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Understanding Standards of Value and Levels of Value

A PRECURSOR TO THE APPLICATION OF PREMIUMS AND DISCOUNTS

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Understanding Standards of Value and Levels of Value

INTRODUCTION

Standards of Value and Levels of Value

INTRODUCTION

- **Premiums and discounts are highly misunderstood by users of business valuations**

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INTRODUCTION

- **Arguments against the use of premiums and discounts**
  – ***Do not apply***
  – ***Subject to wide ranges***
  – ***Lack of substantive evidence***

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INTRODUCTION

- **Premiums/discounts do not exist in the marketplace**
  – ***They are not observable***
  – ***Therefore, they are subject to a great deal of professional judgment***

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INTRODUCTION

- **Premiums/discounts are required to reconcile value conclusions**
  – ***Due to imperfect data, premiums and discounts <u>MUST</u> often be applied***

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INTRODUCTION

- **The key is understanding fundamental concepts unique to the correct determination and application of these valuation adjustments**

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INTRODUCTION

- **Today's program is intended to introduce those foundational concepts which will be used in later programs regarding premiums and discounts**
- **For general discussion purposes, concepts will be addressed in conjunction with premiums and discounts related to control and discounts related to a lack of marketability**

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Standards of Value and Levels of Value

FUNDAMENTAL CONCEPTS

- **Standards of Value**

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FUNDAMENTAL CONCEPTS

- Standards of Value
- **Levels of Value**

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FUNDAMENTAL CONCEPTS

- Standards of Value
- Levels of Value
- **Approaches and Methodologies**

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FUNDAMENTAL CONCEPTS

- Standards of Value
- Levels of Value
- Approaches and Methodologies
- **Fundamental Theory**

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FUNDAMENTAL CONCEPTS

- Standards of Value
- Levels of Value
- Approaches and Methodologies
- Fundamental Theory
- **Assignment Specifics**

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FUNDAMENTAL CONCEPTS

- Standards of Value
- Levels of Value
- Approaches and Methodologies
- Fundamental Theory
- Assignment Specifics
- **Mechanical Propriety/Implications**

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STANDARDS OF VALUE

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STANDARDS OF VALUE

- **Often the most confusing area of valuation**
- **Definitional aspects of value often go unaddressed or are technically lacking**

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STANDARDS OF VALUE

- **Standards = Definition**
- **No "value" is useful until it is understood exactly how "value" is defined**

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STANDARDS OF VALUE

- **Business valuators provide technical definition requirements to attorneys**
- **Attorneys provide guidance as to the proper standard for the subject legal matter**

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STANDARDS OF VALUE

- **Not always discernable**
  - ***Lack of statutory guidance***
  - ***Variations in judicial decisions***
  - ***Poor definitions in legal documents***

Standards of Value and Levels of Value

STANDARDS OF VALUE

- **Fair Market Value**
- **Investment Value**
- **Intrinsic/Fundamental Value**
- **Fair Value Under State Statutes**
- **Fair Value for Financial Reporting**

Standards of Value and Levels of Value

STANDARDS OF VALUE – FAIR MARKET VALUE

- **Most common standard**
  - ***Income tax***
  - ***Gift and estate tax***
  - ***Marital dissolution***
  - ***Non-shareholder litigation***

Standards of Value and Levels of Value

STANDARDS OF VALUE – FAIR MARKET VALUE

- **Definition**

"the price at which the 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, both parties having reasonable knowledge of relevant facts.

Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property."

Standards of Value and Levels of Value

STANDARDS OF VALUE – FAIR MARKET VALUE

- **Assumes a hypothetical sale transaction**
- **Risks envisioned by hypothetical buyers and sellers must be considered (i.e. control/marketability)**

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STANDARDS OF VALUE – FAIR MARKET VALUE

- **Key considerations**
  - ***Contemplates broad universe of potential hypothetical buyers, including financial and strategic buyers***
  - ***Financial value***
  - ***Based on prevalent economic and market conditions at the date of valuation***

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STANDARDS OF VALUE – FAIR MARKET VALUE

- **Key considerations**
  - ***Hypothetical buyer must be able, as well as willing***
  - ***Payment is in cash or its equivalent***
  - ***Must allow for consideration of benefits and/or risks associated with control and risks associated with a lack of marketability***

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STANDARDS OF VALUE – INVESTMENT VALUE

- **Essentially the specific value of an investment to a particular class of investors or a specific investor (i.e. control/marketability)**

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STANDARDS OF VALUE – INVESTMENT VALUE

- **Differs from fair market value – it is buyer-specific**
- **Also referred to as synergistic or strategic value**

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STANDARDS OF VALUE – INVESTMENT VALUE

- **Considers buyer-specific motivations and advantages**
  - ***Ability to enhance future operating performance***
  - ***Ability to mitigate certain risks***
  - ***Ability to modify capital structure***
  - ***Ability to add synergies to current operations***

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STANDARDS OF VALUE – INVESTMENT VALUE

- **Strategic value versus financial value**
- **Will almost always exceed fair market value**
- **This standard of value is nearly always the value that motivates buyers and sellers in the merger and acquisition markets**

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STANDARDS OF VALUE – INTRINSIC/FUNDAMENTAL VALUE

- **Represents specific analyst's judgment of value based on perceived characteristics inherent in the specific investment**

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STANDARDS OF VALUE – INTRINSIC/FUNDAMENTAL VALUE

- **Example**
  - ***Stock trading at $10.00 per share may be deemed to be worth $13.00 per share by a specific industry analyst***
  - ***When all analysts agree that the stock's value is $13.00, that value now shifts to fair market value***

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STANDARDS OF VALUE – INTRINSIC/FUNDAMENTAL VALUE

- **Rarely used in litigation and valuation applications**
- **New Jersey family court**

Standards of Value and Levels of Value

STANDARDS OF VALUE –
FAIR VALUE UNDER STATE STATUTES

- **Used in the resolution of shareholder disputes**
- **Thus, generally a legally-developed standard of value or a statutory definition, depending on jurisdiction**

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STANDARDS OF VALUE –
FAIR VALUE UNDER STATE STATUTES

- **Defined, with respect to dissenter's shares,**

" as the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action <u>unless</u> the exclusion would be inequitable."

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STANDARDS OF VALUE – FAIR VALUE UNDER STATE STATUTES

- **While most states have a statute with this or a similar definition, there is little authoritative guidance on the computational aspects of this standard**

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STANDARDS OF VALUE – FAIR VALUE UNDER STATE STATUTES

- **Note:**
  - ***Fair value, for these purposes, has been distinguished from fair market value***
  - ***Usually, this standard does not include discounts related to a lack of control or a lack of marketability***

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Standards of Value and Levels of Value

STANDARDS OF VALUE –
FAIR VALUE FOR FINANCIAL REPORTING

- **Note:**
  - ***Fair value, for these purposes, has been distinguished from fair market value***
  - ***Usually, this standard does not include discounts related to a lack of control or a lack of marketability***

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STANDARDS OF VALUE –
FAIR VALUE FOR FINANCIAL REPORTING

- **Defined by accounting literature generated by the Financial Accounting Standards Board (FASB)**
- **No relationship whatsoever to fair value under state statutes**

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STANDARDS OF VALUE –
FAIR VALUE FOR FINANCIAL REPORTING

- **Defined by FASB ASC 820 (formerly SFAS No. 157)**

  " Fair value is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability."

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STANDARDS OF VALUE –
FAIR VALUE FOR FINANCIAL REPORTING

- **FASB ASC 820 *Fair Value Measurement and Disclosures***
  - ***SFAS No. 157 Issued September 15, 2006***
  - ***Effective for fiscal years beginning after November 15, 2007***
  - ***FASB Accounting Standards Codification 820 (ASC 820) replaced SFAS No. 157 effective September 30, 2009***

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STANDARDS OF VALUE – SUMMARY

- **Understanding the standard of value is tantamount to garnering a conclusion which is in alignment with the purpose of the valuation**

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LEVELS OF VALUE

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LEVELS OF VALUE

- **Historically, the business valuation community has looked to three basic levels of value**
  - ***Control, marketable***
  - ***Minority, marketable***
  - ***Minority, nonmarketable***

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LEVELS OF VALUE

- **Key determinant of propriety of premiums and discounts**
- **Usually defined by the attributes of control and marketability**

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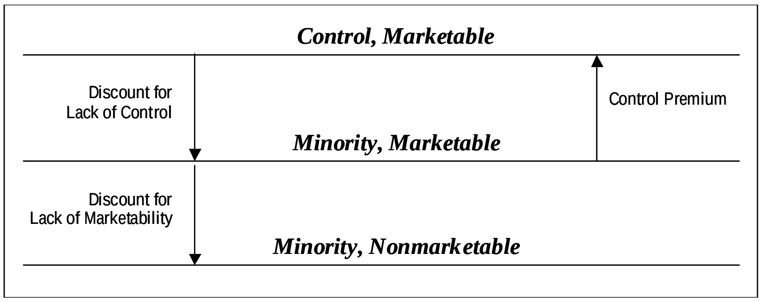
LEVELS OF VALUE – TRADITIONAL MODEL



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LEVELS OF VALUE – TRADITIONAL MODEL

- **Presumption is that the type of value is financial value**
- **Envisions the same measurement type with varying equity ownership interest characteristics**
- **Multiplicative vs. an additive method of application**

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LEVELS OF VALUE

- **Multiplicative vs. Additive Application of Discounts**
  - *The sum of the discounts for lack of control and lack of marketability produces an overall lower discount than simply adding the two raw numbers together*

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LEVELS OF VALUE

- **Multiplicative Application of Discounts**

DISCOUNTS		VALUE
100%	*Control, Marketable*	$ 10.00
20%		(2.00)
80%	*Minority, Marketable*	$ 8.00
25%		(2.00)
60%	*Minority, Nonmarketable*	$ 6.00

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LEVELS OF VALUE

- **No direct measurement source for the determination of discounts for lack of control**
  - ***Theoretically, premiums and discounts are the algebraic inverse of each other***

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LEVELS OF VALUE

- **There are control premium studies with relevant, although questionable, information relating to the premium for control**
- **From these, base discounts for lack of control can be developed**

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LEVELS OF VALUE

- **Converting control premium to discount for lack of control**

Formula: x = 1 - [1 / 1+y]

Where y = median premium paid

x = implied minority discount

Assume y = 24%

x = 1 - [1 / 1+.24]

x = 1 - .806

x = 19.4%

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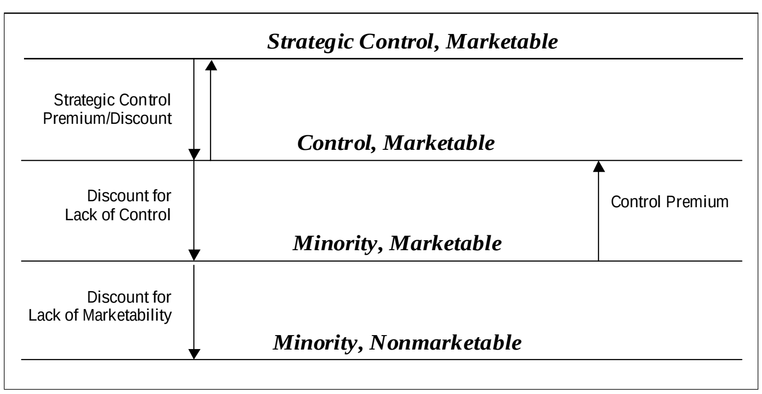
LEVELS OF VALUE – EXPANDED MODEL



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LEVELS OF VALUE – EXPANDED MODEL

- **While the three levels of value in the traditional model reflect a financial value and can be used in fair market value, the fourth, and new, level reflects a synergistic value, and is used in investment value**

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LEVELS OF VALUE – ALTERNATIVE MODELS

- **Numerous variations have been proposed**
- **Most are highly theoretical and of little practical use in day-to-day application**

Understanding Standards of Value and Levels of Value

FUNDAMENTAL THEORY

Standards of Value and Levels of Value

FUNDAMENTAL THEORY – KEY CONCEPTS

- **Value of a business or business interest is determined by transactions between buyers and sellers**
- **Investors are risk averse**
- **Propriety of any premium/discount is undeterminable until the base to which adjustments are applied is clearly defined**
- **No "prescribed" levels or ranges of discounts or premiums exist from which the valuator can ascertain the proper adjustments for a specific case**

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FUNDAMENTAL THEORY – KEY CONCEPTS

- **Though not totally mutually exclusive concepts, the discount for a lack of ownership control (minority) and the discount for lack of marketability are generally held to be separate and distinct**
- **In instances where the business valuator deems it appropriate to apply both a discount for lack of ownership control and a discount for lack of marketability, the application of discounts is multiplicative, not additive**

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FUNDAMENTAL THEORY – KEY CONCEPTS

- **Due to specific characteristics requiring the application of discounts for both a lack of control and a lack of marketability, minority ownership interests in privately held businesses are generally worth much less than their proportionate share of the overall business value**

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VALUATION APPROACHES AND METHODOLOGIES

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VALUATION APPROACHES AND METHODOLOGIES

- **Three broad approaches to value**
  - ***Income approach***
  - ***Market approach***
  - ***Cost/asset approach***
- **Within these approaches are numerous methodologies that require a wide variety of inputs and analysis**

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INCOME APPROACH

- **Most common methods used for privately-held businesses**
  - ***Capitalized returns***
  - ***Discounted future returns***
- **Conclusions attained using these methods are marketable values**

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INCOME APPROACH

- **Control or minority conclusion solely a factor of adjustments to the numerator in the calculations**

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INCOME APPROACH

- **Control vs. minority**

	Control		Minority
Cash Flow	$ 750		$ 750
Control Adjustment	250		0
	1,000		750
Capitalization Rate	.20		.20
	$ 5,000		$ 3,750
Difference		$ 1,250	
Discount for Lack of Control 25%			

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MARKET APPROACH

- **Allows valuators to more directly tie their conclusions to marketplace data**
  - ***Guideline company method***
  - ***Transaction method***
- **Results are generally deemed to represent marketable conclusions**

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GUIDELINE COMPANY METHOD

- **Valuation multiples developed from public stock market data**
- **Value conclusions historically and currently presumed to be minority conclusions**
- **Newer school of thought – conclusions are neither minority nor control**

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TRANSACTION METHOD

- **Commonly referred to as the merger and acquisition method**
- **Requires valuator to identify guideline companies from private transaction databases of completed transactions**
- **Conclusions are control, marketable values**

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COST/ASSET APPROACH

- **Underlying Assets Methods**
  - *More suited to valuing controlling interests*
  - *Generally, should only be used to value minority interests if those interests can cause company to sell its assets, or if the company is the type of company whose stock should normally be valued primarily on an asset basis (i.e. an investment holding company)*
  - *Methods generally produce a control, marketable value*

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COST/ASSET APPROACH

- **Excess Earnings Methods**
  - *Variations in model inputs can change the result to minority, but such a result is extremely difficult to reconcile and defend*
  - *In most cases, the excess earnings methods produce a control, marketable value*

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COST/ASSET APPROACH

- **Multiple of Discretionary Earnings Methods**
  - ***Inputs to models under this method are based on purchase and sales transactions***
  - ***The result is generally control, marketable values***

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FACTORS INFLUENCING PREMIUMS OR DISCOUNTS

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FACTORS INFLUENCING PREMIUMS OR DISCOUNTS

- **Many applications of premiums and discounts are limited by the purpose of the business valuation and other statutory, judicial or economic influences**
- **Numerous internal and external factors can affect the application or the size of a premium and/or discount**

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FACTORS INFLUENCING PREMIUMS OR DISCOUNTS

- **Purpose of the valuation**
  - ***Marital dissolution in many states, including Pennsylvania, requires a determination of fair market value (which is inclusive of any applicable premiums and discounts)***
  - ***A business valuation undertaken for purposes of providing a conclusion of fair value in a dissenting shareholder action is not likely, in most jurisdictions, to include discounts for lack of control and often excludes discounts for lack of marketability, as well***

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FACTORS INFLUENCING PREMIUMS OR DISCOUNTS

- **Specific ownership interest attributes**
  - ***Any restrictions attendant to the equity ownership interest under valuation related either to control or marketability will influence the applicability and size of premiums or discounts***
    - Shareholder agreement setting forth a restriction on transferability of shares will affect holder risk and, thus, the level of the discount for lack of marketability
    - Likewise, if shares under valuation are subject to a "put," a market for the shares may be deemed to exist which would decrease any discount for lack of marketability.

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FACTORS INFLUENCING PREMIUMS OR DISCOUNTS

- **Ownership structure**
  - ***Very important in the consideration of premiums and/or discounts***
  - ***A highly fragmented ownership structure will often nominalize valuation premiums accorded a minority interest, while a very limited structure may result in just the opposite***

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FACTORS INFLUENCING PREMIUMS OR DISCOUNTS

- **Voting rights**
  - *Voting rights and the control prerequisites encompassed in those rights have a substantial impact on perceived investment risk and, ultimately, value*
  - *A lack of voting rights attendant to nonvoting shares generally makes those shares less desirable and less marketable*

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FACTORS INFLUENCING PREMIUMS OR DISCOUNTS

- **Size of company**
  - *Greater revenue, capital, income and diversity of businesses all combine to combat equity ownership risk in larger companies*
  - *Accordingly, the size of the company under valuation is an important influence on risk and use of premiums or discounts*

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FACTORS INFLUENCING PREMIUMS OR DISCOUNTS

- **Size of block of stock under valuation**
  - ***Controlling interest vs. a noncontrolling or minority interest***
    - As attributes of control are lessened, the general treatment under business valuation principles is to increase the discount for lack of control, thereby decreasing value
  - ***Size of block related to dispersion of remaining equity interests***
    - "Swing vote" capability –the ability of a noncontrolling block of stock to join with another minority block of stock to exercise control – generally results in a lower discount for lack of control

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FACTORS INFLUENCING PREMIUMS OR DISCOUNTS

- **Dividend/distribution history**
  - ***Entities with strong history of cash flow distributions through dividends or partnership distributions tend to require lower discounts for lack of marketability than entities that do not***
    - Based on the precept that the lion's share of entity risk is remediated through regular cash flow distributions
  - ***Valuators assume the dividends or distributions will follow historical trends into the future, enhancing marketability, thus, a lower discount for lack of marketability is warranted***

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FACTORS INFLUENCING PREMIUMS OR DISCOUNTS

- **Financial condition of the subject company**
  - ***Business entities with less attractive operating and financial results on an historical basis will garner a perception of greater investor risk in the future***
  - ***The investment risks will equate to a decrease in value of the subject equity ownership position and may be accounted for through the application of a larger discount for lack of marketability***

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FACTORS INFLUENCING PREMIUMS OR DISCOUNTS

- **Federal and state regulatory restrictions**
  - ***Treasury regulations regarding estates and gifts***
  - ***Department of Labor rules regarding Employee Stock Ownership Plans (ESOPs)***
  - ***FASB pronouncements***
  - ***Shareholder protection statutes***

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FACTORS INFLUENCING PREMIUMS OR DISCOUNTS

- **State corporation statutes**
  - ***States requiring supermajority control positions (NY, IL) have a significant influence on the propriety of premiums and discounts and the level of those valuation adjustments***

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IMPLICATIONS

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IMPLICATIONS

- **Premiums and discounts under constant challenge**
  - ***IRS success in Tax Court***
  - ***Fact finders in litigation and family court***
  - ***Equity ownership interest holders subject to shareholder buy/sell agreements***

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IMPLICATIONS

- **All opinions of value are fact-specific to the attendant equity ownership interest**
  - ***Determination of premiums and discounts also case-specific***
  - ***All factors (internal and external) that might influence overall risk associated with the particular block of equity under valuation must be considered***
  - ***Third-party empirical evidence must be reconciled to the specific selected adjustment – critical to successful defense of any premiums and/or discounts applied***

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