

## Technical Topics

# PCOC: A New Way to Assess Cost of Capital

For many years, valuation analysts have used public market data as a standard input for assessing private company value. Drawn from sources such as Ibbotson and Duff & Phelps, public company data is used to determine the cost of capital for a business — a key component to a valuation.

To make public company data relevant to private companies, analysts typically use one of two methods to convert the data: the modified capital asset pricing model (CAPM) and the build-up method (BUM).

CAPM and BUM have clear pros and cons. Many analysts aren't 100 percent sold on them, citing the fact that private and public companies have different risks and returns, liquidity, access to capital, pricing mechanisms, holding periods and transaction costs. Yet, CAPM and BUM are the current standards. While not perfect, these methods are litigation tested and peer reviewed. Properly calculated, they generally withstand IRS scrutiny based on years of accepted usage.

### A New Game in Town

But now there's a new method to consider — a new way to calculate the cost of capital known as the private cost of capital (or PCOC) method. Developed by valuation experts Rob Slee and John Paglia, with support from Paglia's employer Pepperdine University, this method provides

another input to consider when determining the cost of capital.

PCOC is based on a simple idea: What do players in the private capital market think about rates of return and where they're headed? To find out, Pepperdine has conducted a survey semi-annually since 2009, aggregating answers from more than 730 respondents.

Slee and Paglia divide the private capital markets into five segments aligned with the major institutional investor arms of the private investment arena: bank lending, asset-based lending, mezzanine financing, private equity and venture capital. Each segment has different return, investment and research characteristics. The median cost of capital rates per type of funding are determined by aggregating and analyzing all of the survey results.

*PCOC provides a useful tool for valuation analysts to use when assessing cost of capital.*

For example, based on the most recent survey, the median rates of return are as follows:

- Banks: 6.8 percent
- Asset-based lenders: 13 percent
- Mezzanine financier: 18.5 percent
- Private equity groups: 25 percent
- Venture capital investors: 38.2 percent

Of course, PCOC requires adjustments, just like any other cost of capital deri-

vation. Analysts must take four steps to convert these numbers into figures applicable to their specific valuation targets. According to the August 2010 issue of *Business Valuation Update*:

1. Analysts must first determine which types of private capital are most applicable to the target company. This could be just one or several of the five categories.
2. Since no target company is likely to be a perfect model for any investor, the median return figures must be risk adjusted to reflect reality. For example, if a company has a lower EBITDA, its cost of capital from the private capital markets may be closer to the upper quartile of return than the median figures.
3. To derive a percentage of the total capital structure for each source, analysts must value each source of capital from the subject company.
4. The PCOC is the sum of the individual percentages for each capital source.

The PCOC method is creating quite a buzz in the valuation world. Of course, if accepted by the valuation community, it will take years for it to become standard methodology. In the meantime, PCOC provides a useful tool for valuation analysts to use when assessing cost of capital. ■

## Economic Damages

# Considerations in Calculating Lost Profits

**B**usinesses face all sorts of traumas, from breaches of contract to faulty products and patent infringement. Often these events wind up in litigation, and valuation analysts are called upon to calculate the profits lost by one party or the other.

While each case is different, there are certain key elements common to the calculation of lost profits. Here is a look at a few of them:

**Revenues vs. Profits.** Lost profits are usually not lost revenues. Lost revenues may lead to lost profits, and additional costs due to the damaging event may lead to lost profits. But lost profits are typically defined as the loss in gross margin dollars: revenues less direct cost and variable costs.

**Deductible Costs.** Which costs “count” in the lost profits calculation? If sales commissions aren’t paid because you can’t sell a defective product, or advertising temporarily stops due to a catastrophe, those “unspent” dollars should come out of the calculation.

Conversely, if costs spike after recovery from the event — if advertising or marketing expenses increase to reestablish the business, for example, or if the company has to hire a toxic waste disposal company to clean up the site — those costs should be added into the calculation.

Courts differ on which expenses should be included in the calculation so it helps to be familiar with court decisions in particular jurisdictions. Depreciation, factory overhead and officer compensation are among the most debated expenses.

**Timeline.** While a business valuation calculation assumes that the business will generate income in perpetuity, a lost profits calculation covers a specific time period. There are three methodologies to calculate loss over this period of time:

The *yardstick method* compares how the company in question performed during the loss period relative to similar companies during that period.

The *before-and-after method* looks at how the business was doing before the damaging event and how it operates once it gets back to normal afterward, using the actual figures from the damage period. The difference between the “before” and “after” figures equal the lost profits, although it is important to note there are many addi-

tional factors that need to be included in this approach.

The *but for method* may produce the most logical and practical results, since many implied factors are considered. In this method, the analyst calculates what the profits would have been “but for” the damaging event. Economy, competition, capital needs and capacity are a few of the many factors considered when using this methodology.

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**Mitigation.** The business owner has a responsibility to mitigate lost profits by acting prudently. For example, if a food manufacturing facility is going to be out of commission, management should stop or reduce incoming ingredients shipments. Hourly labor, utilities and regular maintenance should be reduced appropriately. If a vendor is incapacitated but suitable replacements exist, management has a responsibility to use them. Reasonable mitigation efforts are considered in the calculation.

Lost profits calculations are complicated and frequently require depositions and courtroom testimony. Because of their valuation experience, financial skills and appraisal qualifications, CPAs are excellent candidates to perform these calculations and serve as expert witnesses. ■

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*Our experienced valuation team is ready to assist with economic damages calculations. Call us today for more information.*



# A Look at the State of Estate and Gift Valuation

For almost a decade, wealthy taxpayers were looking forward to 2010, when estate taxes would disappear for a year due to the Bush tax cuts. This temporary reprieve cost the U.S. Treasury dearly, but many taxpayers didn't take advantage of this opportunity because they didn't know what the law was going to be moving forward.

With new legislation passed last December, the estate and gift tax scenario is back to a more "normal" situation. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2011 restored the federal estate tax, with a \$5 million exemption per person for 2011 and 2012. Surprising to many, the lifetime gift tax and GST exemption also jumped to \$5 million for 2011 and 2012.

But changes are looming after 2012. In 2013, unless there is action by Congress again, the estate tax and gift tax exemption drops to \$1 million. While the maximum estate and gift tax rate is 35 percent

for 2011 and 2012, it climbs to 55 percent in 2013.

### A Two-Year Window

The 2010 legislation allows many taxpayers to make larger lifetime gifts this year and next. While this rare two-year window is a welcome relief, it's also forcing business owners to make some long-term decisions in a short-term time frame.

From a valuation perspective, there's another wrinkle: Generally, the government doesn't like valuation discounts for marketability or lack of control for family transactions. These discounts are perceived by the IRS more as a way to

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transfer wealth with substantially reduced tax implications, rather than as legitimate adjustments required to reflect the value of a closely held business.

Because of this perception, there is talk that the Obama administration would like to consider legislating away these discounts, which would result in much higher business valuations for certain family transfers.

### A Perfect Storm of Opportunity

Consider the current outlook for business owners:

- The potential for family valuation discounts is going away.
- The increased gift tax exemption is being diminished in two years.
- Business values are low due to the economy.
- Low interest rates will probably rise.
- Baby boomer owners are retiring.

All of these circumstances are creating a perfect storm of opportunity for business owners. Given this scenario, it's an excellent time to consider estate and succession planning between now and 2013. Indeed, even individuals with relatively modest wealth should pay more attention to gift, estate, buy/sell and succession planning in this time period. ■

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*Please let us know if we can assist you with valuation services required for gift, estate, succession and buy/sell planning.*



## Where's the Value?

The two-year window is not only prompting business owners to consider their gift and estate planning, but also motivating them to focus more on business value — not just the amount of value, but where the value lies in the business. For example, it's important to figure out how personal and corporate goodwill amounts impact a gift and estate plan.

If the business is based on client relationships, it's likely that there is a fair amount of personal goodwill involved. In this case, aging owners may want to spend time fostering closer relationships between coworkers and clients, thereby transforming personal goodwill into corporate goodwill and building the value of the business. ■

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**Mark B. Bober, CPA, ABV, CVA, CFF** – Partner and Director of Litigation, Valuation & Forensic Services Group, with expertise in business valuation, forensic investigations, litigation support, and M&A Transaction Support due diligence. Mark also has extensive testimony experience. He can be reached at either 330.255.2425 or mbober@bobermarkey.com.



**Marcy A. Venarge, CPA, ABV, CVA, CFF** – Manager, Valuation/Litigation Services, currently focused on business valuation, forensic accounting and managing forensic projects. Marcy is Accredited in Business Valuation and is a Certified Valuation Analyst. She can be reached at 330.255.2450 or at mvenarge@bobermarket.com.

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## USPAP in Business Valuation

**V**aluation analysts are typically credentialed by one or more organizations: the National Association of Certified Valuators and Analysts (NACVA), the Institute of Business Appraisers (IBA), the American Society of Appraisers (ASA) or the American Institute of Certified Public Accountants (AICPA).

Each organization has valuation standards to which members must adhere. So how do valuation analysts decide which organization's standards to use?

As members of AICPA, CPAs must follow the AICPA Statement on Standards for Valuation Services (SSVS). But many CPAs are also credentialed by another entity and must follow that group's valuation rules as well.

The Uniform Standards of Professional Appraisal Practice (USPAP), adopted by several organizations including the ASA, is also a common and relevant set of standards that many CPAs follow.

### Paying Attention to Nuances

USPAP, which first appeared in 1987, has been cited by the IRS as a "generally accepted appraisal standard." It has also been cited explicitly by the U.S. Treasury in connection with non-cash charitable contributions in the Pension Protection Act of 2006 implementation guidance, and has been accepted by federal and state courts.

USPAP includes standards for all types of appraisal services, including real estate, personal property and

business interests. SSVS is used only for valuations of businesses, business interests, securities and intangible assets.

There are other nuances as well. For example, SSVS allows CPAs to perform limited scope analyses known as calculation engagements. While not suitable for litigation, the calculation report is helpful in estate planning and other situations where a formal report is not required.

For valuation analysts, professional judgment is necessary to determine which standards should be followed in which circumstances. For this reason and others, hiring a knowledgeable analyst is a must. ■

*Want to know more about various valuation standards? We can explain them in detail.*



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