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HOT TOPICS IN VALUATION: 2023 EDITION

*Explore the Current Landscape*



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## INTRODUCTION



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### *Hot Topics in Valuation – Explore the Current Landscape*

## INTRODUCTION

- ***We have experienced and continue to experience unprecedented times***
  - Pandemic presented unique challenges
  - Increasingly faster development of technology
  - Inflation
  - Supply chain issues

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## *Hot Topics in Valuation – Explore the Current Landscape*

### INTRODUCTION

- *Valuation of privately held businesses has become increasingly complex*
- *Fundamentals remain the same; inputs and considerations present challenges*
- *Today's goal is to address the current landscape that we, as valuers, must navigate*

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## *Hot Topics in Valuation – Explore the Current Landscape*

### INTRODUCTION


- *Topics addressed this morning:*
  - Economic outlook
  - Interest rate environment & cost of capital
  - Deal highlights
  - Inflationary impacts on valuation
  - Price versus value
  - Circumstances prompting a valuation
  - Valuation in the courts

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ECONOMIC OUTLOOK



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ECONOMIC OUTLOOK

- ***Regional Economic Outlook***
  - Auto dealers, homebuilders, and residential realtors said that higher interest rates, along with persistent inventory shortages, constrained sales
  - Bankers reported that loan volumes declined further
  - By contrast, manufacturers said that demand increased slightly in recent months, particularly in goods categories with longer lead times
  - Looking forward, contacts are generally more pessimistic about the near-term outlook for demand

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### ECONOMIC OUTLOOK

#### ■ *National Economic Outlook*

- Consumer spending increased slightly, with some retailers reporting more robust holiday sales
- Auto sales were flat on average, but some dealers noted that increased vehicle availability had boosted sales
- Tourism contacts reported moderate to robust activity augmented by strong holiday travel
- Manufacturers indicated that activity declined modestly on average, and, in many Districts, reported that supply chain disruptions had eased
- Housing markets continued to weaken, with sales and construction declining across Districts
- Commercial real estate activity slowed slightly, on average, with more notable weakening in the office market

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### ECONOMIC OUTLOOK

#### ■ *Federal Open Market Committee – Monetary Policy Commentary*

- Russia's war against Ukraine is causing tremendous human and economic hardship and is contributing to elevated global uncertainty
- Committee decided to raise the target range for the federal funds rate to 4.5% to 4.75%
- Committee anticipates that ongoing increases in the target range will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2% over time

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### ECONOMIC OUTLOOK

- **Treasury Yield Curve**
  - A flattening yield curve can foreshadow an economic slowdown
  - Inverted yield curve (when longer maturity yields fall below shorter-term yields) can foreshadow an economic recession
  - On February 24<sup>th</sup> of this year, the rate for the three-month Treasury bill was 4.86%, while the rate for the 10-year Treasury bond was 3.95%, indicating an inverted yield curve

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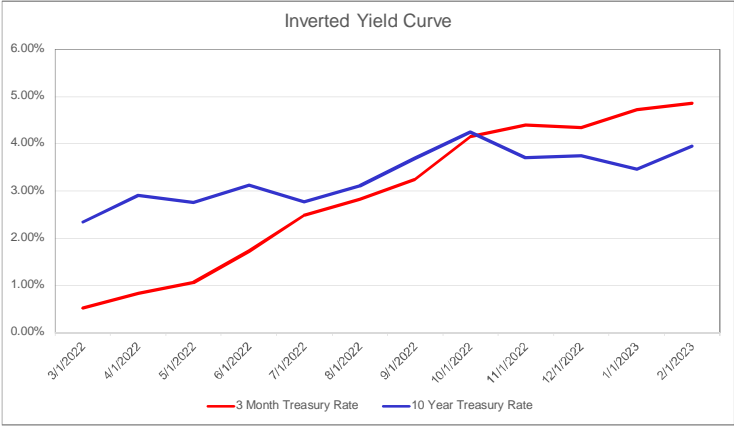
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### ECONOMIC OUTLOOK


- **Inverted Yield Curve**

Inverted Yield Curve



Date	3 Month Treasury Rate	10 Year Treasury Rate
3/1/2022	0.05%	2.30%
4/1/2022	0.10%	2.80%
5/1/2022	0.20%	2.70%
6/1/2022	0.50%	3.10%
7/1/2022	1.00%	2.80%
8/1/2022	1.50%	3.10%
9/1/2022	2.50%	3.50%
10/1/2022	3.50%	4.20%
11/1/2022	4.20%	3.70%
12/1/2022	4.30%	3.70%
1/1/2023	4.50%	3.50%
2/1/2023	4.86%	3.95%

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### ECONOMIC OUTLOOK

- **Current Employment Conditions**
  - January 2023 unemployment = 3.4%
    - Little change from previous month, has shown little change since 2022
  - Total nonfarm payroll employment increased by 517,000
  - Job growth was widespread, led by gains in leisure and hospitality, professional and business services, and health care; employment also increased in government, partially reflecting the return of workers from a strike

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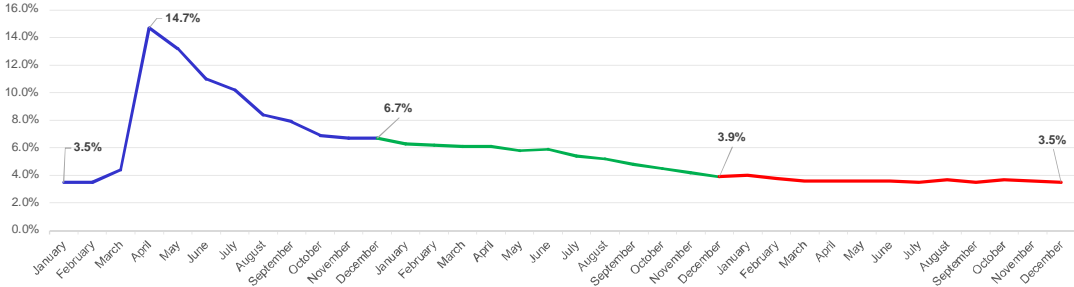
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## Hot Topics in Valuation – Explore the Current Landscape

### ECONOMIC OUTLOOK

- **Historical Unemployment Rates**

Historical Unemployment Rates (2020 - 2022)



Month	Unemployment Rate
January 2020	3.5%
February 2020	3.5%
March 2020	3.5%
April 2020	14.7%
May 2020	13.5%
June 2020	12.5%
July 2020	11.5%
August 2020	10.5%
September 2020	9.5%
October 2020	8.5%
November 2020	7.5%
December 2020	6.7%
January 2021	6.7%
February 2021	6.7%
March 2021	6.7%
April 2021	6.7%
May 2021	6.7%
June 2021	6.7%
July 2021	6.7%
August 2021	6.7%
September 2021	6.7%
October 2021	6.7%
November 2021	6.7%
December 2021	6.7%
January 2022	3.9%
February 2022	3.9%
March 2022	3.9%
April 2022	3.9%
May 2022	3.9%
June 2022	3.9%
July 2022	3.9%
August 2022	3.9%
September 2022	3.9%
October 2022	3.9%
November 2022	3.9%
December 2022	3.5%

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### ECONOMIC OUTLOOK

#### ▪ *Other Major Economic Indicators*

- Consumer Price Index
  - CPI rose 0.5% in January 2023
  - Biggest price increases in shelter, food, and gasoline
- Employment Cost Index
  - Compensation costs increased 5.1% for civilian workers, costs for private industry workers increased 5.1%, and costs for state and local government workers increased 4.8% in 2022

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### ECONOMIC OUTLOOK

#### ▪ *Gross Domestic Product (GDP)*

- Per the Bureau of Economic Analysis (BEA), real gross domestic product increased at an annual rate of 2.7% in the fourth quarter of 2022, after increasing 3.2% in the third quarter
- “The increase in the fourth quarter primarily reflected increases in inventory investment and consumer spending that were partly offset by a decrease in housing investment.”
- Growth in GDP is sign of healthy economy

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### ECONOMIC OUTLOOK

#### ▪ *Additional Sources*

- Industrial Production and Manufacturing
- Consumer Confidence
- Housing and Construction

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### ECONOMIC OUTLOOK

#### ▪ *Current Construction in Pittsburgh*

- New UMPC Presbyterian Hospital
- UMPC Mercy Pavilion
- First National Bank Headquarters
- Terminal Modernization Program at Pittsburgh International Airport

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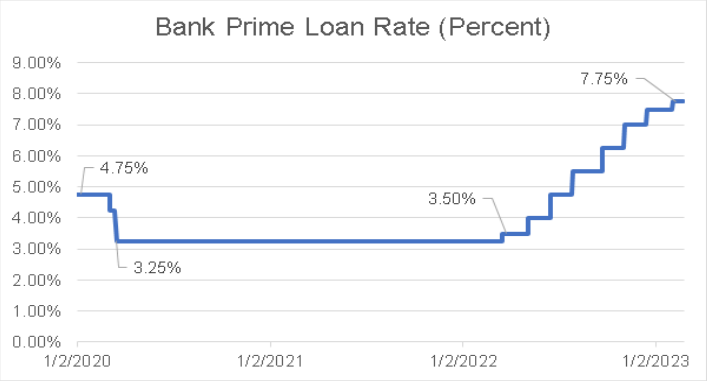
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## Hot Topics in Valuation – Explore the Current Landscape

### ECONOMIC OUTLOOK


- Interest Rates

Bank Prime Loan Rate (Percent)



Date	Bank Prime Loan Rate (Percent)
1/2/2020	4.75%
1/2/2021	3.25%
1/2/2022	3.50%
1/2/2023	7.75%

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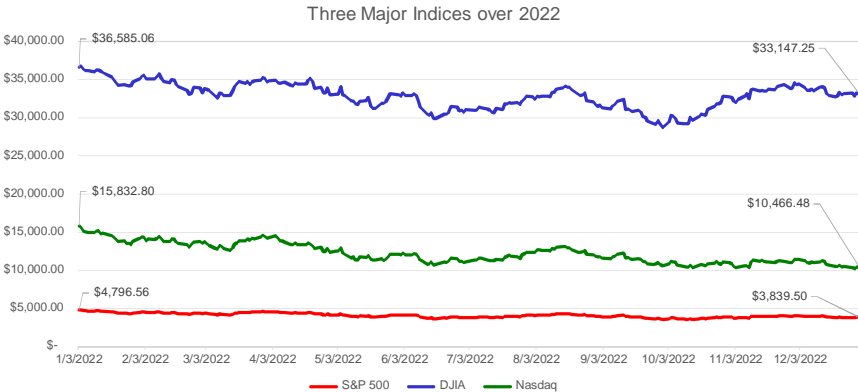


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## Hot Topics in Valuation – Explore the Current Landscape

### ECONOMIC OUTLOOK

Three Major Indices over 2022



Index	Start (1/3/2022)	End (12/3/2022)
DJIA	\$36,585.06	\$33,147.25
Nasdaq	\$15,832.80	\$10,466.48
S&P 500	\$4,796.56	\$3,839.50

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### ECONOMIC OUTLOOK

#### ■ *Conclusion*

- Post-pandemic economic expansion halted by inflation rise
- Inverted yield curve = looming recession
- As of today, lots of economic uncertainty

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## INTEREST RATE ENVIRONMENT & COST OF CAPITAL CONSIDERATIONS



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### INTEREST RATE ENVIRONMENT & COST OF CAPITAL

#### ■ **Background**

- Weighted Average Cost of Capital (WACC)
  - Cost of financing operations
  - Hurdle rate when analyzing investment opportunities
  - Discount rate/risk rate utilized to bring cash flows to present value

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## *Hot Topics in Valuation – Explore the Current Landscape*

### INTEREST RATE ENVIRONMENT & COST OF CAPITAL

#### ■ **Background**

- Weighted Average Cost of Capital (WACC)
  - Direct impact on indicated value of business
  - Simplified valuation equation:  $\text{Value} = \text{Benefit Stream} \div \text{Risk Rate}$
  - Inverse relationship between WACC and value

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### INTEREST RATE ENVIRONMENT & COST OF CAPITAL

#### ▪ *Components of the WACC*

- $WACC = (K_e \times W_e) + (K_d \times W_d)$
- where,
  - $K_e$  = equity cost of capital
  - $W_e$  = weight of equity capital
  - $K_d$  = after-tax cost of debt
  - $W_d$  = weight of debt capital

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### INTEREST RATE ENVIRONMENT & COST OF CAPITAL

#### ▪ *Cost of Equity*

- Under the Build Up Model
  - $K_e = R_f + ERP + R_s + CSR_P$
- where,
  - $K_e$  = equity cost of capital
  - $R_f$  = risk-free rate
  - $ERP$  = equity risk premium
  - $R_s$  = size premium
  - $CSR_P$  = company-specific risk premium

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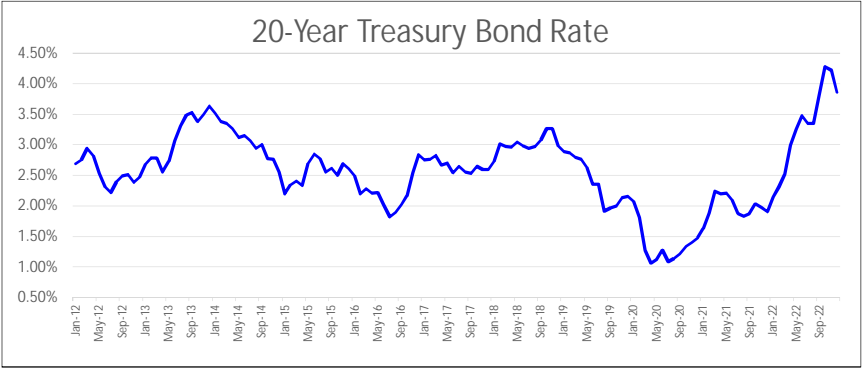
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INTEREST RATE ENVIRONMENT & COST OF CAPITAL

Cost of Equity


Risk-free Rate

20-Year Treasury Bond Rate



Date	Rate (%)
Jan-12	2.80
May-12	2.50
Sep-12	2.30
Jan-13	2.50
May-13	2.80
Sep-13	3.50
Jan-14	3.60
May-14	3.20
Sep-14	2.80
Jan-15	2.30
May-15	2.80
Sep-15	2.50
Jan-16	2.20
May-16	1.80
Sep-16	2.80
Jan-17	2.80
May-17	2.50
Sep-17	2.80
Jan-18	3.00
May-18	3.20
Sep-18	3.20
Jan-19	2.80
May-19	2.20
Sep-19	2.00
Jan-20	1.80
May-20	1.10
Sep-20	1.20
Jan-21	2.20
May-21	1.80
Sep-21	1.80
Jan-22	2.50
May-22	3.50
Sep-22	4.25

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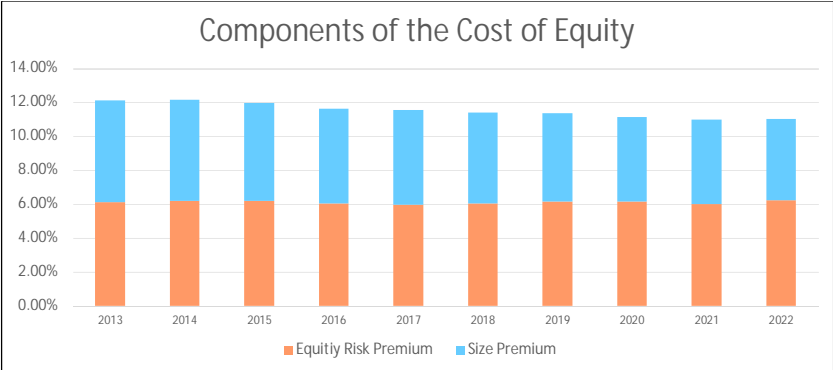
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INTEREST RATE ENVIRONMENT & COST OF CAPITAL

Cost of Equity

Equity Risk Premium  
& Size Premium

Components of the Cost of Equity



Year	Equity Risk Premium (%)	Size Premium (%)	Total Cost of Equity (%)
2013	6.00	6.00	12.00
2014	6.00	6.00	12.00
2015	6.00	6.00	12.00
2016	6.00	5.80	11.80
2017	6.00	5.80	11.80
2018	6.00	5.80	11.80
2019	6.00	5.80	11.80
2020	6.00	5.50	11.50
2021	6.00	5.50	11.50
2022	6.00	5.50	11.50

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INTEREST RATE ENVIRONMENT & COST OF CAPITAL

- Cost of Debt
  - Cost of next dollar of financing
  - Third-party borrowing rates
  - Dependent on current lending environment

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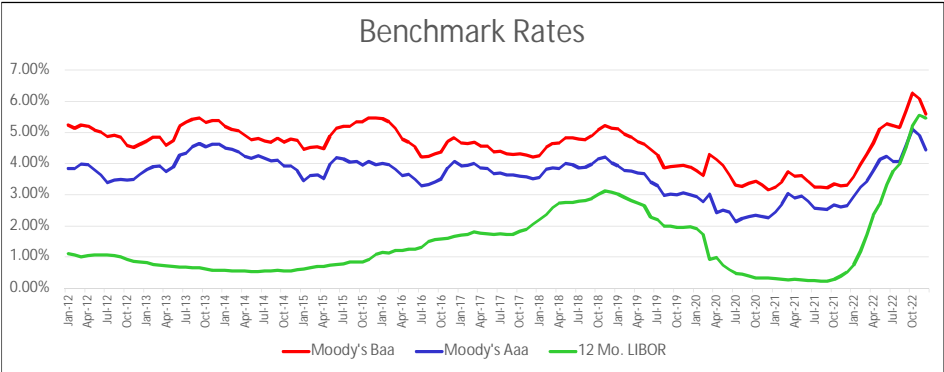


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Hot Topics in Valuation – Explore the Current Landscape

INTEREST RATE ENVIRONMENT & COST OF CAPITAL

- Cost of Debt
  - Benchmark Rates



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## *Hot Topics in Valuation – Explore the Current Landscape*

### INTEREST RATE ENVIRONMENT & COST OF CAPITAL

#### ■ *Observations*

- Overall, the WACC has increased
- In isolation, negative impact on value
- Increased attractiveness of other investment alternatives
- Inverted yield curve leads to higher cost of equity

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## DEAL HIGHLIGHTS



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### DEAL HIGHLIGHTS

- ***Guideline Completed Transaction Method***
  - Also referred to as “Merger and Acquisition Method”
  - Observes value indicators produced through closed and completed transactions
    - Greater availability of transaction data
    - Transactions providing financial data to business valuers under this method are grouped into one of four categories

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### DEAL HIGHLIGHTS

- ***Guideline Completed Transaction Method***
  - Categories
    - Public company sale
    - Private company to public company sale requiring an SEC 8-K
    - Private company to public company sale with no SEC 8-K
    - Private to private company sale

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### DEAL HIGHLIGHTS

#### ▪ **Guideline Completed Transaction Method**

- Common Databases and Information Sources
  - Guideline Transaction Method
    - BIZCOMPS – contains over 12,650 private company transactions with median selling price of about \$167,000
    - DealStats – new platform that incorporates private-company transaction comparables from Pratt's Stats and Public Stats
    - Done Deals – contains 7,000 transactions for private/public mid-market companies
    - Institute of Business Appraisers (IBA) database – contains transaction data for sales of small to medium-sized businesses

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### DEAL HIGHLIGHTS

#### ▪ **GF Data**

- Database for middle-market transactions that includes 4,685 transactions from 271 active private equity contributors
- Transactions include targets with a total equity value (TEV) between \$10 million and \$250 million and a TEV/TTM Adjusted EBITDA between 3 and 18 times

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DEAL HIGHLIGHTS

GF Data

– Summary of last 6 quarters of activity:


– Deals deferred due to Covid in 2020, picked up in second half of 2021, especially Q4

– Year-over-year drop in 2022 was magnified by “land-rush conditions” in 2021

– Concern about macro conditions (inflation, labor availability, persisting supply chain issues, and prospect of recession)

All Transactions	3Q21	4Q21	1Q22	2Q22	3Q22	4Q22
# of Deals	79	172	92	71	70	64
TEV/EBITDA	7.6x	7.5x	7.5x	7.4x	8.2x	6.8x

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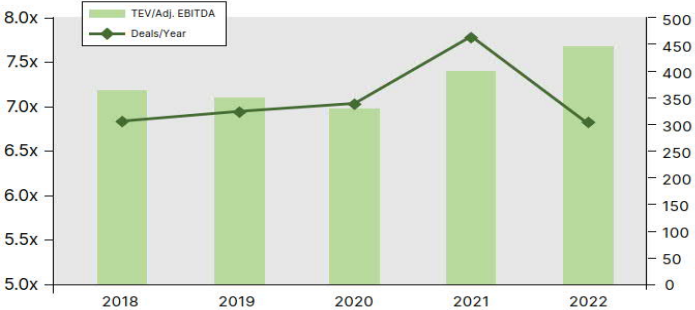
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DEAL HIGHLIGHTS

GF Data –  
Last 5 Years of Deals


AVERAGE MULTIPLES AND DEAL VOLUME



Year	TEV/Adj. EBITDA (Average Multiple)	Deals/Year
2018	~7.1x	~320
2019	~7.1x	~340
2020	~7.0x	~360
2021	~7.4x	~460
2022	~7.7x	~310

GF SOURCE: GF DATA® an ACG Company

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DEAL HIGHLIGHTS

GF Data –  
Multiples by Industry


TEV/EBITDA—BY INDUSTRY

INDUSTRY	2003 -2017	2018	2019	2020	2021	2022	Total	N =
Manufacturing	6.1	6.8	6.5	6.7	7.1	7.4	6.4	1894
Business services	6.5	7.1	7.2	7.1	7.3	7.4	6.9	1040
Health care services	7.3	7.8	8.0	7.6	8.0	8.4	7.5	429
Retail	6.7	8.1	9.3	6.5	8.6	8.0	7.1	135
Distribution	6.5	6.9	7.0	7.5	7.2	7.2	6.8	503
Media & Telecom	7.4	7.8	9.4	8.3	6.3	9.1	7.6	74
Technology	8.2	9.6	10.0	7.6	10.3	8.1	8.6	163
Other	6.2	7.2	6.5	6.2	7.3	6.9	6.4	447
N=								4685

Please note that N for 2003-17 encompasses fifteen years of activity.


 GF SOURCE: GF DATA® an ACG Company

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INFLATIONARY IMPACTS ON VALUATION



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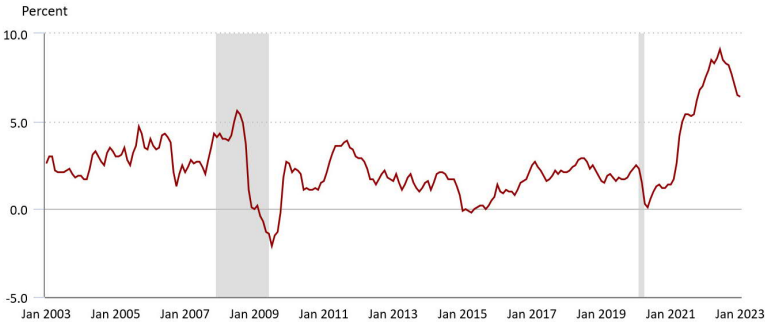
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### INFLATIONARY IMPACTS ON VALUATION

■ **Short-Term Inflation**


– Consumer Price Index  
% Annual Change  
Previous 10 Years

– How did we get here?



Source: U.S. Bureau of Labor Statistics.

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## Hot Topics in Valuation – Explore the Current Landscape

### INFLATIONARY IMPACTS ON VALUATION

■ **Short-Term vs. Long-Term Inflation**


– Impact on current or immediate investor expectations

– Investment holding period assumptions

– Importance of short-term and long-term expectations

– Combined influence

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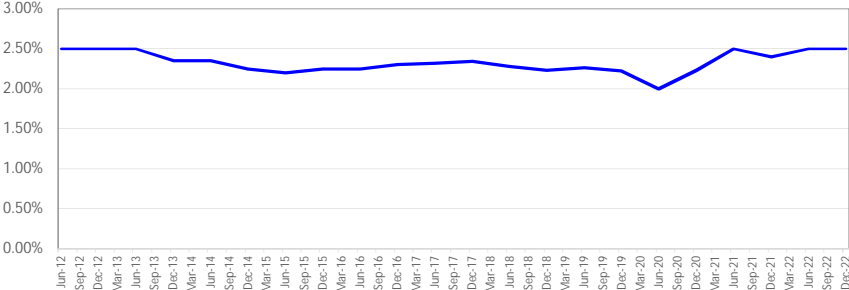
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## Hot Topics in Valuation – Explore the Current Landscape

### INFLATIONARY IMPACTS ON VALUATION


- Long-Term Inflation
  - Livingston Survey

10 Year Forecasted CPI Inflation Rate



Date	Rate (%)
Jun-12	2.50
Sep-12	2.50
Dec-12	2.50
Mar-13	2.50
Jun-13	2.50
Sep-13	2.40
Dec-13	2.40
Mar-14	2.40
Jun-14	2.40
Sep-14	2.35
Dec-14	2.35
Mar-15	2.30
Jun-15	2.30
Sep-15	2.30
Dec-15	2.30
Mar-16	2.30
Jun-16	2.35
Sep-16	2.35
Dec-16	2.35
Mar-17	2.35
Jun-17	2.35
Sep-17	2.35
Dec-17	2.35
Mar-18	2.35
Jun-18	2.35
Sep-18	2.30
Dec-18	2.30
Mar-19	2.30
Jun-19	2.30
Sep-19	2.30
Dec-19	2.30
Mar-20	2.00
Jun-20	2.00
Sep-20	2.00
Dec-20	2.00
Mar-21	2.50
Jun-21	2.50
Sep-21	2.50
Dec-21	2.40
Mar-22	2.40
Jun-22	2.50
Sep-22	2.50
Dec-22	2.50

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## Hot Topics in Valuation – Explore the Current Landscape

### INFLATIONARY IMPACTS ON VALUATION

- Merger and Acquisition Activity
  - High inflation tends to drop M&A multiples
  - Stock prices ↓ investors rate of return expectations ↑
  - Deal volume declines in times of high inflation
  - Rising interest rates = Increased financing costs = More expensive transaction

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## *Hot Topics in Valuation – Explore the Current Landscape*

### INFLATIONARY IMPACTS ON VALUATION

#### ■ *Public Markets*

- Impact on profitability/corporate earnings
- Impact on required rates of return
- Impact on price to earnings (P/E) multiples

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## *Hot Topics in Valuation – Explore the Current Landscape*

### INFLATIONARY IMPACTS ON VALUATION

#### ■ *Private Company Appraisals*

- Income Approach
  - Impact on expected benefit stream
  - Impact on discount rate (cost of capital)

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## *Hot Topics in Valuation – Explore the Current Landscape*

### INFLATIONARY IMPACTS ON VALUATION

#### ■ *Private Company Appraisals*

- Market Approach
  - Ensure that impact of inflation is not double counted
  - Narrower timeline of transactions considered comparable
  - Public markets – focus on current multiples
  - Private transactions – potentially fewer number of transactions available

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## PRICE VERSUS VALUE



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## *Hot Topics in Valuation – Explore the Current Landscape*

### PRICE VERSUS VALUE

- *“Price is what you pay; value is what you get” – Benjamin Graham*
- *Price is arbitrary*
- *Value is fundamental*



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## *Hot Topics in Valuation – Explore the Current Landscape*

### PRICE VERSUS VALUE

- *Determining value is the initial step in a potential transaction*
- *Companies transact on prices that are more or less than their value*
- *Identify differences between price and value*

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## *Hot Topics in Valuation – Explore the Current Landscape*

### PRICE VERSUS VALUE

- ***Reasons why price and value are not equal:***

- Every buyer is unique
- Emotions can influence
- Price may not be 100% cash
- Synergies of strategic buyer

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## *Hot Topics in Valuation – Explore the Current Landscape*

### PRICE VERSUS VALUE

- ***A stock price below its value is the ideal circumstance***
- ***“A cynic is a person who understands the price of everything, but the value of nothing” – George Bernard Shaw***

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# POLLING QUESTION

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# CIRCUMSTANCES PROMPTING A VALUATION

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## *Hot Topics in Valuation – Explore the Current Landscape*

### CIRCUMSTANCES PROMPTING A VALUATION

#### ▪ *Succession planning*

- Approximately 40% of baby boomers own privately-held businesses – many are multi-generational
- Children of baby boomers are not taking over the businesses
- Planning an exit will require a valuation and vetting of options

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## *Hot Topics in Valuation – Explore the Current Landscape*

### CIRCUMSTANCES PROMPTING A VALUATION

#### ▪ *Estate planning*

- Taxable estates and planning for preservation of family assets
- Valuation is at the heart of any planning
- Gifts can be leveraged through valuation discounts

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## *Hot Topics in Valuation – Explore the Current Landscape*

### CIRCUMSTANCES PROMPTING A VALUATION

- ***Sale of a business***
  - Sale to a third party – financial or strategic buyer
  - Sale to an employee stock ownership plan (ESOP)
  - Management-led buyout

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## *Hot Topics in Valuation – Explore the Current Landscape*

### CIRCUMSTANCES PROMPTING A VALUATION

- ***Shareholder/Partner buyouts***
  - Triggering events (retirement, death, voluntary/involuntary withdrawal, divorce)
  - Buyout in accordance with an agreement
  - Could lead to a shareholder dispute

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## *Hot Topics in Valuation – Explore the Current Landscape*

### CIRCUMSTANCES PROMPTING A VALUATION

#### ▪ *Quantification of Damages*

- Plaintiff suffers permanent loss
- Remedy applied is have defendant purchase the business at the date of loss
- May need to consider lost profits

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## *Hot Topics in Valuation – Explore the Current Landscape*

### CIRCUMSTANCES PROMPTING A VALUATION

#### ▪ *Divorce*

- Spouse owns an interest in a privately held business
- Value is included in the marital estate for equitable distribution purposes

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## VALUATION IN THE COURTS



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### *Hot Topics in Valuation – Explore the Current Landscape*

## VALUATION IN THE COURTS

### ■ *Shareholder Dispute – Buy-Sell Agreement*

- Hartman v. BigInch Fabricators & Construction Holding Co., 161 N.E.3d 1218 [Ind. Sup. Ct. 2021]
  - Agreement required a buyout at “appraised market value”
  - Court used fair market value with applicable discounts for lack of control and lack of marketability

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## *Hot Topics in Valuation – Explore the Current Landscape*

### VALUATION IN THE COURTS

#### ▪ **Shareholder Dispute – Buy-Sell Agreement**

- [Estate of Connie Collins v. Tabs Motors of Valley Stream Corp.](#), No. 160529/2019 (NY County 2021)
  - Price in agreement was based on a fixed per share value

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## *Hot Topics in Valuation – Explore the Current Landscape*

### VALUATION IN THE COURTS

#### ▪ **ESOP**

- [Walsh v. Bowers](#), 2021 U.S. Dist. LEXIS 177184 (Sept. 17, 2021)
  - DOL claim that ESOP paid in excess of fair market value
  - Decisive victory against DOL; failure to follow standard valuation practices

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## *Hot Topics in Valuation – Explore the Current Landscape*

### VALUATION IN THE COURTS

#### ■ ***Tax – Gift***

- [Estate of Aaron U. Jones](#), T.C. Memo 2019-101, Docket No. 27952-13 (August 19, 2019)
  - Involved taxes paid on gifts of ownership interests in two S corps
  - IRS contended business valuation was too low – delta between IRS and Mr. Jones was \$89M
  - Court validated the valuator's approach and method of valuation

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## *Hot Topics in Valuation – Explore the Current Landscape*

### VALUATION IN THE COURTS

#### ■ ***Tax – Estate***

- [Estate of Michael J. Jackson v. Commissioner](#), T.C. Memo 2021-48 (May 3, 2021)
  - Contested assets – image and likeness, and equity interests in two entities
  - Valuations prepared by Estate's experts for image and likeness were favored by the Court
  - Court rejected tax affecting

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## Hot Topics in Valuation – Explore the Current Landscape

### VALUATION IN THE COURTS

- Tax – Estate of Michael J. Jackson v. Commissioner**

Asset	Estate	Commissioner	Tax Court	Percentage for the Winner
Jackson’s Image and Likeness	\$3,078,000	\$161,307,045	\$4,153,912	99% TP
New Horizon Trust II 50% Interest in Sony/ATV	\$0	\$206,295,934	\$0	100% TP
New Horizon Trust III Mijac Music	\$2,267,316	\$114,263,615	\$107,313,561	94% IRS
Total	\$5,345,316	\$336,866,594	\$111,467,473	68% TP

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## Hot Topics in Valuation – Explore the Current Landscape

### VALUATION IN THE COURTS

- Valuation Procedures**
  - [SEC v. Bluepoint Inv. Counsel](#), 2022 U.S. Dist. LEXIS 92776
    - Known or knowable
    - Raises question – to what extent and what effort must a party go to uncover all of what “could” have been known?

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## CONCLUSION

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### *Hot Topics in Valuation – Explore the Current Landscape*

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## CONCLUSION

- *The current landscape presents additional challenges to business valuers*
- *There will continue to be wide variances between price and value*
- *The interest rate environment will continue to impact indications of value*
- *The economic outlook of 2023 will have a great impact on valuations this year*

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