



GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants

***Business Valuation: Essential Approaches &
Current Perspectives - Market Approach***



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Business Valuation: Essential Approaches & Current Perspectives - Market Approach

INTRODUCTION



Basics of the Market Approach & Current Perspectives

INTRODUCTION

- **Market Approach**
 - One of three approaches to determine value
 - Brings information from “real” market transactions into valuation process
 - Predicated on economic concept of substitution
 - Issues arise in the application of the approach and methods thereunder



Basics of the Market Approach & Current Perspectives

INTRODUCTION

▪ **Market Approach**

- Numerous problems leading to misapplication of underlying theory
- Primary issues relate to:
 - Standard of Value
 - Premise of Value
 - Level of Value
 - Sufficient Similarity



Basics of the Market Approach & Current Perspectives

INTRODUCTION

▪ **Market Approach**

- The current economic environment is making this approach to valuation more complex
 - Uncertainty surrounding how the pandemic will play out will impact the building blocks of the market approach
 - Market multiples
 - Expected future returns (EBITDA, cash flow)



***Business Valuation: Essential Approaches &
Current Perspectives - Market Approach***

METHODS UNDER THE
MARKET APPROACH



Basics of the Market Approach & Current Perspectives

METHODS AVAILABLE UNDER THE MARKET APPROACH

- ***Methodologies***
 - Guideline Public Company Method
 - Guideline Transaction (Merged and Acquired) Method
 - Subject Company Past Completed Transaction Method
 - Rules of Thumb



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METHODS AVAILABLE UNDER THE MARKET APPROACH

▪ ***Guideline Public Company Method***

- Selected multiples developed from identification and analysis of companies traded freely on open stock exchange
 - Draw comparable guideline companies from large pool of candidates
 - Offers significant amount of quality financial, industry, and economic data due to SEC mandates
 - Observes actively-traded stocks price driven by independent third-party investors



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METHODS AVAILABLE UNDER THE MARKET APPROACH

▪ ***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
 - Both public and private company transactions



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METHODS AVAILABLE UNDER THE MARKET APPROACH

- ***Subject Company Completed Transaction Method***
 - Review and consider past transactions involving companies' equity interests
 - Control or minority transactions
 - Ascertain the independent, objective and arm's length nature of the transaction
 - Identify and unwind those elements of the deal that are not arm's length



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METHODS AVAILABLE UNDER THE MARKET APPROACH

- ***Rules of Thumb***
 - Multiples set forth by various parties, publications, industry organizations etc.
 - Most based on suggested multipliers applied to a variable
 - Multiples of sales
 - Multiple of Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)
 - Multiple of Earnings Before Interest and Taxes (EBIT)
 - Multiple of Sellers Discretionary Cash Flow or Owners Cash Flow



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METHODS AVAILABLE UNDER THE MARKET APPROACH

- *Valuator must exercise care in selecting the most appropriate method to use in any particular assignment*
- *Often market approach conclusions are best utilized as sanity checks against results developed under another approach*



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CONSIDERATIONS IN THE APPLICATION OF THE MARKET APPROACH





Basics of the Market Approach & Current Perspectives

STANDARDS OF VALUE IN THE MARKET APPROACH

▪ ***Standard of Value***

- Identification of the type of value being utilized in a specific engagement
 - Realizable result of completed transaction bargained at arm's length
 - Driven by purpose of valuation engagement
 - Guides valuation process



Basics of the Market Approach & Current Perspectives

STANDARDS OF VALUE IN THE MARKET APPROACH

▪ ***Standards of Value***

- Fair Market Value
- Investment Value
- Intrinsic or Fundamental Value
- Fair Value
- Fair Value – Statutory



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STANDARDS OF VALUE IN THE MARKET APPROACH

- ***Considerations in Business Valuation Fundamentals***
 - Desired standard of value driven by purpose of engagement
 - Indicated standard of value is a result of methods applied by business valuator
 - Must determine if indicated value resulting from valuation calculations provides value aligning with desired standard



Basics of the Market Approach & Current Perspectives

STANDARDS OF VALUE IN THE MARKET APPROACH

- ***Fair Market Value or Investment Value?***
 - Conclusion developed under guideline public company method aligns more so with fair market value conclusion
 - As part of public markets, active/freely-traded shares rarely incorporate strategic or synergistic perceptions regarding value of those equities
 - Public markets comprised of financial investors rather than strategic acquirers



Basics of the Market Approach & Current Perspectives

STANDARDS OF VALUE IN THE MARKET APPROACH

- ***Fair Market Value or Investment Value?***
 - Conclusions developed under guideline completed transaction method generally viewed as investment standard of value
 - Transactions represent acquisitions of controlling interests in target companies
 - Single, specific buyer motivations and attributes embedded in purchase price



Basics of the Market Approach & Current Perspectives

STANDARDS OF VALUE IN THE MARKET APPROACH

- ***Fair Market Value or Investment Value?***
 - Business valuers consider the following when analyzing specific transactions and amount of synergies embedded within:
 - Does the buyer provide a similar product or service to the target?
 - Does the buyer provide a complementary product or service?
 - Has the buyer made acquisitions in the industry previously?
 - Does the buyer have an existing business relationship with the target as a vendor or customer?



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STANDARDS OF VALUE IN THE MARKET APPROACH

- ***Fair Market Value or Investment Value?***
 - If indicated standard of value does not align with desired standard, business valuator must:
 - Adjust indicated value so result aligns with desired standard, using reasonable inputs, and apply as primary method
 - Adjust indicated value so result aligns with desired standard, using best available inputs, and apply as secondary method
 - Dismiss the use of that particular approach if adjustment cannot be reasonably quantified



Basics of the Market Approach & Current Perspectives

ISSUES IN APPLYING GOING CONCERN PREMISE OF VALUE

- ***Definition of “Premise of Value”***
 - An **assumption** regarding the **most likely set of transactional circumstances** that may be applicable to the subject valuation; for example, going concern or liquidation.



Basics of the Market Approach & Current Perspectives

ISSUES IN APPLYING GOING CONCERN PREMISE OF VALUE

- ***“Most Likely” set of transactional circumstances***
 - Should be interpreted literally by valuers
 - Assess probability of operational/financial structure changes then forecast future expected economic benefits under set of circumstances that have the highest probability to occur
 - These probability estimates should be tied to specific “set of transactional circumstances that are applicable to the subject valuation”



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ISSUES IN APPLYING GOING CONCERN PREMISE OF VALUE

- ***Issues in Application***
 - Some valuers suggest that the most likely buyers are strategic or synergistic buyers, also arguing that the resulting value developed from synergistic transactions is fair market value
 - However, in many cases, the most likely buyer is not relevant as valuers are required to look at a hypothetical buyer
 - Contemplating a single buyer in a synergistic transaction violates a fundamental precept in the definitions of fair value and fair market value



Basics of the Market Approach & Current Perspectives

ISSUES IN APPLYING GOING CONCERN PREMISE OF VALUE

- ***Issues in Application***

- The going concern premise of value should be interpreted to encompass just those assets and liabilities that are in place at the date of valuation (modified by any expected changes that are known as of that date)
- It is not appropriate to include unexpected changes, especially those related to strategic or synergistic benefits that may be afforded by an investment buyer



Basics of the Market Approach & Current Perspectives

UNDERSTANDING LEVELS OF VALUE

- ***Level of value relates to the control and marketability characteristics of the ownership interest***

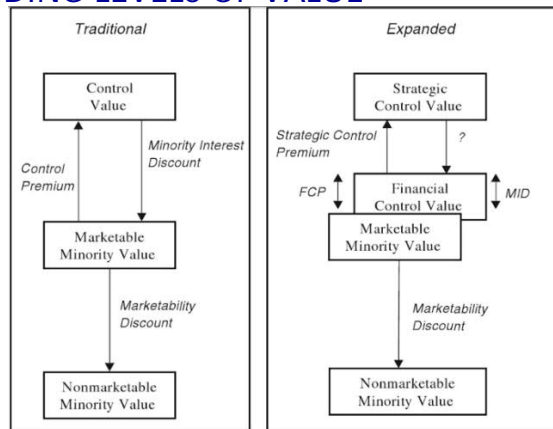
- Ownership interest with control over the entity's operations is more valuable than a non-controlling interest
- Higher level of marketability (can be quickly converted to cash at minimal cost) increases the value of the ownership interest

- ***Level of value is determined by specific characteristics of entity ownership interest, it is not judgmental***



Basics of the Market Approach & Current Perspectives

UNDERSTANDING LEVELS OF VALUE



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UNDERSTANDING LEVELS OF VALUE

- ***Conflicting opinions about the level of value produced under the guideline public company method***
 - Stock prices based on trading of minority blocks, so value is non-controlling, marketable, and requires an upward adjustment to valuation multiples for the attribute of control
 - Others argue that the resulting conclusion of value is neither control nor minority value, and the application of a control premium is not required



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UNDERSTANDING LEVELS OF VALUE

- *Valuators must understand the levels of value in order to reconcile the conclusion of value determined under the market approach methods by applying the appropriate discounts and/or premiums*
- *As certain strategic transactions include specific-buyer motivations, valuers must make adjustments to account for these synergies; however, it is difficult to quantify the amount of the deal that relates specifically to the premium*



Basics of the Market Approach & Current Perspectives

SUFFICIENT SIMILARITY IN GUIDELINE COMPANIES

- *“Sufficient similarity” criteria underlies both methods under the market approach*
- *Inferences of value must be taken from companies/transactions that are sufficiently similar to the subject company*
- *Process for determining appropriate level of similarity has not been defined in standards/guidance or judicial decisions*
- *As such, selections require professional judgment*



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SUFFICIENT SIMILARITY IN GUIDELINE COMPANIES

- ***Governing guidance of IRS Revenue-Ruling 59-60***
 - Companies must be in “same or similar” line of business
 - “Other relevant factors” may considered on case-by-case basis:
 - Main products and/or services; customers and clients
 - Markets served (current and future)
 - Product distribution capabilities
 - Competition, supplier and employee relationships
 - Financial performance



Basics of the Market Approach & Current Perspectives

SUFFICIENT SIMILARITY IN GUIDELINE COMPANIES

- ***Elements of Comparability:***
 - Size and growth
 - Sample size considerations
 - Financial analysis



Basics of the Market Approach & Current Perspectives

SUFFICIENT SIMILARITY IN GUIDELINE COMPANIES

- ***Elements of Comparability – Fluctuating Multiples***
 - Important to consider historical trends in underlying data used to develop valuation multiples derived from public companies
 - Recent positive/negative events in public companies can result in multiples that lead to unreliable indicators of value
 - Meaningful fluctuations in market multiples of the guideline companies can cause variation in the valuation conclusions, and can cause such companies to be insufficiently comparable



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SUFFICIENT SIMILARITY IN GUIDELINE COMPANIES

- ***Other Comparability Issues***
 - Sufficient comparability is more difficult to determine under the guideline completed transaction method due to very limited information from transactions involving privately-held businesses
 - Specific buyer motivations influence transaction prices and inability to estimate synergistic premiums is problematic
 - Understanding deal structure makes it impossible to fully understand how price equates to value



Basics of the Market Approach & Current Perspectives

SUFFICIENT SIMILARITY IN GUIDELINE COMPANIES

- ***Other Comparability Issues***
 - Consideration of new tax regime
 - Significant lack of information about these transactions leaves many additional questions unanswered
 - Valuators should attempt to find as much information as possible to avoid challenges to their conclusions of value
 - If limitations in application of this method cannot be overcome, it should be used to confirm or reconcile other conclusions of value



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CURRENT ISSUES IN APPLYING THE MARKET APPROACH

- ***Applying multiples to subject company metric (i.e. EBITDA) that does not represent the current economic environment***
- ***Multiples derived from pre-COVID transactions will not likely reflect the risk associated with an investment***



Basics of the Market Approach & Current Perspectives

CURRENT ISSUES IN APPLYING THE MARKET APPROACH

- ***The COVID crisis will impact market approach:***
 - Presence or existence of willing buyer
 - Existence of non-distressed sellers
 - Access to capital



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CONCLUSION & PRACTICAL CONSIDERATIONS





Basics of the Market Approach & Current Perspectives

CONCLUSION & PRACTICAL CONSIDERATIONS

- ***Complexity and inter-workings in application of methods under the market approach can lead to misunderstandings***
- ***Improper application of the market approach and its methods can result in incorrect conclusions of value***
- ***Difficulty lies in identifying “sufficiently similar” guideline companies and transactions, then adjusting results to arrive at the proper standard and level of value***



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CONCLUSION & PRACTICAL CONSIDERATIONS

- ***Professional judgment plays a significant role in many aspects of applying the market approach***
- ***Current economic environment leads to difficulty in applying the market approach***
- ***Market approach often cannot be used as primary indication of value; rather should serve to corroborate other methods***



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CONCLUSION

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FINAL QUESTIONS?

THANK YOU!