FOR EMPLOYERS

Business Valuation

Proposal

Presented to

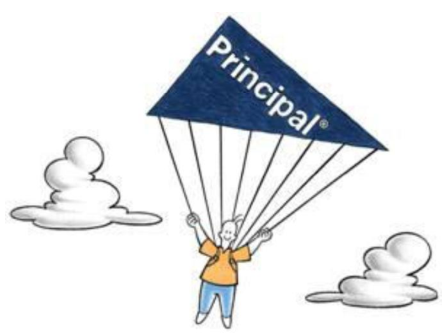
Sample Company

Presented by

<Producer Name>

Based on financials from

2011 - 2013



BB9868SBVAL-07 | t130719015x | ML 13-004228

Important Notes

These pages depict certain business planning options. All of these options are based on the information you shared with us for this purpose and the assumptions stated throughout the report. Of course, any variance in the information or assumptions could change the results.

Inclusion of one or more of these options does not constitute a recommendation of that option over any other option(s). This report simply shows the effect of particular options on your business and potentially your estate, based on certain assumptions detailed in the report.

All assets assume specific growth rates, which are provided by the client. These individual rates are used to project the possible growth of the business. These projections are made to estimate future business insurance needs.

Although the informal business valuation from The Principal® can provide a valuable starting point in helping you determine the value of your business, the valuation will not be a substitute for a formal valuation nor does it establish a value for tax purposes. A formal valuation should be constructed with the guidance of your legal and/or tax advisors.

The term Proposed Plan, when used within this report, does not imply a recommendation that a specific business planning option should be implemented. Rather it represents a summary of potential considered strategies, which each individual should discuss with his or her tax advisor, attorney, and/or other professional advisor before taking any action.

Because your business planning goals may change in the future, periodic monitoring should be an essential component of your program.

While this communication may be used to promote or market a transaction or an idea that is discussed in the publication, it is intended to provide general information about the subject matter covered and is provided with the understanding that The Principal is not rendering legal, accounting, or tax advice. It is not a marketed opinion and may not be used to avoid penalties under the Internal Revenue Code. You should consult with appropriate counsel or other advisors on all matters pertaining to legal, tax, or accounting obligations and requirements.

Insurance products from the Principal Financial Group® are issued by Principal National Life Insurance Company (except in New York), Principal Life Insurance Company. Securities offered through Princor Financial Services Corporation, 800-247-1737, member SIPC, Des Moines, IA 50392.

The Problem of Business Valuation

How to Determine the Value of Your Business

An exact method for determining the value of a business does not exist. The more "experts" you ask, the more opinions you will receive. And more than likely, the opinions will vary widely.

There are many instances when the value of business assets is needed, such as for buy-sell agreements, business loans, and for estate planning purposes. At your death, the value of your estate is subject to estate taxes. Your business assets are part of your estate. Therefore, the higher the value of your business in your estate, the more estate taxes you will pay. The lower the value of your business, the less estate tax you will pay. The IRS will attempt to value your business at the highest reasonable level, while your heirs will try to minimize the value of your business.

There are many methods by which a business may be valued. Five of the most commonly used methods are described below.

- **Book Value:** The value at which the business is carried on a balance sheet, with all assets adjusted for fair market value (fair market value may not be the same as the depreciated value for income purposes).
- **Straight Capitalization Method:** The amount of capital that would have to be invested at a specified rate to yield the current average net annual earnings of the business.
- **Capitalization of Earnings Method:** Assumes that part of earnings are attributed to the assets of the business (book value). Remaining earnings are capitalized at a rate consistent with the relative risk of the business. The result is then added to book value.
- **Years' Purchase Method:** A conservative rate (the pure money rate for an investment with generally accepted lower risk) is used to determine the earnings attributed to assets. The balance is assumed to be provided by goodwill. The earnings provided by goodwill are then multiplied by the number of years for which goodwill is expected to be valuable to a purchaser. The result is then added to the book value to obtain the valuation.
- **Discounted Future Earnings Method:** Projected future business earnings are forecasted, and then discounted using an appropriate rate which reflects the return from the next best investment opportunity with a comparable level of risk. The sum of the discounted future earnings is the current valuation.

The average of these five methods is not an acceptable method of valuation. It is shown in this presentation for comparison purposes only. Each business should have a professional appraiser determine the method that will best represent all of its factors.

Informal Business Valuation Assumptions

Sample Company

Business Name Sample Company

Financial:

Book Value	3,500,000
Average Annual Earnings	750,000
Excess Owner Salary	150,000

Calculation:

Capitalization Rate	24.000%
Fair Rate of Return	5.000%
Goodwill Multiplier	4 years
Annual Growth Rate	10.000%
Forecast Future Earnings	5 years
Rate to Discount Future Earnings	15.000%

Discounts for Restrictions:

Lack of Marketability Rate	0.000%
Lack of Control Rate	0.000%

Informal Business Valuation

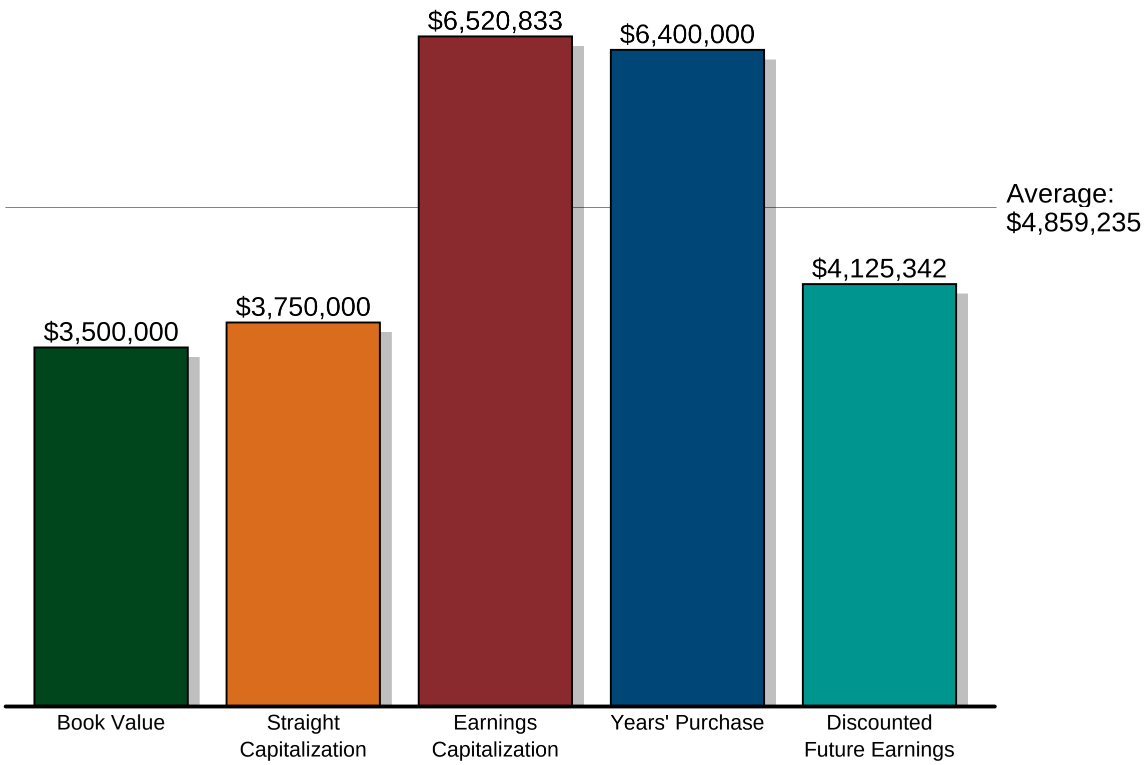
Comparison of Methods

	Value
Book Value:	$3,500,000
Straight Capitalization Method:	
Adjusted Average Annual Earnings[1]	$900,000
Capitalization Rate	÷ 24.000%
Total Value	$3,750,000
Capitalization of Earnings Method:	
Adjusted Average Annual Earnings[1]	$900,000
Estimated Earnings on Assets[2]	- 175,000
Excess Earnings	725,000
Excess Earnings Capitalized at 24.000 %	3,020,833
plus Book Value	+ 3,500,000
Total Value	$6,520,833
Years' Purchase Method:	
Adjusted Average Annual Earnings[1]	$900,000
Estimated Earnings on Assets[2]	- 175,000
Earnings Attributed to Goodwill	725,000
Multiply by 4 Years Goodwill	2,900,000
plus Book Value	+ 3,500,000
Total Value	$6,400,000
Discounted Future Earnings Method:	
Adjusted Average Annual Earnings[1]	$900,000
Annual Growth Rate	10.000%
Years to Forecast Future Earnings	5
Rate to Discount Future Earnings	15.000%
Resulting Future Value	$4,125,342

[1] Adjusted Average Annual Earnings is the sum of an Average Annual Earnings of $750,000 and an Excess Owner Salary of $150,000.
[2] Estimated Earnings on Assets is calculated from the book value and a Rate of Return of 5.000%.

Informal Business Valuation

Valuation Graph



Book Value	$3,500,000
Straight Capitalization	$3,750,000
Earnings Capitalization	$6,520,833
Years' Purchase	$6,400,000
Discounted Future Earnings	$4,125,342

Each business should have a professional appraiser determine which method will best represent its value. The average of the five valuation methods is not an acceptable method of valuation. It is shown in this presentation for comparison purposes only.

Discounting Business Interest

The nature of the ownership of a business interest may allow for discounting for tax purposes. In general, any restrictions or limitations on the owner of the business interest will make that interest eligible for discounting. The discounts most often used are for lack of marketability and lack of control. Lack of marketability stems from any restrictions on the owner to sell the stock, or from a lack of a ready market for the stock. This is common in closely-held and family businesses. Lack of control usually applies to minority interests, where the owner lacks sufficient stock to have a controlling interest in the business. Similiar limitations may also be affected by the terms of the stock itself. In either case, the value of the stock to its owner may be significantly less than the fair market value under these circumstances. Independent written appraisals are used to determine the discount rate(s) to apply. These discounts are applied sequentially. For example, a 25% lack of marketability discount and a 20% lack of control discount result in a 40% total discount (rather than 45%). Any indicated discounts are reflected in the graph values shown above.

Valuation Guidelines

Revenue Ruling 59-60

A buy-sell agreement can be used to establish or "peg" the value of a business interest for tax purposes. So long as the agreement meets the standards set by IRC Section 2703 and related case law, it should be accepted by the IRS. This assumes, of course, that the value specified in the agreement is deemed to be a reasonable valuation as of the time of the agreement. A perfectly legitimate buy-sell agreement will still be challenged if the value it specifies is not a reasonable estimation of the value of the business interest in question. So the question still exists as to how to determine this value.

Estate and gift tax regulations show that the standard to be used here is fair market value, which is loosely defined as "the amount at which the asset would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all relevant facts." While this may be an adequate definition for the purpose of valuing many assets, it is usually far too vague a standard to be useful when valuing business interests.

Revenue Ruling 59-60 supplements this vague standard by specifying several important factors that must be considered when valuing a business interest for tax purposes. It establishes that although several valuation methods exist, no single method is adequate for determining an acceptable value for a business interest. Instead, all relevant facts and circumstances regarding the business must be considered. The ruling lists the following factors which must be accounted for:

- the nature and history of the business
- the outlook of the economy in general and of the specific industry
- the financial condition of the business and the book value of its stock
- the earning capacity of the company
- the dividend-paying capacity of the company
- the nature and value of any intangible assets of the business, such as goodwill
- the relative size of the block of stock to be valued and prior sales of the stock
- the market price of actively traded stock of corporations in the same or similar business

The relative weights of each of these factors is largely dependent on the circumstances of the business and of the specific interest in question. The ruling therefore provides specific guidelines to apply, while retaining the flexibility needed for individual circumstances.

Buy-Sell Agreements

One method to solve the problem of business valuation is to establish a buy-sell agreement. A buy-sell agreement is a contract between a buyer and a seller which stipulates that the buyer must purchase the property in question from the seller upon the occurance of a specified event. The event is usually death, disability or retirement of the owner of the property. A price for the property in question is specified in the agreement. Therefore, a buy-sell agreement can solve the problem of establishing a reasonable value for a business interest.

To ensure that the value established in a buy-sell agreement will be accepted by the IRS*, the following criteria must be met.

- The agreement must be a bona fide business arrangement, negotiated at arm's length.
- It must not be merely a device to transfer the business interest to family members for less than full and adequate consideration.
- The terms of the agreement must be comparable to those found in similar arrangements entered into at arm's length.
- There must be an option to buy and a binding obligation to sell.
- The price must be fixed in the agreement, or the agreement must specify a formula or method for determining the price.
- The agreement must prohibit the owner of the business interest from selling or otherwise disposing of the property during lifetime without first offering it to the other party at a price which does not exceed the price determined in the agreement.

* These guidelines are derived from IRC Section 2703 and prior case law. While it is still a question of fact, the buy-sell agreement and its established business value will likely be accepted by the IRS and the courts for federal estate tax purposes if all of the above requirements are met, and if the value set in the agreement follows the standards of Revenue Ruling 59-60 and supplemental rulings, as outlined on the Valuation Guidelines page. If the business is held primarily by family members, it is subject to the special valuation rules of Chapter 14 (IRC Sections 2701-2704).

NOTE: The conference Committee Report for the Revenue Reconciliation Act of 1990 recognizes that there is more than one method of valuing a business (even in the same industry) and it does not require that the method producing the highest value be used.