA average in terms of profit margin. Over the last six years, ABC CO.'s profit margin has ranged from 1.8% to 6.9% vs. RMA's 3.0%.

### 4.3 The Statement of Cash Flows

Revenue Ruling 59-60 requires that I examine "the dividend paying capacity" of the company. Schedule 4 presents cash flow statements from 2003-2008. There was ample ability to pay dividends. Most of the cash flow was used to buy trucks net of borrowing.

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#### **4.4 Ratios**

From Schedule 5, efficiency ratios such as sales/total assets, return on assets, return on equity and sales to working capital seem to be lower for ABC CO. than the RMA average, indicating a less efficient use of resources.

#### **5. Normalization Adjustments**

Certain normalization adjustments were considered which convert stated financial results into a more realistic picture of the company. However, because the subject interest represents a minority holding, there is theoretically no ability to influence these decisions.

To be sure, William Loch, who owns the company and provides guidance to his son, David, is probably underpaid at \$0 compensation. David, who earns about \$100,000 per year, is possibly underpaid for the degree of responsibility that he holds. According to Milliman's Executive Compensation Survey, the lowest base salary for the highest paid executive in the Pacific Northwest is \$210,000 per year, which falls in the 25<sup>th</sup> percentile of those surveyed in private companies with sales under \$25 million.

Mr. Loch indicates that he believes that other components of the financial statements present a realistic picture of the company's financial performance.

#### **6. Valuation Approaches**

##### **6.1. Methods Considered**

I considered the Income Approach, the Asset Approach and the Market Approach.

##### **6.1.1. Asset Approach**

Within the Asset Approach, the Adjusted Net Asset Method focuses on the balance sheet. The two methods considered under this approach are the Net Liquidation Value Method and the Value-In-Use Method. The Net Liquidation Value Method is appropriate for businesses that are unprofitable and when the best value that could be obtained would be through a sale of assets. The Value-In-Use Method is appropriate when the company is a going concern and is tangible assets intensive.

##### **6.1.2. Income Approach**

The Income Approach to valuation determines the expected future cash flows from an investment and then discounts those cash flows to present value at an appropriate rate of return. The selected discount rate or rate of return should reflect the degree of uncertainty or risk associated with realizing the future cash flows compared to cash flows available from alternative investments. Within the Income Approach, there are two methods: Single Period Capitalization Benefits and Discounted Future Benefits. The Single Period Capitalization Method estimates the value of the company based on the value of a projected future income stream that is relatively constant and

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predictable. The Discounted Future Benefits method attempts to forecast cash flows over the next three to five years.

### **6.1.3. Market Approach**

The Market Approach to valuation rests on the premise that a business can be valued with reference to what comparable companies have sold for in an open and unrestricted market. This approach uses comparable or *guideline* company data to assess the value of the subject entity. There are two primary market approaches: the Guideline Public Company Method and the Guideline Company Transactions Method.

Revenue Ruling 59-60 requires the analysis of prior “sales of the stock and the size of the block to be valued; and the market price of stocks of corporations engaged in the same or similar line of business having their stocks actively traded in a free and open market, either on an exchange or over the counter.”

## **6.2. Valuation Methods Used**

### **6.2.1. Asset Approach**

Because ABC CO. is a business with significant tangible assets, the Asset Approach was used. The primary asset that needs adjusting is the value of the truck fleet. I asked a truck dealer, Beall Corporation, to place a value on the fleet. Mr. Kevin Sales, the company's sales manager, provided a schedule of values based on his experience as well as published reports.

Schedule 7 provides a list of all of the truck assets as well as the company's Adjusted Book Value of **\$1,276,915** excluding discounts for lack of control and marketability.

### **6.2.2. Income Approach – Capitalization of Benefits**

I selected the Single Period Capitalization Method instead of the Discounted Future Benefits Method since management does not make forecasts. In addition, there is no discernable trend to the company's performance over the past six years from which to make a forecast.

There is the question of what to do with the nine-month period ending September 30, 2008. One option is to calculate “last twelve months” (LTM). Another is to take the nine months and annualize it. There are two problems with LTM: double-counting of the fourth quarter of 2007 and the unavailability of compiled cash flow data for that quarter. Annualizing nine-month data misses seasonality. In ABC CO.'s case, the fourth quarter is slower than other periods. Thus, annualizing would likely overstate results.

Recognizing flaws in both methods, I elected to annualize the ninth-month data, but rather than use a weighted average which emphasizes more recent data, I elected a simple average of the six periods.

#### **6.2.2.1. Determining The Benefit Stream**

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Because the company carries significant debt, I will use the simple average of cash flow to invested capital, which equals Operating Income plus Depreciation minus Capital Expenditures. As can be seen in Schedule 6, the benefit stream is **\$274,078**.

#### **6.2.2.2. Determining The Equity Discount Rate**

The discount rate is an estimation of the rate of return necessary in the marketplace to attract the capital of a “willing buyer.” It is the rate of return available on alternative investment opportunities with comparable risk. The “build-up” method is a common way to determine the discount rate. It adds the following factors:

- Risk-free rate. This is the 20-year U.S. Treasury Bond. At September 30, 2008, it was 4.4%.
- Equity risk premium. Ibbotson Associates calculates the average annual rate of return premium since 1926. This study shows that an investment in common stock, as represented by the Standard and Poor's 500 (S&P 500) Stock Composite Index, has, since 1926, provided an additional return above the yield of long-term (20-year) government bonds of 7.1%.
- Industry risk premium. Ibbotson Associates calculates risk premiums by SIC number. According to Ibbotson, SIC 421 for Trucking produces an extra risk of 0.2%.
- Small stock risk premium. According to Ibbotson, there is an additional risk factor for the smallest companies defined by market value of equity equaling 3.7%, reflecting the additional return that investors in small companies require.

Using Ibbotson, the discount rate excluding the risk of the specific company would be  $4.4 + 7.1 + 0.2 + 3.7 = \mathbf{15.4\%}$ .

In the past few years, another source of data has emerged from Duff & Phelps, a leading financial advisory firm. This data source provides a combined equity and small-stock risk premium using 25 data points. As a valuation analyst, I am able to create a graph of 25 data points and 25 corresponding equity risk premiums. By inputting a 26<sup>th</sup> data point into a mathematical equation, an equity risk premium for ABC CO.'s size can be calculated.

Using this method, the following combined equity risk premiums using six size definitions were determined for ABC CO.:

- Market Value of Equity, 20.5%
- Book Value of Equity, 17.5%
- 5-Year Average Net Income, 14.2%
- Total Assets, 17.2%

- 
- Sales, 15.1%
  - Number of Employees, 14.5%

Using Duff & Phelps, the average of these discount rates excluding industry and specific company risk is 16.5%. Adding the industry risk of 0.2% arrives at **16.7%**.

Taking an average of Ibbotson at 15.4% and Duff & Phelps at 16.7% arrives at **16.1%** for the cost of equity.

One more addition to the build-up method is required: the Specific Company Risk Premium. To determine the specific company risk, points are added for negative risk factors. Points are subtracted for positive risk factors. These point assignments are very subjective and do not rely on third party data.

The company is a very strong competitor, outperforming its peers in many areas. The current president, David Loch, has worked in the business all of his adult life. The drivers are first rate and are paid top wages. The company keeps close watch on driver fuel efficiency and safety. Fuel costs began to decline in the third quarter of 2008. In addition, I noted earlier that public companies in the transportation sector have performed well in recent quarters. I would subtract 2 points for these positive risk factors.

However, the company is operating in a very difficult economic environment of rising unemployment. Demand for gasoline, the product that ABC CO. is in business to transport, is directly related to price as well as the level of economic activity. Historically, Oregon has not fared well when the U.S. has entered recessionary periods. Because of this very difficult environment, I believe that it is necessary to add an additional 4 points for specific company risk for negative factors. The net addition is 2 points, for a total of **18.1%**.

### **6.2.2.3. Determining The Weighted Average Cost of Capital (WACC)**

If the company's cost of equity is 18.1% (determined above) and its cost of debt is 7.5% as indicated in the notes to its financial statements, the company's WACC is a blend of these two costs, weighted by the market value of debt and equity.

However, because there is no market for the securities, we must estimate market values in order to compute the capital structure weightings. This requires an iterative process as shown in Schedule 8.

The first iteration assumes private company debt is worth the same as its book value (\$479,071). Private company equity is initially valued at its adjusted net asset amount (\$1,276,915). A WACC is calculated in the first iteration using the proportion of debt (27.3%) and equity (72.7%) in the capital structure. WACC equals  $(.273 \times 0.075) + (.727 \times .181) = 15.21\%$ .

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Now, the market value of equity is calculated by dividing the benefit stream, \$274,078 by .142 = \$1,928,768. The capitalization rate, 0.142, is determined by subtracting the long-term growth rate of 1%, determined in the next section. As this process continues, the WACC converges to **15.4%**.

#### **6.2.2.4. Determining Capitalization Rate**

The capitalization rate equals the discount rate less the long-term growth rate. Long-term growth takes into account prior sales and earnings growth, the market, the company's capacity in terms of physical plant and management time as well as other factors.

The company's growth will be hampered by the recessionary environment in Oregon that was evident at the valuation date and which was expected for the foreseeable future. While Oregon continues to enjoy modest population growth, perhaps 1% per year, there is unlikely to be much inflation over the short term. The company has not demonstrated that it is able to grow its bottom line in keeping with its top line growth. Therefore, I believe that a 1% growth rate is appropriate as of the valuation date.

Since the capitalization rate equals the discount rate minus the growth rate, the **capitalization rate is 15.4 – 1.0 = 14.4%**.

#### **6.2.2.5. Income Approach Calculation**

Before taking discounts for lack of control and lack of marketability, the Market Value of Invested Capital indicated by this method is

$$\$274,078 / .144 = \$1,903,319.$$

Deducting long-term debt of \$479,071 at September 30, 2008 arrives at a Market Value of Equity equal to **\$1,424,248**.

### **6.2.3. Market Approach**

The Market Approach to valuation rests on the premise that a business can be valued with reference to what comparable companies have sold for in an open and unrestricted market. This approach uses comparable or *guideline* company data to assess the value of the subject entity. There are two primary market approaches: the Guideline Public Company Method and the Guideline Company Transactions Method.

#### **6.2.3.1. Guideline Public Company Method**

Revenue Ruling 59-60 requires the consideration of "the market price of stocks of corporations engaged in the same or a similar

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line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.”

The Guideline Public Company Method implements this requirement. It is based on the premise that pricing multiples of publicly traded companies can be used as a tool in valuing closely held businesses.

I was able to identify public companies in the context of discussing the industry in which the company does business. However, these companies operate in other parts of the country, haul different cargo and are generally more than 100 times larger in terms of sales. Therefore, I don't believe that they can be used as guideline public companies.

#### **6.2.3.2. Guideline Company Transaction Method**

This method examines private company transactions. I consulted Pratt's Stats® and BIZComps®, two transaction databases and found a total of 30 appropriate transactions that were completed over the past ten years. I excluded companies such as moving & storage concerns that were not comparable but were nevertheless listed in SIC 4212. I checked to see that the transactions in each database were not duplicated in the other one. Also deleted were outlier multiples.

As displayed in Schedule 9, the median Price/Sales ratio is 0.576 and 0.638, respectively, in the two databases. The Pratt's Stats® database also indicates a median Price/EBIT of 6.385, a Price/Discretionary Earnings of 2.85 and a price to book value of 1.872. The BIZComps® database indicates a Price/Sellers Discretionary Earnings (SDE) of 2.581. In both databases, “discretionary” earnings refer to Operating Profit plus Owners Compensation plus Non-Cash Charges such as depreciation. ABC CO. owner's compensation is \$0.

These ratios were applied to the subject company and a simple average was taken. The result: **\$1,528,858**.

### **7. Reconciling Methods**

Using the Asset Approach, I determined the value to be **\$1,276,915**.

Using the Income Approach, the value was determined to be **\$1,424,248**.

Using the Market Approach, the result was **\$1,528,858**.

Revenue Ruling 59-60 prohibits the use of a simple average to arrive at a conclusion. However, a weighting process is appropriate, as described by leading valuation expert Gary Trugman in his text, Understanding Business Valuation.

Of the three methods, I believe that the Asset Approach is the most reliable. The Income Approach uses a simple average of six time periods for the benefit stream, in the absence of any reliable forecast. Given the uncertain economic environment, there is no way of knowing how close this estimate will be to the outcome. The Market Approach is based on

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data for companies in the same SIC category, but that category covers truckers who are hauling all types of products, and therefore is not specific enough.

A reasonable allocation would be to weight the Asset Approach, the Income Approach and the Market Approach according to a proportion of 50-25-25. In doing so, the blended value is **\$1,376,734**.

## **8. S Corporations**

ABC CO. is an S Corp., which means it does not pay tax at the entity level. A number of years ago, some valuation analysts argued that the earnings of S Corporations should be tax-affected. Their theory was that a portion of the tax paid on the individual's tax return is really an imputed corporate tax that would have had to be paid had the entity been a C Corporation. According to the 2007 edition of the CCH Business Valuation Guide, a 1999 gift tax case that was upheld on appeal held that tax-affecting S Corporations was not correct. Other analysts have since argued that S Corporation earnings should not be tax-affected downward, but should actually receive a premium. In my view, the S Corp. is already receiving a premium valuation compared to the comparable C Corp. because no tax is deducted in developing the benefit stream. Applying a premium would seem to double count the S Corp. benefit. Therefore, I elected not to make any S Corp. adjustment.

## **9. Discount For Lack of Control (DLOC)**

I did not adjust ABC CO.'s compensation expense upward to reflect what might be an underpayment of salary on the theory that the minority shareholder does not control discretionary spending. As a result, we have essentially already taken a discount for lack of control. Any further adjustment would be double counting.

## **10. Discount For Lack of Marketability (DLOM)**

The concept of marketability relates to how quickly and certainly an asset can be converted into cash. An owner of publicly traded securities knows the value of his holdings through stock quotations on the organized exchanges such as the New York Stock Exchange or NASDAQ. The common stock of a closely held company is not as liquid as the common stock of a publicly traded company. Accordingly, an owner of privately held securities will demand a price discount for the lack of liquidity. The discount for lack of marketability (DLOM) reflects such liquidity differences between closely held and publicly traded securities.

There are two general types of empirical studies designed to quantify the lack of marketability discounts associated with minority interests in closely-held companies.

- Restricted stock studies – studies of the private sale of restricted shares of the stock of publicly traded companies, specifically recognized by Revenue Ruling 77-287.
- Pre-Initial Public Offering (Pre-IPO) – studies of the private stock sale transactions of a closely held company that subsequently completed a successful IPO of its stock.

Restricted stock is identical to the freely traded stock of a public company with the exception that it is restricted from trading on the open market for a certain period of time. Restricted stock cannot be sold on the open market, but may be sold in private placements.

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More than a dozen restricted stock studies have been performed during the past 40 years. The results of these studies have produced DLOMs in the 20-35% range. Here are some of the leading restricted stock studies:

- Hall and Polacek. In a paper appearing in Estate Planning magazine in 1994, Lance Hall and Timothy Polacek found a mean discount of 23% on transactions taking place between 1979 and 1992.
- Silber. In a paper appearing in Financial Analysts Journal in 1991, William Silber found a mean discount of 34% on deals taking place between 1981 and 1988.
- Management Planning, Inc. This valuation firm compiled an analysis of the discounts on restricted stocks during the period 1980 and 1996 and found a median discount of 25%.

The Pre-IPO studies compare pre-IPO private transaction prices with post-IPO trading prices to determine the marketability discount associated with holding closely held stock. Discounts on Pre-IPO studies tend to be higher than discounts on restricted stock studies.

- Emory. John D. Emory, president of Emory Business Valuation, LLC studied 593 transactions from 1980 to 2000. The mean and median marketability discounts from the studies was 47% and 48%, respectively.
- Willamette Management. Willamette Management Associates analyzed private sale transactions in pre-IPO stock that took place during the 36 months prior to the company's IPO. The results of the 21 Willamette Management studies conducted over the 1975-2000 period indicated median discounts ranging from 28% to 63%.
- Valuation Advisors LLC developed a searchable web-based database that provides pre-IPO data. The IPO Database contains nearly 3,000 transactions between 1999 and 2005. The median lack of marketability discount for the six years ranged from 28% to 72%, depending on the time between the pre-IPO time and the post IPO measurement date.
- Hitchner. James Hitchner, a leading valuation professional, conducted a series of studies. The mean and median discounts on the 23 transactions that he studied in 1995-1996 were 51% and 52%, respectively. He also conducted other studies between 1980 and 1995, and found marketability discounts in the 45% range.

In his text, Financial Valuation, Application and Models (Second Edition), Hitchner makes the following observations about empirical studies: 1) Smaller companies have larger DLOMs; 2) The studies focus on public companies that have an active market for their stock, while closely held businesses are unlikely to ever go public, suggesting a greater DLOM for OPHF than the study subjects; and 3) Valuation analysts who rely solely on these empirical studies may understate private company DLOMs.

The median DLOM from the above studies is 45%.

The landmark court case on the subject is Bernard Mandelbaum et al. v. Comm., a gift tax case dated June 12, 1995. The court considered nine factors which should be considered when determining whether DLOM should be at the high or low end of the range.

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- Financial strength – OPT is strong, which lowers the DLOM
  - Dividend policy – random, higher DLOM
  - Company’s reputation – highly ranked, lower DLOM
  - Management depth – thin ranks, higher DLOM
  - Control vs. minority – minority, higher DLOM
  - Restrictions on transferability – family only, higher DLOM
  - Holding period – not applicable
  - Redemption policy – not applicable
  - Costs associated with going public – not applicable

Based on these factors, I have chosen to assign a DLOM at **35%**.

## 11. Conclusion of Value

Applying a 35% DLOM to \$1,376,734 equals \$894,877, or **\$895,000 rounded**.  
That equals **\$8,950 for a 1% interest**.

## 12. Credentials & Professional Affiliations

Stuart Weiss, CPA/ABV is accredited in business valuation by the American Institute of Certified Public Accountants. He is also a Certified Valuation Analyst, a designation issued by the National Association of Certified Valuation Analysts. He is closely associated with BV Resources, the valuation profession’s leading publishing company. During the summer of 2008, he served as Interim Managing Editor of BV Update, a major valuation publication. In addition to his business valuation activities, he has been a principal in a family business and has written annual reports, business plans, college textbooks, magazine/newspaper articles and financial commentaries for clients throughout the U.S. Prior to these activities, he was a staff writer for Business Week magazine in New York as well as an analyst with Oppenheimer & Co. in New York. In addition to completing more than 40 hours per year in continuing education, he holds an MBA and an MS from Stanford University after graduating Phi Beta Kappa from UCLA. He is a member of the American Institute of Certified Public Accountants and the Oregon Society of CPAs.

