



## Business Valuation

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## Business Valuation



The need for valuing a closely held business arises potentially from a number of sources. These include:

- Buy-Sell Agreements
- Minority Stockholder Disputes
- Estate and Gift Taxation Needs
- Marital Disputes

Regardless of the need or of which party is being represented, the approaches, concepts and results of a business valuation should be the same.

One of the “problems” is that valuations are subject to numerous subjective interpretations, rather than precise scientific applications of the facts and data sources. Therefore, it is not only common, but also probable, that competent, conscientious and sincere experts will arrive at different results from the same data. However, if the subject is approached as objectively as possible and proper valuation techniques used, differences that exist should be rather minor, so taking the numbers in total and dividing them by the number of valuations should result in a fair appraisal.

This is certainly not the case where there are two appraisals that are considerable disparate. In such a situation, justice is rarely served when the results are simply split down the middle – the baby in the

Solomon story. Just as in that case, justice would not have been served by an average; neither is it served when two valuations, so far apart that one or both of them have to be flagrantly in error, are simply averaged. Such poorly done reports can be recognized by an intelligent, informed and careful analysis.

This document should give you an understanding of valuation procedures and the proper contents and approaches for a valuation report. In addition, you will be able to zero in on reports that have flagrant violations, recognize such violations of good valuation technique and, at the same time, be able to appreciate those reports that most likely are well done.

### The Starting Point

The starting point in virtually any valuation of a closely held business is the reconstructed financial statement of the business. The emphasis is placed on “reconstructed” for very valid reasons. In the typical situation, even (though to somewhat lesser degree) audited (certified opinion) financial statements are usually not truly indicative of the operations and worth of that business. There may be a multitude of reasons, but the most common are for the bottom line preservation, that is, to save taxes.

Unless financial statements have been “pumped up” for bank financing, it is most common that the financial statements and, especially the tax returns, actually understate the results of the business. Various steps may have been taken, some proper tax wise and some not, to reduce the corporate profit and the personal income of the principals to minimize the tax burden.

- Payment of personal expenses through the business

This common maneuver may include the payment of substantial amounts of personal expenses through the business (auto, medical, entertainment, utility bills, family on the payroll, etc.).

- Burying expenses to obtain a tax deduction

No one in business for any length of time can feign surprise at the concept of a business burying various expenses to obtain a tax deduction. Of course, varying degrees of this practice apply. It is one thing from a business to pay for personal entertainment (dinners, etc.) and write off a company car as 100% business instead by 60% business. It is an entirely different thing for a business to pay

personal utility bills, to rake cash off the top before it hits the books, to permit relatives in no-show jobs to be on company payroll, etc.

- Use of LIFO inventory versus FIFO

There are other very legitimate tax and non-tax reasons why financial statements may understate the value of a business. From a tax point of view, for instance, this could include the use of LIFO (last-in, first-out) inventory. Inventory represents a pool of merchandise, the sale product of the business, bought over a period of time, usually at varying prices. The most common inventory method is FIFO (first-in, first-out). That is, as items are sold, they are considered sold from the items earliest purchased.

In an inflationary period, this means that the items sold are given the lower price costs and the items remaining in inventory the higher price costs. This, in fact, is typically the normal flow, and typically represents the true economic result of the sales operations of a company. LIFO, however, a perfectly legitimate tax maneuver, treats items sold as coming from those last purchased, which means they are expensed at a higher price value and, thus, the remaining inventory is stated at a lower value. The result is that a greater amount of cost is written off and less inventory value is left for the balance sheet, thereby understating the worth of the company.

More and more companies are adopting LIFO to save tax dollars, especially considering the inflation of the past several years. Notwithstanding the apparent reduction in the rate of inflation, we still have inflation, and barring expectations of a deflationary society, LIFO for a profitable operation is probably a wise move. Yet, when viewing financial statements stated on a LIFO basis, one must recognize that both the profits and balance sheet are understated.

- Assets appreciated or depreciated very quickly

Other balance sheet understatements include assets that have either appreciated over time or depreciated far more rapidly than the true economics of the situation. An example occurs when a company owns the plant and land on which it is operating. That land might have been purchased many years ago. In such a case, it is likely worth far more than stated on the balance sheet. This happens because basic accounting principles require assets be carried at cost.

- There may be no relevance of cost versus market value

In a situation such as real estate, it is obvious that an appraisal of the realty would be necessary.

- Also very common is the use of rapid depreciation

In an inflationary economy, this depreciates buildings and equipment far more rapidly than they depreciate economically. A typical example would be a luxury car, purchased at \$50,000, written off to zero that in reality may be worth \$20,000 to \$30,000.

Recognition of depreciation adjustments to real value must be given for a proper valuation of the business that has substantial written down assets.

### **The Investigation**

The necessary precursor to arriving at reconstructed financial statements is the employment of an investigative accountant. While an experienced accountant is not an appraiser in the area of real estate, antiques, collections and the like, few occupations gain as much financial insight into the workings of a business and its market worth as do accountants.

Depending on experience, the accountant may have the ability to double as an appraiser. This will depend on the complexity of the case and the money involved. It might be a prudent move to engage a qualified business appraiser.

With the cooperation of both sides, it will typically take a qualified investigative accountant or business appraiser a month ideally, or more typically, two or three months to do a complete job.

### **Beginning the Valuation**

Once the investigative phase is completed, there is a sufficient database from which to begin the valuation. It is common and good practice to utilize the viewpoint of several years, typically five, of operations of the business to appreciate a more complete financial history. Except in unusual circumstances, when a business has existed for several years, it is inappropriate to use only one or two years for valuation purposes.

These one or two years may not be indicative of the financial results of the company.

Five years, if available, assist in understanding whether or not the company has consistently grown or shrunk, shown profits or losses,

fluctuated widely from year to year or been stagnant and gone nowhere. Putting several years on a comparative schedule gives insight into the overall expense and income structure of the business and highlights significant aberrations from year to year that should probably require special attention before the actual valuation procedure.

For example, perhaps in one year, repairs and maintenance to the business building were several thousand dollars more than in any other year.

This might lead one to discover in that year a storm or fire had damaged the building that was not adequately insured, and this was a rather extraordinary expense not recurring in nature. In such a case, that extraordinary expense should be removed from the operations of the company, as being not indicative of what one would expect from continuing operations. The other side of the coin is the removing of extraordinary income.

Used properly, financial statements should be expressed in such a way to reflect a pattern of the business and what one could expect it to do in the future. It is the future for which one buys a company, and the expectations of such on which a valuation is based. Therefore, those items not indicative of a business and those that are non-recurring should be deleted. The tax effect, benefit or detriment of these extraordinary events should also be deleted.

Before one can proceed further using this raw financial operational data, several other steps must be taken and information gathered from outside the business. A business does not operate in a vacuum. It is part of the larger overall society and, inevitably, has competitors and, usually, some sources of industry comparisons. Also, is the country in a recession? What is the state of the area in which the business operates? What is the industry employment picture, etc.?

Depending on the range of the business, these factors will have varying degrees of importance to a valuation. For example, one would certainly approach the valuation of a Chrysler automobile dealership differently today than in 1980. Is a business strong in its industry? Does it have significant competition? If, for instance, it is a retail business, is there significant unemployment in the neighborhood that would be a serious detriment to the business? Is

it located in a prime area or, conversely, is a shopping mall going up to take away from sales? How is it operating in comparison to competitors?

It is a rare business that can be valued in a vacuum, rather than in context with the economy and various other businesses of a similar nature. Not every valuation will have all elements and, in some cases, certain data will not be available in the form of publicly accessible information. However, in most cases, some information will be available for comparisons.

A report should indicate with specificity what analyses were done. It would certainly be possible, though not of the best format, for the analyses to have occurred and not be reflected in the report. Further, any such reflection should refer to the sources. Valuation of a closely held medical practice could not be compared with publicly traded medical practices!

Once the financial data has been gathered, and the relevant external financial and economic data analyzed, make appropriate comparisons. Does the subject company operate more or less profitably than other comparable companies? What are their comparative gross profit percentages? What are the officers taking out of the business as salary and fringe benefits? What is the bottom line? What are certain key ratios, etc.?

One such issue is that of reasonable compensation. A reasonable, but not excessive, charge to the business operations should be made for compensation, direct and indirect, to the chief executive. For example, if it is common practice for the chief executive of this type and magnitude of operation to receive a salary of \$80,000 a year, and if the subject company's executive is receiving \$150,000 a year, it is possible that the extra \$70,000 in compensation is attributable not to the services of the executive, but rather to a return on the capital and goodwill of the business.

Alternatively, perhaps the chief executive is only drawing a salary of \$50,000 a year when competitors are realizing \$80,000. This business may not be doing as well and, therefore, may have no or significantly less goodwill. In such a case, an additional \$30,000 of compensation should probably be imputed to this executive for valuation purposes. This, of course, may throw the business into a deficit position.

Once the necessary adjustments described above and the appropriate comparisons are made, the operational results theoretically put this company into the proper perspective with its competitors and the industry in general. One is now in a position to use these numbers as a sound basis for valuation.

#### Valuation Procedures

Revenue Ruling 59-60 is often quoted as a basis for valuation. Keep in mind that this revenue ruling is a theoretical, conceptual approach toward valuation. It admonishes the appraiser to take into account all relevant factors and delineates those factors to a degree. It does not specifically explain or give a formula for the valuation of a business.

If one does not understand how to value a closely held business interest, the use of Revenue Ruling 59-60 will not yield credible results. For example, 59-60 indicates that the appraiser should look at the industry, consider the history of the operations, consider the dividend paying capacity of the business, etc. Nowhere does it state that three times gross, or 22% of net, or 1½ times book value or whatever is an appropriate method for evaluating a business.

Revenue Ruling 68-609 is a formula approach. This ruling is the most used and most abused in the valuation of closely held businesses. It is most used because it is authoritative, has gained significant following and is fairly simple to understand and apply. It is the most abused because just as it is simple to understand and apply, it is also simple to misapply and distort. The ruling itself states its methodology, that formula approach should only be used when no better approach is available.

In many cases, no attempt is made to find a better approach, and 68-609 is used because it is easy and available. It is also often used because no better approach is available. The various aspects of the use of this ruling are detailed below, and the thought and analytical processes involved are often applicable to other valuation methods.

The application of Revenue Ruling 68-609 is approached by using several (typically the most recent five) years of financial information, and deciding whether a weighting factor should be used. That is, should each year be given equal weight or should there be some adjustment in favor of more current years? This works both ways.



For example, if a company is on a consistent up trend, weighting the years (five times multiple for the most current year, four times the second most current year, etc.), gives the most weight to most current years and, other things being equal, these years are usually most indicative of the future.

Alternatively, if the company is on a steady down trend, the same weighting formulation applies. Perhaps the company has been stagnant over the last several years. In that case, weighting the years' results is inappropriate. It would be proper to simply give each year equal weighting, because no one year is more indicative of what to expect from the business than any other year.

There is more to consider. Occasionally, one or two years of these five should be totally disregarded. One or two might have had such unusual happenings that the years are not appropriate. An example might occur if the company was on strike, or benefited because a major competitor was on strike.

In such instances, the entire year might be disregarded as irrelevant to a valuation. Once the use of weighting factors has been determined and applied, the sum of the results of these factors is divided by the sum of the weighting factors to arrive at an average annual result, the average annual net earnings of the business.

The next step in the application of Revenue Ruling 68-609 is to subtract from the average earnings return of investment. The need for this is evident when one considers that a business has a pool of assets. This pool of assets and its value is entitled to earn something, simply by virtue of existing. Thus, if the equity of this business was \$100,000, that by itself should enable the business to earn as much as 10% return or \$10,000 a year.

This return on investment must be subtracted from the above-determined net earnings of the business. Once done, the result is often called "excess earnings" or the earnings of the business attributable to goodwill or the intangible value of the going concern. Excess earnings are not simply the existence of assets but also reflect some increment in the business such as years of existence, a good reputation, favorable positioning in the market, etc.

Next, one must capitalize on the excess earnings. Capitalization of excess earnings is an area often misused, and one with a great deal of latitude. The terminology used here is cap rate (the capitalization rate), or a multiple factor. The multiple factor is the inverse of the cap rate. That is, if a business has a cap rate of 20%, an investor would expect a 20% return on his or her money or, in other words, a return of investment in five years. Five is the multiple factor, the inverse of the 20% (1/5).

If one multiplies the earnings by five, the same as dividing by 20%, the result suggests the amount a buyer would be willing to pay for the business. Based on this purchase price, the business should throw off a return sufficient to yield 20% to return the investment in five years. The question is, of course, what is an appropriate capitalization rate.

Revenue Ruling 68-609 gives insight into what the IRS, at the time the ruling was formulated, considered the reasonable or normal range of capitalization rates. At the same time, it also gave a comparable range for return on investment. Note that those ranges are only guidelines. Exceptions always occur and each situation must be viewed as unique, requiring an approach that does not accept a number or set of numbers without prior thought and consideration. The ruling gives the range for return on investment as 8-10%.

While that may have been appropriate when the ruling was formulated in 1968, in today's financial markets a rate closer to 12% may be more appropriate. Basically, 12% is considered a risk less rate.

Similarly, the current market situation together with the specifics of the company must be considered when the cap rate is determined. The ruling gave a cap rate range between 15 and 20%. That means a multiple between  $6 \frac{2}{3}$  and 5. The lower cap rate is still realistic, except for special situations involving a high-flyer or technology issue. Then, utilizing a considerably lower cap rate (that is, a considerably higher multiple than  $6 \frac{2}{3}$ ) is appropriate for a company in a growth industry with significant prospects for the future.

In fact, some market situations point to the earnings of a company with absolutely no bearing on the stock price because investors are

buying future prospects regardless of current earnings. Generally, however, for most closely held businesses, a cap rate between 12 and 15% is a normal low range. On the high end, the ruling indicates 20%, a multiple of five.

Nevertheless, that concept is still inappropriate in many instances. If the business is risky, has thin management (and replacement of management is difficult and/or time-consuming), has a dim or questionable future or if other factors exist to throw a cloud on the assurance of a continued stream of future earnings, a cap rate considerably higher than 20% might be appropriate.

For example, if valuing a company that makes one product and its major customer is Chrysler Corporation, a 20% cap rate (a 5 multiple) might be far too small for a company with limited product, limited market and such a tenuous major customer. In this situation, a 25 or 30%, or perhaps even 50% cap rate, might be appropriate. The point is each situation is different and must be viewed in light of the specific company, the industry, its environment and its competition.

Once the proper cap rate has been selected, it must then be applied to the above-determined excess earnings. The result is generally considered capitalized goodwill, an intangible asset attributable to the earnings power of the business. This figure is added to the adjusted book value to arrive at a value for the total entity. Additional factors, such as marketability and minority interest discounts will be discussed later.

Industry comparisons are often a very viable approach when publicly traded companies are of comparable nature. This requires being able to find several, rather than merely one or two, companies of similar nature manufacturing or selling or servicing the same or at least a similar product or market as the subject company.

In addition, some comparability of size is desirable; so as to not compare unrelated businesses, such as a “mom and pop” convenience grocery store versus Supermarkets General Corporation. Often, no comparable can be found. This typically happens when dealing with a company with limited product or a service business, especially a professional.

Often, publicly held companies, even in a similar business, are considerably diverse. Nevertheless, suitable comparable can sometimes be found. When available, they present real world market situations comparisons may be made between companies on which the public is regularly bidding versus the subject company.

**Application of this information is approached in three ways:**

**Price Earnings Ratio**

The recent history of comparable publicly traded companies should be reviewed to determine the range in which they are trading on the market. This is a price earnings ratio, commonly known as the P/E ratio.

For example, if seven comparable companies have price earnings ratios of 2, 5, 5 ½, 6, 7, 7 ½, and 11 it would be appropriate to drop the lowest and highest since they are obviously aberrations compared to the others. Then average the remaining five.

Once the appropriate P/E ratio has been determined, it may be applied to the company being valued. It is important to maintain comparability. That is, the P/E ratios of publicly held companies are always stated as after-tax P/E ratios because of the nature of the financial data supplied. Therefore, comparisons must be with the company's after-tax dollars. This may require taking into account various circumstances that had a material effect on taxes.

For instance, if the company paid no taxes because of substantial and unusual investment tax credits that year, it is necessary to adjust net earnings to reflect a hypothetical tax; this puts the company into proper perspective with comparable publicly traded companies. Perhaps the subject company is not incorporated. In that case, calculate the anticipated corporate taxes as if the company was restated as a corporation. Once the correct earnings figure is multiplied by the appropriate price earnings ratio, the result is the company's worth.

**Book Value**

The second form of applying comparable companies' data is by comparing book values. One might compare book values in relation to earnings and make some sophisticated statistical comparisons to arrive at valid correlations between book value, earnings and market value. Book value typically comes into play in a situation where the

assets of the company are far more important as to its value than company earnings.

This would be more typical for capital-intensive industries that are not growing too quickly; therefore, the underlying assets are more important than the likely future earnings stream. In general, however, comparisons with book value are not nearly as useful and meaningful as comparisons with earnings. The problem is that book value is not the most usable number since it has the potential for innumerable variations and misrepresentations because of the cost and tax basis purposes of accounting.

#### Dividend Paying Capacity

The third form of applying comparable companies' financial data is by comparing dividend paying capabilities or ratios. This is infrequently used with closely held companies because the concept of dividends is not one that is readily used or applicable to such companies. A dividend is paid with after-tax dollars and, while taxable to the recipient, is not deductible by the company.

In closely held companies, dividends are the exception to the rule inasmuch as compensation from the company would most likely be obtained through deductible vehicles rather than such non-deductibles as dividends. Nevertheless, in the evaluation of a profitable company, where cash flow permits dividends and a reasonable base of comparison with several publicly traded companies of reasonable comparability exists, a dividend paying comparison might be meaningful.

Using so-called industry norms or multiples, sometimes loosely defined, is fraught with risks of improper application. It is common to hear reference to a business being worth one times gross or two times new or something comparable. This approach has some basis in fact, but must be used carefully. It is generally applicable only to service organizations and rarely to manufacturing or capital intensive businesses.

Any multiple factor approach has the potential for gross distortion if the wrong multiple or wrong number to be multiplied is used. For example, if one were valuing a medical practice, the difference between a multiple of 50% of gross and 150% of gross in a business grossing \$200,000 a year is \$200,000, not an insignificant sum.

Similarly, if the multiple is to be applied to net earnings, one must be careful to include the right items in net – officer salary, net profits or loss, retirement plan contributions and certain other excessive or improper fringe benefits. The multiple approach is rarely, applicable to a manufacturing operation due to the many complex nuances of such an operation.

Recent sales are, perhaps, the best method because one is using an actual, real life transaction instead of a theoretical approach. However, sales of a closely held company's stock, let alone recent sales, rarely occur. The very nature of a closely held business precludes, in most cases, parties selling any part of the business. In the exceptional situation with a recent sale of part of the entirety of the business, the nature of that sales transaction must be examined carefully.

To be usable it must occur between parties dealing at arm's length with the usual caveats included:

- Neither under a compulsion to buy or sell
- Both are fully aware of the facts, etc.

Often, the type of sale one finds in a closely held business is between a parent and child, where there is no arm's length nature and a bargain element exists in the sale.

In addition, in the sale of part or all of a closely held business, it is not unusual to disguise part of the sale for tax purposes. Some sort of employment contract or consulting agreement, ostensibly for services but in reality, for which no services are rendered may exist. This creation is strictly a tax maneuver.

Sometimes a sale is motivated by age. The selling party may be close to retirement and may be unable to transact a truly arm's length sale, as both parties are aware the seller's age is a detrimental factor in his or her ability to obtain a full, fair price.

In the exceptional case, when a truly valid recent sale of a comparably sized portion of the business has taken place, that sale would be, without question, the best basis on which to value the company.

The component asset method is equivalent to an orderly liquidation value. This may be used in situations when the company is not going anywhere, the value of its assets yield approximately the same or even more than the company is yielding in terms of profits, without the risk of continuing in business. Basically, the company does not have a financial or economic cause to exist.

This approach can also be used when the concept of goodwill may be hard to establish and when, at least as a beginning point for discussion purposes; the company has unquestionable, significant, underlying assets in excess of its book value. This method requires the valuing of each asset of the business. Then, the assets must be offset by the liabilities to arrive at a hard asset value.

An example of this type of method would be to use an abbreviated balance sheet. Add the realizable value of the various assets – i.e., cash and equivalents at face value, receivables at 80-90% of face, inventory from 50-90% of book (of course, any inventory adjustments have to be readjusted back), restatement of fixed assets, (adjusting for economic rather than tax motivated depreciation), etc. From that, subtract the liabilities of the business. The result is the equity, the component asset value of the business.

#### **Discounts/Premium**

The preceding steps have reconstructed the financial data and established a valuation of that data to arrive at a business value. Additional steps remain to reflect various nuances of the market and the proportionate interest owned in the company. These are generally known as discounts or, in one case, a premium:

#### **Marketability discount**

The marketability discount (actually, a lack of marketability discount) refers to the cost, stated in the form of a discount percentage, of marketing a company. The assigned value of a company should, under most circumstances, include a cost to market it, with the resultant diminution of its overall value. Stated in simplest form, the cost of marketing may be expressed in the concept of, for example, a 10% broker fee or a 10- 12% underwriting fee.

A body of thought holds that marketability discounts should be considerably higher as they apply here to closely held businesses for which no ready market exists. In addition, a prospective buyer would have to wait an indefinite period to resell it and regain his or her monies, especially if a minority stockholder. Generally speaking,

however, in the absence of a specific circumstance requiring a more substantial marketability discount, discounts range between 10 and 12%.

#### **Minority Interest or Lack of Control Discount**

The minority interest or lack of control discount is one of the most significant discounts. The latter description is important if dealing with a 50% owner of a business. This is certainly not a minority interest, but if the other 50% are owned by one other stockholder, it is a lack of control situation. This discount recognizes the fact that a minority stockholder, by definition, has no control and thereby does not have the ability to call the shots in a business.

A minority stockholder, in the face of a majority stockholder or a grouping of other stockholders sufficient to make a majority, cannot determine corporate direction, dividends, officers' compensation, whether the company will be sold or acquire another business, etc. A minority interest has limited authority, and is, to a degree, subject to the whims of the majority. The problem with this discount is determining the percentage.

If a business is acknowledged to be worth \$1,000,000, the portion of the business for sale is 10% and, for argument's sake, the other 90% is held by one other individual, how much would an investor be willing to pay for that 10%, knowing he or she is more or less at the mercy of the 90% owner and may not be able to easily sell the 10% interest? These discounts range from the fairly low levels of 10 or 15% to as high as the 60-70% range. No definitive guidelines set X percent as the amount of discount to be applied in all circumstances.

Various factors determine an acceptable minority discount. Among these factors are:

- Number of other stockholders and ownership positions
- Whether the minority situation is a swing vote
- Relationship between stockholders or subject stockholder
- Prior sales of stock in the company
- Liquidity or marketability of company
- Restrictions on the minority owner to sell interests

It is possible that no minority discount is needed.



While this is unusual, an example occurs when a company is up for sale and, coincidentally, a divorce proceeding is in process involving a minority stockholder. In this case, besides the obvious issue of the asking price, having the company for sale at that time weighs heavily against a minority discount, since all owners would be bought out proportionately upon the sale.

#### **Controlling Interest Premium**

The other side of the coin of a minority interest discount is a controlling interest premium. This is generally applicable only when someone owns more than 50% of a business but less than 100%; therefore, that ownership interest may be worth more than its simple arithmetical proportionate share.

The concept is similar to that of the minority interest wherein the person who controls the business calls the shots – determines if the business pays dividends, salaries for top people, who guide the overall direction of the company, etc.

In certain cases, a premium may exist even when it is not a majority interest. By nature of the size of an interest, as related to other ownership interests, the equivalent of a controlling interest or swing vote can exist. Obviously, whatever premium is determined will increase the value.

#### **Summary**

The extensive process of valuation using all of the issues and formulas above is generally referred to as a business appraisal. Organizations have been established just for this purpose, and their technical qualifications are considerable. However, the process is lengthy and frequently expensive. For some purposes, such as the sale of a substantial business or the funding of an Employee Stock Ownership Plan (ESOP) such a procedure is unavoidable.

On the other hand, if one is preparing an estate plan and needs to quickly obtain a value of the business, a less formal business valuation is preferable. Frequently, when the employee/owners of a business wish to enter a Buy-Sell Agreement, the business valuation is sufficient to arrive at a satisfactory value for the development of an Agreement.

*Source: Financial Planning Consultants, Inc.*

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- To provide competent, prompt, client focused service which, in the same circumstances, we would expect for ourselves.
- To treat all clients with fairness and equity, to assure the best value possible.
- To remain your life-long financial partner to take care of your ever-changing needs.
- To help you reach your life's financial goals by understanding what is important to you.



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