Understanding Standards of Value and the Market Approach in Controversy

presented by the GYF Business Valuation & Litigation Support Services Group

Grossman Yanak & Ford LLP
Certified Public Accountants and Consultants

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Robert J. Grossman, CPA/ABV, ASA, CVA, CBA

Bob heads our firm's Tax and Business Valuation Groups. He has nearly 40 years of experience in tax and valuation matters that affect businesses, both public and private, as well as the stakeholders and owners of these businesses. The breadth of his involvement encompasses the development and implementation of innovative business and financial strategies designed to minimize taxation and maximize owner wealth. As his career has progressed, Bob has risen to a level of national prominence in the business valuation arena.

His expertise in business valuation is well known, and Bob is a frequent speaker, regionally and nationally, on tax and valuation matters. Bob is a course developer and national instructor for both the American Institute of Certified Public Accountants (AICPA) and the National Association of Certified Valuators and Analysts (NACVA). He has served as an adjunct professor for Duquesne University and Saint Vincent College. He has also written articles for several area business publications and professional trade journals.

After graduating from Saint Vincent College in 1979 with Highest Honors in Accounting, Bob earned a Masters of Science degree in Taxation with Honors from Robert Morris University. He is a CPA in Pennsylvania and Ohio and is accredited in Business Valuation by the AICPA. Bob also carries the well-recognized credentials of Accredited Senior Appraiser, Certified Valuation Analyst and Certified Business Appraiser.

A member of the American and Pennsylvania Institutes of Certified Public Accountants (PICPA), Bob has previously chaired the PICPA Pittsburgh Committee on Taxation. He has also served as Chair of the Executive Advisory Board of NACVA, its highest Board; as well as Chair of NACVA's Professional Standards Committee and its Education Board.

Bob received NACVA's "Thomas R. Porter Lifetime Achievement Award" for 2013. The award is presented annually to one of the organization's 6,500 members, who has demonstrated exemplary character, leadership and professional achievements to NACVA and the business valuation profession, over an extended period.

Bob is a member of the Allegheny Tax Society, the Estate Planning Council of Pittsburgh and the American Society of Appraisers. He has held numerous offices in various not-for-profit organizations. Bob received the PICPA Distinguished Public Service Award and a Distinguished Alumnus Award from Saint Vincent College.

Bob and his wife, Susie, live in Westmoreland County. They have two grown children.

Melissa A. Bizyak, CPA/ABV/CFF, CVA

Melissa, a partner in the firm's Business Valuation & Litigation Support Services Group, has practiced in public accounting for more than 21 years. She has significant experience addressing business valuation and tax-related issues for privately-held concerns and their owners.

Her business valuation experience is diverse, including valuations of companies in the manufacturing, oil and gas and technology industries. These valuations have been performed for various purposes such as financial reporting, equitable distributions, buy/sell transactions, dissenting shareholder disputes, Employee Stock Ownership Plans (ESOPs), value enhancement and gift and estate tax purposes. Melissa also provides litigation support services, including expert witness testimony.

After graduating from the University of Pittsburgh in 1994 with a B.S. in Business/Accounting, Melissa spent two years with a local accounting firm in Pittsburgh. She joined Grossman Yanak & Ford LLP in 1997.

Melissa is a certified public accountant and is accredited in business valuation and certified in financial forensics by the American Institute of Certified Public Accountants (AICPA). She has also earned the AICPA Certificate of Achievement in business valuation. Additionally, Melissa carries the credential of Certified Valuation Analyst, conferred by the National Association of Certified Valuators and Analysts (NACVA).

Her professional affiliations include the AICPA, the Pennsylvania Institute of Certified Public Accountants (PICPA) and the Estate Planning Council of Pittsburgh. She is a member and previously served as the Chair of NACVA's Executive Advisory Board. Melissa has written business valuation course-related materials and serves as a national instructor for NACVA. She has also authored articles appearing in professional publications.

Melissa is a graduate of Leadership Pittsburgh, Inc.'s Leadership Development Initiative. She serves on the Board of Directors of the Children's Museum of Pittsburgh and is a member of the Executive Leadership Team for the American Heart Association's "Go Red for Women" initiative. Melissa is also a mentor for women business owners through Chatham University's MyBoard program. She was one of four female CPAs in the State of Pennsylvania to be honored in the PICPA's "Women to Watch" awards in 2017.

Melissa resides in the South Hills of Pittsburgh with her husband and their two sons.

Brad W. Matthews, CPA/ABV, CVA

Brad has focused his career on providing valuation and litigation support services since joining Grossman Yanak & Ford LLP in 2011. His experience includes financial statement and historical financial trend analysis, financial modeling, and business risk assessment, as well as performing calculations required for the preparation of business valuations and other consulting projects.

Brad has served clients in many industries including manufacturing, professional services, financial services, engineering, construction, retail, management consulting, oil and gas, and technology. He has played a significant role in providing business valuation services for a range of purposes including gift and estate tax planning, Employee Stock Ownership Plans (ESOPs), marital dissolutions, corporate divorce/shareholder disputes, financial and tax reporting, buy/sell transactions, and general business planning. Further, his litigation support experience includes the determination of lost profits and economic damages arising from various disputes.

Brad graduated from the University of Pittsburgh, earning a double major in Accounting and Finance with a minor in Economics. Brad is a graduate of Class XXIV of Leadership Pittsburgh Inc.'s Leadership Development Initiative (LDI) program that hones the leadership skills of high-potential young professionals.

He is a certified public accountant (CPA) and has earned the Certified Valuation Analyst (CVA) designation conferred by the National Association of Certified Valuators and Analysts (NACVA).

In his spare time, Brad enjoys golfing, following Pittsburgh sports and spending time outside with his family. He lives in the North Hills with his wife, Alexis.

Katie A. Smith

Katie has nearly three years of experience providing business valuation and litigation support services at Grossman Yanak & Ford LLP. Her responsibilities include financial statement analysis, financial trend analysis, risk identification and financial modeling, as well as performing corporate, industry and economic research. Katie serves clients operating in a broad array of industries including manufacturing, professional services, financial services, engineering, construction, and technology.

Katie has assisted in the valuation of privately held companies for gift and estate tax planning, corporate divorce/shareholder disputes, shareholder buyouts, employee stock ownership plans (ESOPs), financial reporting, and general corporate planning purposes.

Additionally, she has provided litigation support services in conjunction with the assessment of minority shareholder oppression, lost profits, and economic damages cases. She has also assisted with the quantification of net disposable income and asset valuations in conjunction with equitable distribution in Pennsylvania divorce proceedings.

Prior to joining Grossman Yanak & Ford LLP, Katie worked as an accounting assistant at a leading manufacturer and distributor of medical supplies and equipment.

Katie graduated cum laude from Geneva College in 2016, with a dual major in accounting and business finance, and a minor in pre-law studies. She proudly maintained full-time employment during her college career and participated in the Volunteer Income Tax Assistance (VITA) program.

In her spare time, Katie enjoys spending time outdoors with her friends and family. She resides in Monaca, Pennsylvania, just north of the City of Pittsburgh.

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Understanding Standards of Value and the Market Approach in Controversy

I. Introduction

Valuation of equity ownership interests is very often at the center of matters of controversy. The necessity of establishing a reasonable determination of "value" in these matters by both sides is a critical element to bringing the underlying legal matter to a successful and fair resolution. Unfortunately, the myriad of complexities surrounding the production of a conclusion (or opinion) of value produced in accordance with professional standards, and in compliance with generally accepted business valuation principles, can make any value determination a daunting task. When these challenges are combined with the many nuances of a legal setting, coming upon an answer that can be found to be reasonable by all sides is difficult, and often causes that final determination of value to be developed through a process, rather than through either party's expert.

While valuation of equity ownership interests is often described as more of an art than a science, users of opinions of value, including the Courts and members of the legal profession, should be aware that there is a substantial amount of authoritative literature and guidance available within the business valuation profession that is intended to bring a certain level of uniformity to the process. Given these resources, it should stand to reason that the experts on each side of a case should be able to produce answers to questions of value within a reasonable proximity to one another.

Increasingly, it seems obvious to the authors that many valuation professionals are taking positions within their work that skirt the fringes of the authoritative literature and guidance, and which move them, and their reported opinions, dangerously close to positions of advocacy. To be sure, business valuation is an imprecise undertaking and, just as sure, reasonable persons can differ in their perceptions of the many factors influencing any valuation expert's opinion of value. Differences in perception are integral to the resolution of these complex matters when conflict arises. Very often, with an open mind, experts are able to work with opposing experts in resolving elements of variation in results so as to bring matters of controversy to a reasonable conclusion in an agreeable and fair manner.

It is important to note, however, that in addition to an open mind, experts must respect the foundational theory underlying the business valuation process and undertake the project with an eye towards the authoritative literature and guidance available within the business valuation profession. To do otherwise is to, essentially, devoid the business valuation process of any ultimate credibility and render the work done by the business valuator as useless.

Failure to follow foundational theory poses further problems. Within the user community and, especially, the legal profession, users of the reports written by such experts tend to taint the credibility of everyone in the profession. It was somewhat disconcerting to hear, when speaking to an audience of judges on expert testimony at the National Judicial College in Reno, Nevada, almost all responded, "no" to the question of whether they view experts as independent of their client's positions. Not only do these preconceived notions on the part of jurists, prior to the admission of expert testimony, work to slow the legal process, but they also position truly independent experts at a technical disadvantage as they begin their efforts to convince the judge that their work is done on an independent basis and free from advocacy.

The means to overcome such challenges is to simply follow the authoritative literature and guidance, as well as professional standards. This should ensure a result that is grounded in foundational theory and that would preclude an alternative answer, should the expert have been engaged by the party on the other side of the case.

This basic premise is the basis for today's program. There are certain key aspects of the technical theory that have become mired down in lengthy reports, which are somewhat cumbersome to the lay reader and, when applied errantly, tend to misinform and misdirect lay readers in their interpretations of the conclusions set forth therein. Unfortunately, the authors of these materials have noted an ever-increasing number of occurrences of this errant application of key technical matters.

As the number of incidences of misapplication of foundational theory increases, the absolutes developed by many highly skilled and well-intended professionals within all of the major valuation organizations over the last 30 years is starting to become lost. When members of the profession begin to move from professional standards of practice and the generally accepted business valuation protocols, they add to the difficulty in interpreting the meaning of their work to the facts at hand and the queries at the heart of the controversy.

To address this problem, today's program is the first in a series where we will discuss certain technical matters being mishandled regularly in the judicial system and how the mishandling of these technical matters threads itself through a typical business valuation project requested of experts in matters of controversy.

Our primary focus today will be the market approach to business valuation. As is well-known within the business valuation user community, there are three broad approaches commonly used to value equity ownership interests. These approaches include the income approach, the cost/asset approach and the market approach. Within each approach, there are a number of commonly accepted methodologies under which expressions of value might be developed for consideration.

Professional standards require that the business valuator consider all three approaches. That is not to say that a business valuator is required to use all three in any particular assignment or that he or she is not permitted to exclude an approach if it does not fit the facts and circumstances. The professional standards require only that all three approaches be considered. Stellar practice would dictate that business valuators fully explain their reasons for using or not using a particular approach in any given assignment, though excluded approaches are often not addressed in the reports. As such, users are left with no alternative other than to surmise the reasons behind the exclusions.

The question then, to the participants today, is: why focus on the market approach first? Certainly, there are numerous problems in misapplication of underlying theory in both the income and the cost/asset approaches. However, the most egregious problems encountered by the authors in recent years have been rooted in misconceptions relating to the market approach and errant application of the foundational theory relating to this approach.

While there are a number of areas of difficulty in applying the market approach and the methods available thereunder, the approach, if properly applied, is sound. Predicated on the general economic concept of substitution (i.e., an investor would not pay more for an equity ownership interest than he or she would pay for an alternative equity ownership interest with similar risks and returns), the market approach lives up to its name by bringing into the business valuation process information drawn from "real" market transactions.

The usefulness of the market approach is most commonly understood in its application to the real estate markets and the appraisal of real properties within that market. It is easy to appreciate the significance of the market approach when one considers the possible sale of a home. If a particular residence is positioned for sale, and several homes (of like condition and size, and within a distance of several miles) have recently sold for $350,000, it is likely that these "market" transactions will have a heavy influence in estimating the value of the home being positioned for sale. Because potential buyers are generally not going to pay significantly more than the average sales price for a home in that area, and the seller is generally not going to accept significantly less than the average sales price of the recently sold homes, those transactions may serve as a strong indicator of the value of the home being put up for sale.

The market approach applies equally as well to the valuation of equity ownership interests. Real market information, if properly applied, allows the jurist to separate the judgment of the expert from that of other actors within the market transacting for similar equity ownership interests.

The issue, of course, is in the application of the approach and the methods available thereunder. There are no two businesses that are exactly alike. Nor are there any two management groups that are exactly alike. As such, it is, first and foremost, necessary that the business valuator demonstrate, through the application of appropriate procedures, that those companies he or she has selected to be used in the market approach, and from where indicators of value will be drawn, have that level of similarity to the company under valuation required to make the use of those value indicators meaningful and useful.

Beyond the issue of similarity in assessing the viability and proper application of the market approach, are the issues of standard of value and the valuation platform. The issue of standard of value is one of definition. Obviously, when one speaks of value, each individual hearing the word has a preconceived notion as to what the term means. Standard and commonly accepted definitions, and understanding the definitions and nuances thereof, allows for the uniform application of procedures within the business valuation process that can lead to meaningful conclusions of value properly aligned with assignment parameters. While it would seem that definitions are well understood by members of the business valuation community, recent cases in which the authors have been involved seem to indicate that proper use of standards of value is an area rife with problems.

Beyond standards of value, proper understanding of a business valuation opinion of value requires the reader to fully understand the premise of value. Premise of value is not as much a standard or definition as it is a characteristic of the type of value being established within the assignment. Generally, premise of value is bifurcated into "value as a going concern" and "value determined under a forced or orderly liquidation." However, the premise of going concern goes far beyond the typical accounting or legal definition as applied in a business valuation. Of recent note, this most important element of fair market value has been misapplied in a number of instances where the authors have been engaged on the opposing side of the matter.

Platform of value refers specifically to levels of value. Levels of value can play an important role in matters of controversy, depending on the nature of the matter involved as well as the size of the equity ownership interest under valuation. Levels of value generally dictate the propriety and need for valuation adjustments. Most often, these adjustments are incorporated as valuation discounts or premiums.

Finally, the matter of internal and external transactions in the subject company equity ownership is an area that seems to be constantly misapplied. In respect to these transactions, focus must first be turned to the independent and arm's length nature of the transactions completed on the inside of the company. With respect to external transactions, the stage of transaction, as well as the appropriate standard of value, must first be considered in drawing any proxy indicators to be applied to subject company measures to produce an estimate of value.

There are additional issues associated with the use of the market approach, including information and database limitations, multiple adjustment calculations, statistical reliability and specific events affecting the propriety of information gleaned from public trading markets. These, as well as other issues, will be discussed throughout this presentation.

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As always, the materials are divided into different chapters to allow for ease of understanding and separation of issues. These chapters include:

Chapter I – ***Introduction***

Chapter II – ***Methods Available Under the Market Approach***

Chapter III – ***Standards of Value and their Application in the Market Approach***

Chapter IV – ***Issues in Applying the Going Concern Premise of Value in the Market Approach***

Chapter V – ***Understanding Levels of Value in the Market Approach***

Chapter VI – ***Sufficient Similarity of Guideline Company Selection***

Chapter VII – ***Conclusions and Practical Considerations***

We appreciate the opportunity to have worked with many of you in the past, and we thank you for your continued support in affording us an opportunity to provide expert economic, financial and valuation services as you represent your clients. We look forward to continuing to work with you.

Please feel free to contact any of the speakers if you have questions that we do not address. Thank you!

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II. Methods Available Under the Market Approach

To best understand the market approach, it is first necessary to understand the different methodologies that are available to the business valuator under the approach. As with the income approach and the cost/asset approach, there are multiple methods under the market approach by which a value conclusion can be ascertained. The methods most commonly employed include:

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

Guideline Public Company Method

Under the guideline public company method, the value multiples selected by the valuator for application to the subject company under valuation are developed from identification and analysis of companies that are traded freely on an open stock exchange in the public markets. Interest in this method is high within the business valuation community and with users of business valuations for numerous reasons.

First, the sheer number of publicly-traded companies offers the business valuator an opportunity to draw comparable guideline companies from a broad pool of potential candidates. There are currently approximately 3,600 companies registered in the U.S. Stock Market, excluding investment funds and trusts. The market, in terms of the number of listed companies, was at its peak in 1996 reaching a high of 7,322 companies.[1] The precipitous drop is the result of two forces: a low number of new listings and a high number of delistings, which are driven by mergers and acquisitions, failure to meet exchange listing requirements and companies going private.

However, although they have decreased in number, public companies have grown in size. Their total market value, as a percent of gross domestic product, is close to the peak reached in 1999.[2]

It is noteworthy that many of these registered and reporting companies represent smaller and medium-size businesses, thus expanding the use of this method from only large companies in the past to many smaller and medium-size privately-held businesses in today's current valuation environment. Thus, it is clear that, more than ever before, the guideline public company method is a useful and necessary undertaking in these valuations.

[1] *Where Have All the Public Companies Gone?*, Editorial Board, Bloomberg Opinion, April 9, 2018. https://www.bloomberg.com/opinion/articles/2018-04-09/where-have-all-the-u-s-public-companies-gone

[2] Ibid.

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Second, the guideline public companies offer a significant amount of quality financial, industry and economic data by which to determine the degree of comparability. The financial reporting requirements mandated by the Securities and Exchange Commission (SEC), as well as severe scrutiny applied to publicly-traded companies by virtue of investment analysts and other interested parties, serve to ensure that the affected companies present a great deal of information to ensure compliance. This information, properly applied, allows for more direct analysis, better selected comparables and, ultimately, a better valuation conclusion.

Finally, the guideline public company method incorporates, by its mechanics, observations of actively-traded stocks that are price-driven by independent third-party investors. Those risks-vs-return considerations contemplated by these investors mirror those that would be considered by a hypothetical buyer or seller of the subject company under valuation. Thus, use of this method directly correlates value to market investor expectations.

Guideline Completed Transaction (Merger and Acquired) Method

The guideline completed transaction method, often referred to as the merger and acquisition method, offers an alternative to the guideline public company method in incorporating market-value observations. Under this method, rather than looking to trading prices of publicly-traded stocks, focus is turned to observations of value indicators produced through closed and completed acquisition transactions.

The guideline completed transaction method has taken on wider appeal over the last several decades due to substantially greater availability of transaction data. The number of transaction databases and transaction source data available to business valuators and users of business valuation reports has grown from zero (at the inception of Revenue Ruling 59-60) to well over 100 as of the date of this presentation.

Transactions providing financial data useful to business valuators under this method are generally classified into one of four categories:

- Private company sale to public company requiring an SEC 8-K filing
- Private company sale to public company with no SEC 8-K filing
- Private company sale to private company

In most instances, valuation assignments requiring market transaction observances related to medium-size and smaller privately-held companies default to databases setting forth information on private company sales to private companies.

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Over the last decade, those databases capturing private-company transactions that are most often used by business valuators in the application of the guideline transaction method have added information from a substantial number of transactions per year. As the databases grow, the validity of this method will garner even more acceptance.

The most significant challenge to business valuators in using the guideline completed transaction method is availability of detailed information sufficient to interpret deal structure and to draw inferences of comparability. A number of the databases contain incomplete information that, ultimately, is inadequate for such assessments. Given this very serious limitation, the guideline completed transaction method is seldom used as a primary valuation method. However, it is still important to consider the method as confirming indications of value produced under other valuation methods. As such, its usefulness should not be dismissed out-of-hand.

Subject Company Past Completed Transactions Method

Perhaps the most straight forward way to incorporate "actual" transaction data into the business valuation process is to review and consider past transactions involving the subject companies' equity interests. Generally, these types of transactions are either classified as control or minority transactions. In the case of either a past control or a past minority transaction, the independent, objective and arm's length nature of the deal must be ascertained before the financial and valuation relevance can be determined.

Very often, dealings in private enterprises work to circumvent good faith and independence where motivations of the parties invoke self-interest. In such cases, it is necessary for the business valuator to "identify" and "unwind" those elements of the deal that are not arm's length. If this cannot be accomplished, the usefulness of past transaction data is questionable and, in a worst-case scenario, useless, in determining value at the current date.

If the company under valuation was recently acquired in total in an arm's length transaction, the value indicators resulting from that deal will be critically important in assessing current value. If it was acquired at arm's length, the "transaction" would serve as a credible guideline company under the guideline completed transaction method. Minority transactions from the past in the subject company's equity interests are much more likely to lack the "arm's length" character necessary to prove useful in the business valuation context.

Also, in many instances, one or more parties to the past transaction may be found to lack the financial sophistication to properly assess the transaction in which they were a participant. Even if the past transaction was found to be conducted at arm's length, this lack of participant sophistication could easily void the usefulness of those transactions.

Rules of Thumb

Rules of thumb are, very simply, multiples set forth by various parties, publications, industry organizations or business brokerage services. Most often these rules of thumb are based on suggested multipliers applied to an easily identifiable variable within the subject company's financial statements. Examples include the following:

- Multiple of Sales
- Multiple of Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)
- Multiple of Earnings Before Interest and Taxes (EBIT)
- Multiple of Seller's Discretionary Cash Flow or Owner's Cash Flow

Rules of thumb provide a useful means to confirm the reasonableness of value conclusions developed under more rigorous valuation methods. While it is generally considered improper to dismiss rules of thumb out-of-hand, it is also deemed improper within the business valuation community to accept rules of thumb carte blanche, without further analysis and understanding of how they were developed.

Guidance for the use of rules of thumb is set forth in the American Society of Appraisers' Business Valuation Standards[3] as follows:

> *Rules of thumb may provide insight on the value of a business, business ownership interest, or security. However, value indications derived from the use of rules of thumb should not be given substantial weight unless supported by other valuation methods, and it can be established that knowledgeable buyers and sellers place substantial reliance on them.*

The most glaring challenge when using rules of thumb is the total lack of detail supporting the multiples. Seldom do the promoters of rules of thumb include details such as where (geographically) and when (date of transaction) the underlying transactions occurred. Also, it is uncommon to have detail available describing deal structure, deal terms or the acquired company's profitability. This "missing" detail is critical to the valuation process and this ommission often negates the usefulness of rules of thumb.

The four methods discussed above briefly describe the most common methods employed by the business valuation community in applying the market approach. The balance of the program will focus on providing a detailed understanding of the two-guideline company methods, including those mechanical steps required for proper utilization of the methods, as well as the advantages and disadvantages specific to these methods.

[3] American Society of Appraisers - *ASA Business Valuation Standards, BVS-V Market Approach to Business Valuation,* 2009, Section V, page 13.

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Common Databases and Information Sources

This section will present a brief discussion of some of the databases and sources that are available to valuators for use in applying the guideline public company and guideline completed transaction methods under the market approach. There are numerous information source choices available when a business valuator decides to rely upon a market approach. A business valuator who performs his/her due diligence will check each source for the best and most reliable data upon which to base his/her conclusion. However, it is also important to note that the sources can at times be duplicative, and it is critical that a business valuator not double count a transaction. The common databases and ressources available under each method are described below.

Guideline Public Company Method

When using guideline publicly-traded companies to value a subject company, different data sources are used. S&P Capital IQ and YCharts, both web-based platforms that cover the financial markets, are two options valuators use for comparables.

Although S&P Capital IQ is more robust in its offerings, both platforms allow a valuation analyst to quickly identify potentially comparable public companies to further vet for appropriate use under the market approach. Equity screens can be created by sector, industry, underlying financial metrics, etc. to expediently determine a narrower universe for consideration in the application of the guideline public company method.

Both databases contain the underlying financial information for publicly-traded companies and current and historical price and enterprise value data, allowing a business valuator to quickly determine valuation multiples for consideration. In addition to the financial information provided, both databases include a considerable amount of operational information as well as news, ratings and additional information. All of this information can be extremely valuable in discerning the appropriateness of using any specific public company as a guideline company under the market approach.

There are numerous other resources from which a business valuator can obtain market multiples including Alacra, Compustat, Disclosure, Hoovers, Reuters, Mergent Company Data Direct and OneSource. Each source contains data for currently-operating U.S. companies. They allow an analyst to search the companies using descriptive and financial variables. Adjustments may need to be made to the publicly-traded companies to make them comparable to the subject company. These adjustments are subject to the business valuator's professional judgment.

Guideline Transaction Method

There are a number of databases that gather information on transactions of businesses for use under the guideline completed transaction method. The most commonly used sources are:

- BIZCOMPS®
- DealStats
- Done Deals
- The Institute of Business Appraisers (IBA) database

The BIZCOMPS® database contains data on over 12,650 private company transactions with a median selling price of approximately $167,000. These transactions are searchable by four-digit Standard Industrial Classification (SIC) code and six-digit North American Industrial Classification System (NAICS) code, keyword, annual gross revenue, sale date and sale price ranges, and location of the transaction.

DealStats is a new platform that incorporates the private-company transaction comparables from Pratt's Stats and the public-company transaction comparables from Public Stats. DealStats went live on July 30, 2018, and took the place of the individual Pratt's Stats and Public Stats databases.

The Done Deals database contains nearly 7,000 transactions for private and public mid-market companies over the past 10 years, with sale prices ranging from $1 million to $250 million. Approximately 50% of the transactions have sale prices under $10 million. The underlying data is obtained from public company filings (8-K), when public companies acquire a private company.

The IBA Market Data database contains transaction data for sales of small to medium-sized businesses and has over 37,000 transactions spanning more than 800 different industries. Over 6,000 of the transactions in the database were completed during the last five years.

Conclusion

In selecting the most appropriate method under the market approach to utilize in any particular assignment, a valuator must exercise care to ensure that available information has sufficient similarity between the guideline companies identified in that process and the subject company under valuation. This will be discussed in detail in Chapter VI.

It is also important to note that there is generally some capability under each method to assist in the final determination of value. Often, however, market approach conclusions of value are best utilized as sanity checks against the result developed under another alternative approach.

III. Standards of Value and their Application in the Market Approach

Perhaps the most often confused element of any business valuation is the definition, or "standard" of value. The "true" value of any asset, tangible or intangible, is only realizable as a result of a completed transaction bargained at arm's length. Even then, it is often difficult to discern whether the asset transaction was consummated under independent and arm's length conditions, with fully knowledgeable parties in complete understanding of the economic risks and rewards of acquiring the asset. Very often, the authors have observed ancillary circumstances influencing transactions in business equity that work to void the "arm's length" bargaining that is so sorely needed in utilizing business valuations to resolve matters in a legal setting.

Understanding the standard of value required for any specific assignment is paramount to obtaining a conclusion or opinion of value that is both reliable and, just as important, relevant to the matter at hand.

As set forth in one of the profession's foremost treatises,[4] "The standard of value underlies the theoretical and practical applications of valuation and defines for the appraiser the type of value being sought."

What is Standard of Value?

The standard of value being sought in any particular business valuation application drives the business valuation process and is also critical to the proper analysis of all underlying financial and operational information. While standards of value have received attention and focus from a variety of sources, including the Internal Revenue Service, the Department of Labor, judicial applications and academic treatises, the most commonly accepted source of guidance in this area is provided through the *International Glossary of Business Valuation Terms*,[5] which defines standard of value as follows:

> ***Standard of Value*** *– the identification of the type of value being utilized in a specific engagement, for example, fair market value, fair value, investment value.*

Looking at value as a "type" of value immediately implies that there is more than a single kind of value. The *International Glossary* even notes three examples, which these materials will address, shortly.

The greater significance to the word "type," however, is the notion that there is more to the explanation and understanding of the term, "standard of value" than mere definition. There is no question that is exactly

[4] *Valuing a Business, The Analysis and Appraisal of Closely Held Companies,* Fifth Edition, Shannon P. Pratt and Alina V. Niculita. The McGraw-Hill Companies, Inc., 2008, pg 41.

[5] *International Glossary of Business Valuation Terms*, 2001, as adopted by all major North American Appraisal Organizations.

the case, as each commonly accepted standard of value has its own set of characteristics and attributes, which differentiates it from others.

With respect to assessments of value and the resultant business valuation reports and conclusions of value set forth therein, it is incumbent upon the business valuator, first, to ensure that the reader absolutely understands the many nuances associated with each type of value. Second, and just as important, the engaging party (very often a member of the legal community), must use that information shared by the business valuator to select which standard of value he or she wishes the valuator to determine in the course of the engagement.

To be sure, the authors do not frequently encounter issues with respect to standard of value in the course of starting an engagement. The most common standards of value are generally understood at a very cursory level. What we do often identify as an issue in the course of our assignments is a misunderstanding of the finer points of the standard of value being utilized. These issues often have an impact on the determination of value which we are seeking and can serve to cause problems in the course of any particular business valuation.

Just as importantly, we often observe opposing business valuators taking unjustified liberties with respect to interpreting standards of value. It is difficult to determine if these cases present simple errant understanding of the required standard of value or if the opposing business valuators are posturing to set the opinion of value that they have produced to the most favorable negotiating position possible. In either case, the lack of respect for the characteristics and attributes innate to any particular standard of value can confuse the users of the report, including the trier of fact, in many legal proceedings.

Away from the controversy arena (in instances such as equity sales or repurchases, merger and acquisition transactions, drafting of shareholder/equity holder repurchase agreements, employee equity compensation plans, etc.), standard of value is equally important. The point of properly identifying the standard of value (i.e., the type of value being sought), in these instances is equally as important as those identified for use in a matter of legal controversy, if for no other reason, to avoid controversy at a later date.

The market approach within the discipline of business valuation, by its very nature and due to its mechanical procedures in application, often drives a divergence of opinion among business valuators. The problems arising from a misinterpretation of the standard of value issue can lead to wide variances between business valuator conclusions of value. Interestingly, the authors see adherence to governing professional standards and a deep understanding of the underlying aspects of each standard of value as the only means to avoid such contests going forward.

Understanding Standards of Value and the Market Approach in Controversy

Before moving forward with a dissection of the market approach and how standard of value can lead to issues in many of the resultant conclusions of value produced under that approach, it is important to gain an understanding of each of the relevant standards commonly utilized within the business valuation profession.

Those standards of value most commonly encountered by business valuators and often misunderstood by users of business valuation reports are:

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

While it can be somewhat cumbersome to have multiple standards of value with similar names, it is important that users (including members of the legal community) develop an intimate understanding of these terms before engaging business valuators.

Note that today's program will focus on fair market value, fair value – statutory, and investment value, as those three standards of value are the most problematic in assessing the veracity of conclusions of value produced under the market approach.

Fair Market Value

The most common standard of value is fair market value. This standard of value is used for all income tax and estate and gift tax valuations in the United States and in the Commonwealth of Pennsylvania. It is also used in many family law venues, including Pennsylvania, Ohio and West Virginia. Finally, fair market value is the standard of value most often utilized in equity repurchase agreements such as shareholder, partner and member buy/sell agreements.

The *International Glossary*[6] defines fair market value as:

> ***Fair Market Value*** *– the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.*

[6] *International Glossary of Business Valuation Terms*, 2001, as adopted by all major North American Appraisal Organizations.

Understanding Standards of Value and the Market Approach in Controversy

While similar, it is important to note that there are differences between the definition set forth in the *International Glossary* and the definition that the Internal Revenue Service sets forth in its interpretation. For many years, the primary theoretician in the development of business valuation theory was the Internal Revenue Service due to the prominent nature of the federal estate and gift tax regimes.

The primary definitional explanation of the term fair market value is based on a definition first set forth in 1959 in Revenue Ruling 59-60:[7]

> ***Fair Market Value*** – *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.*

While the language in the two definitions does not align precisely, it should be noted that many of the additional requirements associated with the definition in the *International Glossary* were born out of judicial, academic and economic developments that occurred in the intervening years since the Revenue Ruling was first released. For purposes of this program, we will build a framework based on an amalgamation of both definitions as the characteristics and attributes that are key to the required understanding of fair market value are common to both.

The first critical element is the inclusion in both definitions of the wording "change hands." This language requires that any fair market value determination be driven by a hypothetical purchase/sale transaction. This clearly speaks to the market approach, at least from a conceptual aspect, and is logical in defining value as any ultimate determination of value can only be confirmed in a sale or exchange of the asset under valuation.

Of course, in most determinations of value undertaken for the purpose of assisting legal advisors in representing their clients, there is no real transaction involving the subject company under valuation or any ownership interest therein. In looking at the language the fair market value is *"the price at which the property would change hands."* In the Revenue Ruling, this language was interpreted as guidance that the contemplated purchase and sale was, indeed, hypothetical. This was later confirmed in various judicial decisions and came to be broadly accepted over time. As such, The *International Glossary* definition removed any question of the hypothetical nature of the purchase and sale of the property under valuation.

[7] Revenue Ruling 59-60, 1959-1 C.B. 237, 1959.

Understanding Standards of Value and the Market Approach in Controversy

Given that the common interpretation of fair market value requires consideration of a hypothetical transaction, determination of that value inherently includes focus and attention by the business valuator to those hypothetical buyers and sellers most likely to participate in the hypothetical transaction. It is also important to consider the concerns and issues that a potential hypothetical buyer and seller might contemplate prior to entering into such a transaction.

A significant issue related to these concepts often arises in the context of applying certain methodologies under the market approach. This is especially true with the guideline completed transaction method. As will be illustrated later in these materials, this method is commonly used by business valuators to draw indications of value from completed purchase/sale transactions. The issue that is front and center in these circumstances is that every completed transaction has a single particular buyer and seller.

Fair market value is a financial value. Another way to characterize the financial value element of fair market value is to note that it is not a strategic or synergistic value. The fact that fair market value constitutes a financial value dictates that all hypothetical buyers must be considered in the business valuation process. Generally, the business valuation profession refers to the "entire universe of hypothetical buyers," as consideration must be given to financial buyers and strategic or synergistic buyers. This is in direct conflict with the comparability of information obtained from the guideline completed transaction method under the market approach.

There can be no argument that any completed transaction has a single "actual" buyer and a single "actual" seller. Thus, transactions inherently limit the audience of hypothetical buyers. In addition, consideration must be given to the fact that many (if not most) completed transactions are undertaken at a purchase price that is inclusive of an acquisition premium.

Acquisition premiums are most often predicated upon strategic or synergistic opportunities that the actual buyer contemplates bringing to the acquisition target, after the transaction's closing. In other words, these premiums represent a "sharing" of the additional expected economic benefits associated with integration of certain expected cost savings or revenue enhancements associated with the incorporation of buyer synergies. This is a very common occurrence given the supply and demand for business acquisitions.

At a minimum, it is certain that any purchase price set forth in the completed transactions analyzed in the guideline completed transaction method under the income approach contains "specific buyer motivations." Unfortunately, available information on completed transactions rarely (if ever) is sufficient to establish an estimate of the premium that was paid as a result of strategic initiatives, synergies or buyer motivations.

As a result of this inability to reasonably identify and quantify the acquisition premiums, and the commonly accepted premise that the standard of value developed under the guideline completed transaction method is investment value (discussed later in this chapter). It should be understood that indicators of value developed from application of this method are often not valid determinants of fair market value.

It is important to note that the hypothetical buyer in a fair market value determination is never the most likely buyer. Instead, the most likely buyer is just one of all potential hypothetical buyers envisioned in the "entire universe of hypothetical buyers." This point is often lost in valuations conducted in the course of a controversy matter.

Further, the fair market value standard is inextricably tied to the "going concern" premise of value for healthy operating companies. Discussed in the next chapter, fair market value and going concern anticipate a value of the subject company "as it is" at any particular date of valuation. The inclusion of strategic or synergistic attributes that *might* occur as the result of a hypothetical transaction is to go beyond the scope of the fair market value standard and results in an overstatement of value.

The definition of fair market value also anticipates a value determination under prevalent economic and market conditions at any particular date of valuation. To assume an economic or market turnaround at a point in time beyond the date of valuation will result in a value other than fair market value.

Finally, fair market value, by definition, must allow a reasonable time for exposure in the open market. For equity ownership interests requiring longer periods of exposure, marketability (or rather, the lack of marketability) presents a significant investment risk and, therefore, a value detriment.

Both the guideline public company method and the guideline completed transaction method under the market approach work to produce a value that is presumed to be "marketable." As such, and as will be illustrated later in these materials, discounts are most often applied to adjust the marketable values to "nonmarketable" values, if required in the business valuation process.

Fair Value – Statutory

In most states, fair value is a legal concept and a statutory standard utilized to resolve shareholder disputes for both dissenting shareholder and oppressed equity owner lawsuits and civil actions. In the authors' experience, many states' statutes define fair value as fair market value *without* consideration of certain valuation discounts.

Interestingly, due to the dependence on statutory guidance that varies from one jurisdiction to the next, the authors of the *International Glossary* purposely omitted the term, preferring instead to defer to guidance from the legal community in setting the appropriate definition of fair value on a case-by-case basis.

Understanding Standards of Value and the Market Approach in Controversy

Fair value determinations are rarely undertaken, except in assignments relating to dissenting shareholder and oppressed equity owner disputes. Unfortunately, it is in these types of controversy matters that the authors most often observe undue and unsupportable reliance on the indications of value produced under the market approach. In these instances, it is common to see business valuators working on behalf of plaintiffs to place significant reliance on the market approach (and especially, the guideline completed transaction method), thus, overstating value. Such overstatements often prove troublesome as the chasm between opposing valuators' conclusions of value widen to a range from which it is difficult to negotiate early settlement.

Investment Value

As noted above, fair market value is a financial measure of value. Financial value must be distinguished by users of business valuations from strategic or synergistic measures of value. These latter terms are generally referred to as investment value.

While it is a common type of value sought within the business valuation community, investment value differs markedly from fair market value. The *International Glossary*[8] provides the following definition:

Investment Value *– the value to a particular investor based on individual investment requirements and expectations.*

Investment value is that value under which most completed transactions occur as those transactions are no longer hypothetical but have actually closed. Under these circumstances, actual buyers have negotiated with sellers (presumably at arm's length) to facilitate an acceptable and mutually agreed purchase price.

Logically, completed transactions cannot occur without the presence of a specific buyer who brings certain strategic or synergistic advantages and/or specific buyer motivations, requirements and expectations. Most often, these particular buyer attributes are specific to that one single buyer and, as a result, are not common to all potential buyers in the entire universe of hypothetical buyers envisioned in fair market value determinations. Thus, investment value differs from fair market value in this important way.

As one would conclude, investment value can be referred to as synergistic or strategic value. This reference reflects the impact of those synergistic or strategic benefits one particular buyer may bring to the negotiating table in determining investment value. Such buyer-specific benefits might include:

- An ability to enhance future operating performance
- An ability to mitigate certain risk inherent in the subject company

[8] *International Glossary of Business Valuation Terms*, 2001, as adopted by all major North American Appraisal Organizations.

- An ability to more efficiently finance the acquisition of the subject company
- An ability to assimilate current operations synergistically with the subject company

In most instances, investment value will exceed fair market value. This phenomenon, as noted earlier, is primarily the result of the supply and demand continuum for potential target company acquisitions. As competitive bidding progresses in the negotiation process, the marketplace reveals that prospective specific buyers are generally willing to pay a premium beyond fair market value to close the deal. Additionally, as noted, anticipated post-acquisition cost reductions due to operational synergies may allow for the payment of a premium.

If one were to think of payment of an acquisition premium for any business, or interest in that business, it is easily assessed in terms of expected free cash flow.

By way of example, assume that a company is expected to provide $1,000 per year in future free cash flow and that the risk rate assigned to the investment opportunity is 20%. In this instance, the implied value is $5,000 ($1,000 /.20).

If the buyer believes they can increase the free cash flow from the business post-transaction by reducing costs, net of the tax savings associated with those costs by $200, the expected free cash flow is modified to be $1,200 per year. Assuming the same risk rate, the estimated value is now $6,000 ($1,200/.20).

It would be unreasonable to expect the buyer to pay $6,000 when the business, on a stand-alone basis, is expected to generate just $1,000 of free cash flow. However, the competitive nature of the mergers and acquisition markets dictate that some portion of the $1,000 synergistic premium be shared with the seller.

The resultant negotiated purchase price would clearly be investment value, while the stand-alone value is much closer to fair market value.

Considerations in Business Valuation Fundamentals

A business valuator must determine if the indicated value resulting from the application of the three broad valuation approaches (market-based, income-based and cost/asset-based) provides a value indication aligning with the desired standard. If the resultant value is not in line with the desired standard, the business valuator must perform one of the following actions:

- Adjust the indicated value so that the result aligns with the desired standard, if an adjustment can be quantified and applied using reasonable inputs, and apply the approach as a primary valuation method

- Quantify an adjustment using the best available inputs, adjust the indicated value so that the result aligns with the desired standard, and apply the approach as a secondary or confirming valuation method
- Dismiss the use of that particular approach if an adjustment cannot be reasonably quantified

As discussed earlier in these materials, two primary methods of valuation exist under the market approach for the appraisal of equity ownership interests. These include the guideline public company method and the guideline completed transaction method.

The guideline public company method utilizes trading prices of public companies to calculate an indication of value for the subject company. The guideline completed transaction method utilizes the transaction price of completed transactions of businesses to calculate an indication of value for the subject company.

Detailed in Chapter II, data for the guideline methods are compiled in various transaction databases which source the information from SEC filings and disclosures, foreign securities regulators and brokers' associations, among others. Under both methods, value indications are presented in the form of earnings multiples, which can be applied to subject company earnings.

Fair Market Value or Investment Value?

It is commonly accepted among the business valuation community that a conclusion developed under the guideline public company method under the market approach more closely aligns with a fair market value conclusion. That consensus opinion has developed because the public markets, with active and freely-traded shares, rarely incorporate strategic or synergistic investor perceptions about value of those equities.

The answer is far less clear when considering the guideline completed transaction method under the market approach. The market transactions that have closed and are included in various transaction databases generally represent acquisitions of 100% of the target company, or at least a very large controlling block. As the guideline transaction has closed, there was a single, specific buyer with potential strategic or synergistic attributes and specific buyer motivations. Since this is the case, many valuators interpret the result under the guideline transaction method as an investment standard of value.

When utilizing a market approach and, specifically, the guideline completed transaction method thereunder, a primary issue relating to the standard of value is properly adjusting market-based indications of value for buyer-specific motivations which, by definition, must not be considered under the fair market value and fair value standards of value. Said another way, a business valuator must take data from actual transactions, which, when utilizing the guideline completed transaction method, usually falls under the investment value standard, and attempt to remove the impact of buyer specific motivations to place the information in line with either the fair market value or fair value standards.

When analyzing specific transactions to determine if the transaction is synergistic or strategic in nature, business valuators commonly consider the following:

- Does the buyer provide a similar product or service to the target?
- Does the buyer provide a complementary product or service to the target?
- Has the buyer made acquisitions in the industry previously?
- Does the buyer have an existing business relationship with the target as a vendor?
- Does the buyer have an existing business relationship with the target as a customer?

In each of these cases, it is likely that the buyer in the actual transaction will recognize a larger financial benefit as a result of the acquisition than a purely financial buyer would. Once it is established that the transaction has some level of synergy built into the deal price and resultant earnings multiples, the difficulty then lies in quantifying the impact of the synergy on the deal metrics. The adjustment necessary to bring the indicated value from the investment value standard to the fair market value standard will be discussed later in greater detail.

Conclusion

The standard of value is driven, first, by the purpose of the valuation assignment. In the context of matters of controversy, as well as planning initiatives guided by members of the legal community, the purpose and standard of value are set by counsel after consultation with the business valuator. For this reason, the desired standard should not generally pose an issue for business valuators. However, in applying any selected standard of value, care must be taken to ensure that the many nuances of each particular type, or standard, of value be considered in interpreting the results attained from the application of any valuation approach or method.

In particular, when applying the market approach, the application of the available methods can cause a variety of issues relating to the interpretation of available data, the ability of the business valuator to reasonably isolate buyer-specific motivations, and the certainty that the value indication aligns with the desired standard. As such, business valuators must critically analyze the data and information available in an effort to gain a sufficient understanding of the transaction(s) in order to utilize the market approach as a primary approach to valuation.

It is also incumbent that users of business valuation reports, and in particular, members of the legal community representing clients where matters of value are central to the controversy, be knowledgeable of these same nuances and potential issues that can arise from misinterpretation and misapplication of the standard of value.

IV. Issues in Applying the Going Concern Premise of Value

Perhaps no element of valuation of privately-held businesses, or equity ownership interests therein, is more misunderstood than premise of value. This is a particularly complex concept in applying the market approach to valuation. The difficulty in properly addressing this element of business valuation is how it is intertwined with the standard of value issues discussed in the last chapter of these materials. As a result of this complexity, the authors regularly find this element misused by opposing experts, often causing confusion within the business valuation user community, including the courts.

Any proper understanding of premise of value should be first founded in the definition set forth in the *International Glossary of Business Valuation Terms*,[9] which provides:

> ***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, liquidation*

A careful read of this definition sets out several critical points for consideration, which are each intended to provide guidance to business valuators in the process of conducting a business valuation. Remembering that both the standard of value and the premise of value are essential components to providing a conclusion of value that aligns with the purpose of the valuation assignment confirms the critical nature of understanding these points. Practitioners in the legal community, as well as other users, such as jurists, would be well served to understand these points, as well.

The first point is that the premise of value is an "assumption." Again, by common definition, an assumption is a thing or matter that is accepted as true or as certain to happen without proof. In the world of business valuation, such a definition essentially equates to valuator judgment. While valuator judgment can (and will) vary among business valuators, it should be noted that this matter of assumption must be threaded through various other basic business valuation concepts.

The most important of these basic concepts is that valuation is an exercise that produces an opinion of value as of a single pre-determined date. The intent of a valuation prepared for a particular date of valuation is never intended to apply to a date other than that date, and if the value were to be found to be the same on two different dates, it would simply be coincidence.

In considering any particular date of valuation, a second fundamental concept with which business valuators must comply is that only what is "known or knowable" at that date certain for the valuation is subject to consideration in the procedures adopted in the assignment. The importance of this element of business valuation

[9] *International Glossary of Business Valuation Terms*, 2001, as adopted by all major North American Appraisal Organizations.

cannot be overstated. The authors often find that opposing experts tend to "hypothesize" as to more beneficial expectations that fail to be grounded in historical information associated with the subject company or the expected operational circumstances contemplated by the management group in place at the date of valuation.

It is inappropriate, and noncompliant with professional standards to forecast or project future operational and financial performance that is not expected to result from the operational structure of the subject company at the date of valuation, if that operational structure is expected to continue. This fundamental concept then segues into the next useful phrase in the definition of premise of value, which is, "most likely."

There is no argument from the authors of these materials that every company being valued could change its operational and financial structure. That is not to agree that every change in operational or financial structure would or could improve the performance of the subject company. Nor, is that to be interpreted as the thrust of the language within the definition. "Most likely" should be interpreted literally and, as a result, it is incumbent upon valuators to assess the probability of operational and financial structure changes, then look to forecasting future expected economic benefits under that set of circumstances that carry the highest probability of occurrence. While such an outcome may be more easily understood in developing a financial forecast for purposes of applying a discounted future economic benefit method under the income approach to valuation, it is no less important in developing an expected value measure under the market approach, such as EBITDA, free cash flows, or even revenue.

The importance of the "most likely" language should be apparent. To incorporate a hypothesized change in operational and financial structure of the subject company, without an exceedingly high probability of these changes occurring as of the date of valuation, is to produce a conclusion or opinion of value that is errant and, as such, fails to contribute any clarity to the matter of value.

The "most likely" language is closely linked to the corresponding terminology, "set of transactional circumstances that may be applicable to the subject valuation." In effect, the probability estimates required of valuators in determining "most-likely" are inextricably tied to a specific set of operational and financial circumstances. It goes without saying that only one "set of transactional circumstances" are "most likely" at any date of valuation.

Very often, the authors observe opposing experts and business valuators using the market approach as a means of attempted contravention of these key points within the definition of premise of value. As an example, there is a clear line of demarcation between fair market value and investment value as discussed in the previous chapter of these materials. As illustrated in that chapter, this line of demarcation is generally attributable to an acquisition premium predicated upon specific buyer synergies that any single buyer might bring to the transaction. This circumstance allows for the payment of additional deal consideration because there is the availability of additional free cash flows due to those synergistic advantages.

Assuming the assignment requires determination of fair market value or fair value (as in a shareholder oppression matter), consideration of the potential synergistic transaction (inclusive of the acquisition premium) is not appropriate if the controlling equity owners have no intent to sell in the near- or mid-term. In such a case, of course, the intent of the current controlling equity owners to maintain the current operational and financial structure is a matter of heavy weight in deciding the most likely set of transactional circumstances envisioned in the definition of premise of value.

An aside in matters relating to premise of value (and the general discussion set forth in the preceding paragraph), is that noncontrolling, and/or minority equity owners do not carry with their ownership the ability to influence any major corporate decisions. This consideration must be incorporated into the valuator's determination of the most-likely set of transactional circumstances.

Finally, the definition of premise of value within the *International Glossary of Business Valuation Terms* provides two examples of premise of value: "going concern" and "liquidation." While these materials will touch on matters related to a liquidation premise of value later in this chapter, the primary focus is on the going concern premise of value.

Again, it is important to look to the *International Glossary of Business Valuation Terms*[10] for guidance as to the commonly accepted definition. In the provided definitions, there are two applicable terms:

> ***Going Concern*** – *an ongoing operating business enterprise.*

> ***Going Concern Value*** **–** *the value of a business enterprise that is expected to continue to operate into the future. The intangible elements of Going Concern Value result from factors such as having a trained workforce, an operational plant, and the necessary licenses, systems, and procedures in place.*

Because going concern is subject to definitional variations, the term is interpreted simplistically as the opposite of liquidation. In other words, a company is generally assumed to be in a position in its lifecycle to continue its operations and current success into the future or, alternatively, it is in that position that requires management to cease operations and liquidate the assets of the company after satisfaction of liabilities, if possible.

As an example of this alternate posture, *Black's Law Dictionary*[11] provides the following definitions:

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[10] Ibid.

[11] *Black's Law Library Free Online Dictionary,* 2nd Ed.

Understanding Standards of Value and the Market Approach in Controversy

Going Concern *– a business currently successful with indications in the foreseeable future of continuing to do well.*

Going Concern Value *– an operating, normally functioning business' worth to a buyer. This worth is usually more than the sum of the market's liquidation value of this entity's assets. It is viewed as excess value and is recorded in accounting as a firm's goodwill. This worth comes from market pluses, stated as good reputation, trained and retained workforce, successful processes, proven systems, solid operational equipment, and necessary licenses and permits coverage.*

Finally, the going concern accounting concept refers to the assumption that a company will continue to operate for the foreseeable future. This concept allows the company to include the value of intangible assets and anticipated profitability in its overall worth. Unless there is reason to believe a company is going out of business and ceasing operations, a company is always considered to be a going concern. Pursuant to the Financial Accounting Standards Board (FASB), continuation of an entity as a going concern is presumed as the basis for financial reporting unless and until the entity's liquidation becomes imminent. Preparation of the financial statements under this presumption is commonly referred to as the "going concern basis of accounting."[12]

The focus of accounting literature guidance on the term "going concern" is, first and foremost, on the expectation as to the continued operational and financial viability of the business enterprise at the date(s) at which the financial statements are applicable. In other words, the accounting focus is, generally, on any particular business's ability to continue forward through the end of the next accounting cycle.

While the legal definitions and accounting focus are not precisely in line with the definition of going concern set forth in the *International Glossary of Business Valuation Terms*, they are both helpful in interpreting the proper application of the term in the context of business valuation.

The technical nuances of the term "going concern" are most easily demonstrated through the use of an example. If one were to assume that the purpose of a requested business valuation is to establish the value of a minority-held equity ownership interest for purposes of allowing those equity holders to put their shares back to the company at fair market value (as set forth in their equity agreement), the issue of premise of value becomes an imperative in determination of that value.

The starting point for the analysis is the minority ownership position of the equity group desiring to be bought out. Obviously, a lack of a controlling interest, singularly nor collectively, prevents that group of equityholders from exerting any influence on intended management decisions with respect to the operations or finances of the subject company. Thus, management intent works in such circumstances to influence the most likely set of transactional circumstances.

[12] FASB Accounting Standards Update No. 2014-15 – Presentation of Financial Statements – Going Concern (Subtopic 205-40), August 2014, paragraph 205-40-05-1.

Understanding Standards of Value and the Market Approach in Controversy

Under the market approach, the authors often observe other business valuators and opposing experts suggesting that the sheer number and volume of completed transactions reported in available transaction databases indicates that the most likely buyers of the subject company are strategic or synergistic buyers. As such, these individuals often argue that valuation multiples developed from analysis of these synergistic transactions constitutes fair market value.

The fatal flaw in such an argument is in the going concern premise of value underlying the standard of value. To be sure, as noted in the prior chapter, there are technical standard of value issues which could be argued in either direction. The authors have observed that in certain industries, and at certain timeframes, industry roll-ups and other consolidation practices suggest that the most likely buyer for any enterprise would be an investment buyer. However, in assignments requiring an opinion of fair market value or fair value, most likely buyers are not relevant. In these cases, business valuators are required to look to the hypothetical buyer.

While fair market value and fair value, as standards of value, both contemplate an entire universe of hypothetical buyers (inclusive of both financial buyers and synergistic and strategic buyers, as well as others), completed transactions under the market approach have a single buyer. At a minimum, this single buyer brings single-buyer motivations to the transaction, thus violating a fundamental precept of the definitions of fair market value and fair value.

Financial value with the subject company's expected operational and financial structure as of the date of valuation is the only means to producing fair market value and fair value determinations. While gleaning indicators of value from both the guideline public company method and the guideline completed transaction method under the market approach to valuation through the development of valuation multiples can be helpful, care must be taken to ensure that the resultant conclusions of value address the standard of value expected in the assignment.

The fair market value and fair value standards of value are buoyed by proper application of the going concern premise. At any particular date of valuation, a noncontrolling equity holder maintains an ownership interest in that entity alone. As such, for business valuation purposes, that equity owner is deemed to own his or her share of the subject company's assets, reduced by his or her portion of the company's liabilities. Importantly, he or she also is entitled to the net free cash flows associated with the net assets. Thus, the value of the equity owner's interest is, first and foremost, worth the present value of those expected future economic benefits (free cash flows). The level (or amount) of those free cash flows is dependent on how the net assets are deployed by management, as guided by the majority equity owners.

The value of the noncontrolling interest is based, then, on the operational and financial structure in place at the date of valuation and, importantly, the operational and financial structure expected to be in place in the near- and mid-term future.

This position is supported by the legal definition of going concern value, as stated above as, "An operating, normally functioning business' worth to a buyer." The definition presupposes an operating and "normally" functioning business, suggesting that it is the company's normal activities that are to be considered in a determination of going concern, as opposed to some hypothetical change in the operations brought about by a potential or presumed synergistic acquisition.

Though not as much a bright line, the accounting focus on going concern, referring to the assumption that a company will continue to operate for the foreseeable future, does provide indirect evidence of the need in valuation to consider just the company as its assets are currently deployed. Clearly, any consideration of going concern from an accounting pretext is limited to an analysis of the company's assets and liabilities, as well as possible operational and financial decisions at the date of the financial statements (the balance sheet date). It would be inappropriate to make an assessment of going concern in light of a reorganization or restructuring of some type unless those changes were contemplated prior to the release of the financial statements.

In the end, it is appropriate to interpret the going concern premise of value as encompassing just those assets and liabilities that are in place at the date of valuation, modified by the expected changes known as of that date (i.e., the subject company's expected operational and financial structure.) To incorporate unexpected changes in the operational and financial structure, especially those related to strategic or synergistic benefits that could only be afforded by an investment buyer, is to overstate the value of the enterprise. Assuming the purpose was to develop a determination of fair market value for purposes of facilitating a minority ownership buyout, such an approach would unfairly enrich the departing equity owners at the expense of the remaining equity owners.

The remaining premise of value, liquidation value, is defined in the *International Glossary*[13] as follows:

> ***Liquidation Value*** *– the net amount that would be realized if the business is terminated and the assets are sold piecemeal. Liquidation can be either "orderly" or "forced."*

Liquidation value contemplates a non-operating or poorly-operating company value and one that is moving towards or in the process of liquidating all of its assets. As such, it would not be expected within the business valuation community to have any unrecorded intangible value such as goodwill. In the experience of the authors, material valuations of liquidating companies require fixed asset and real estate appraisals to establish the value of the underlying assets.

[13] *International Glossary of Business Valuation Terms*, 2001, as adopted by all major North American Appraisal Organizations.

Once all asset values are determined, the decision must be made as to the best course of action and whether the liquidation will be orderly or forced.

The terms, "orderly" and "forced" liquidation value, are defined in the *International Glossary*[14] as follows:

> ***Orderly Liquidation Value*** – *liquidation value at which the asset or assets are sold over a reasonable period of time to maximize proceeds received.*
>
> ***Forced Liquidation Value*** – *liquidation value, at which the asset or assets are sold as quickly as possible, such as at an auction.*

It is important to note that all costs of liquidation, including taxes (where applicable), must be factored into the determination of liquidation value. Further, note that any valuations associated with liquidation value are undertaken on a cost/asset approach and, as such, do not present issues within the reach of the market approach or any of the methods thereunder.

Conclusion

Understanding and properly addressing premise of value in business valuation generally, and in the application of the market approach, in particular, is critical to the expression of an opinion or conclusion of value that is technically correct as well as defendable and in compliance with professional guidance and standards.

[14] Ibid.

V. Understanding Levels of Value in the Market Approach

In the context of determining the value of a business ownership interest, the level of value relates to the characteristics of that ownership interest. Specifically, the various levels of value are defined by the interest's attribute of control over the operations of the business, and the marketability of the interest.

Control and marketability attributes are inherently tied to the resultant value of a specific ownership interest. All other factors aside, owning an equity interest that allows the holder the perquisite of control over a business's operations is more valuable than an identical interest that does not allow for control. Marketability refers to the ability to quickly convert property to cash at minimal cost. An asset that cannot be quickly converted to cash, or is not marketable, is worth less to a hypothetical investor than an identical asset which can be converted to cash quickly due to the time and effort needed to liquidate the asset.

Similar to the standard of value, the desired level of value within any valuation assignment is not a judgmental decision on the part of the business valuator; rather, it will be defined by the characteristics of the specific equity ownership interest under consideration. The level of value desired will be determined by the level of control that the ownership interest has over the business, as well as the marketability of the subject ownership interest. Further, depending on the approaches utilized to produce an indication of value, along with the inputs to those approaches, the resulting value indication may need to be adjusted to arrive at the desired level of value.

Historically, the business valuation and finance communities have assumed that the ownership of an asset can be categorized into one of three basic levels of value:

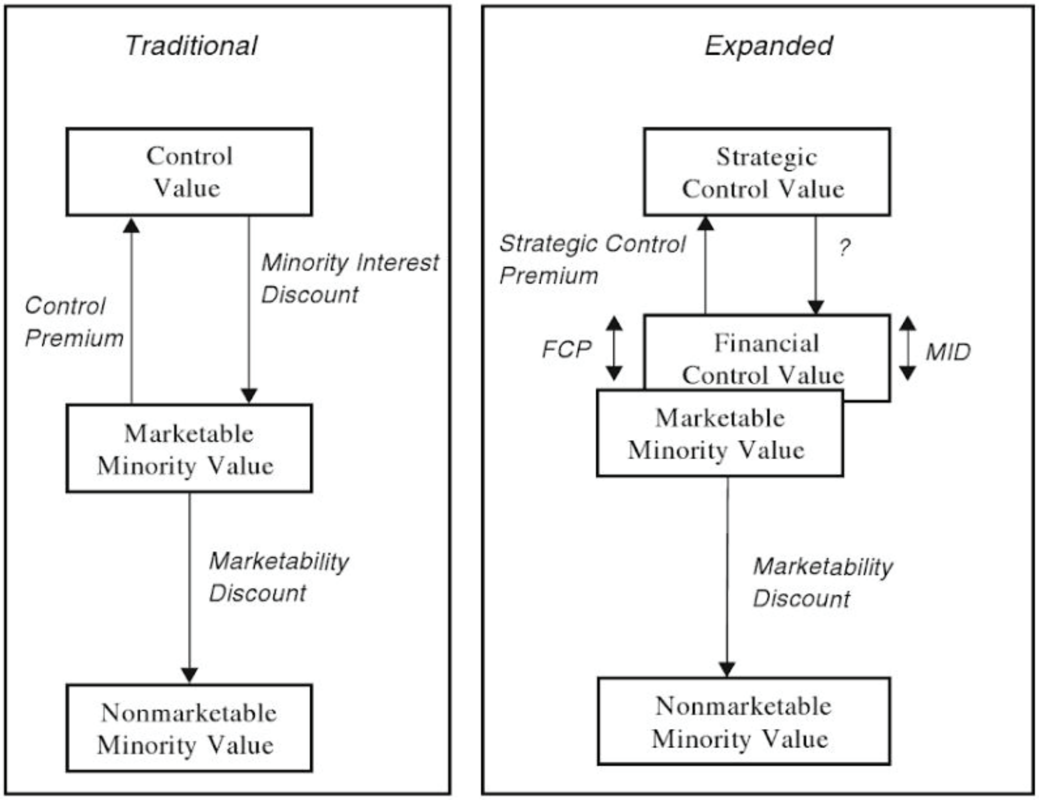
- Control, marketable interest value
- Minority, marketable interest value
- Minority, nonmarketable interest value

It has become apparent, however, through the observation of market-driven information, that premiums paid in the marketplace for controlling interests in business enterprises may also include a synergistic or investment premium. Such observation has led to an expansion of the traditional levels of value model as demonstrated in the graphic on the following page.[15]

It is important for the business valuator to understand the characteristics of the ownership interest under valuation, as well as the standard of value, as this will determine the desired level of value.

[15] *Business Valuation, An Integrated Theory*, Second Edition, Z. Chrisopher Mercer and Travis W. Harms. John Wiley & Sons, Inc., 2008, pg 83.

TRADITIONAL AND EXPANDED LEVELS OF VALUE



As discussed, facts and circumstances embedded in the inputs and calculations prepared during each valuation engagement will determine the level of value implied as a result of the business valuator's procedures. Further, depending on the methodologies employed, the valuation professional will need to determine the applicability of additional discounts or premiums necessary to bring the calculated value to the appropriate level of value.

In almost every case, the result obtained under the guideline completed transaction method is deemed to be either control, marketable value or strategic control, marketable value. In most cases, those values are assumed to be a strategic control, marketable value. The relevant point of a finding that the value determined under the guideline completed transaction method is that the standard of value moves from fair market value to investment value.

As discussed in Chapter III, earnings multiples from any completed transaction inherently incorporate specific buyer and seller motivations. In addition, many of the transactions reported in the valuation databases involve buyers and targets in similar or complementary lines of business. For this reason, many business valuators believe that results under the guideline completed transaction method incorporate an element of synergistic or strategic value.

Understanding Standards of Value and the Market Approach in Controversy

Under the guideline public company method, there are varying schools of thought regarding the resulting level of value derived from prevailing stock prices. The first opinion is based upon the notion that publicly-traded company stock prices are based upon the trading of minority blocks of stock and, therefore, result in a noncontrolling, as if freely-traded (marketable) value. If such were the case, it may be necessary to increase the valuation multiples developed thereunder for the attribute of control. Such a valuation adjustment to the multiple would generally result in a higher value and is generally incorporated as a control premium adjustment.

However, there is a growing element in the business valuation community that rebukes the conclusion that the guideline publicly-traded company method produces noncontrolling, as if freely-traded (marketable) value. These commentators theorize that the conclusion of value attained under the guideline publicly-traded company method is neither a control nor minority value, which leads to the conclusion that the application of a control premium is not required to produce a control value.

The primary support for this theory is the argument that the strict regulations, as well as emphasis on returns at the individual shareholder level for publicly-traded companies, essentially require management to optimize financial operations and performance. Therefore, while the returns anticipated by a shareholder of a public company are based on individual share prices, there is theoretically no ability for a controlling shareholder to further increase those returns without bringing some level of synergy.

Understanding levels of value is critical to reconciling the conclusion of value developed under these market approach methods. For instance, if the valuator is engaged to determine the fair market value of a minority interest in a privately-held enterprise (which is often the case), the result produced under the guideline public company method would require a discount for lack of marketability. Alternatively, if the valuator was determining fair market value under the guideline completed transaction method, the adjustments required might include a discount reflective of the strategic premium included in that conclusion. Thereafter, the valuator would likely apply a discount for lack of control as well as a discount for lack of marketability.

Due to the strategic nature of certain completed transactions, the primary issue for business valuators becomes adjusting the guideline earnings multiples to exclude buyer-specific motivations in a reasonable fashion. While many publications have discussed and critiqued models that can be used to calculate discounts for lack of control and discounts for lack of marketability, no such commentary exists to aid valuators in quantifying adjustments for synergies. Valuators must attempt to determine what amount of each deal relates specifically to the strategic or synergistic premium. Without an indication of how to quantify such a premium, determinations made under this method will most likely be rendered unreliable.

Understanding Standards of Value and the Market Approach in Controversy

In instances where a transaction requires that a fairness opinion be obtained, details within the fairness opinion can help the valuator quantify what portion of the deal price represents a synergistic or strategic premium shared by the buyer with the seller. If the buyer is a public company, information within the buyer's annual or quarterly SEC filings may have information available for valuators to assess the level of synergistic premium paid as part of the transaction. Often, however, the level of detail necessary to precisely quantify the level of synergistic premium in not available.

One unique scenario that can provide business valuators quantifiable proxies for synergistic premiums within the market is when a public company is acquired. Prior to being acquired, the value of public companies is determined by investors trading shares on the open market. As noted, the trading price is generally seen as a marketable value that represents both a control and non-control level of value. When the company is acquired, the difference between the purchase price and the trading price is representative of the premium that the buyer is willing to share with the target in recognition of the synergies that will be recognized after the acquisition by the buyer.

Conclusion

In applying the market approach in valuing a business ownership interest, care must be given to attaining the proper level of value required. As the level of value is driven by the characteristics of the equity ownership interest under consideration, the "target" level of value is pre-determined. The business valuator will need to apply the market approach and potentially apply additional discounts in order to match the concluded level of value to the target level of value.

As users of valuation reports, the legal community must understand the various ways in which levels of value can be interpreted when using the methods under the market approach. If relying on a guideline completed transaction method, care must be taken to ensure the adequate adjustments were made to remove buyer-specific motivations from the earnings-based multiples. Failure to make such adjustments can leave the valuation opinion, and potentially the legal position, vulnerable to attack.

VI. Sufficient Similarity of Guideline Company Selections

In contrast with real property appraisals, one of the more difficult (and, perhaps, the most significant) tasks in applying the market approach in the valuation of privately-held businesses, and ownership interests within those businesses, is the identification of companies that can serve as legitimate proxies for the attendant company under valuation.

The criteria of "sufficient similarity" underlies both the guideline public company method and the guideline completed transaction method. Both methods use multiples derived from companies identified in the marketplace that are unrelated to the company under valuation. To properly apply the market approach to any subject company, it is explicit in all guiding professional literature, commentary and treatises, as well as all professional standards, that any inferences of value drawn from the market be taken from companies that have a "sufficient" level of similarity to the subject company to be a reliable guideline indicator of value. A failure to properly identify those guideline companies that have a sufficient degree of similarity to the subject company or the inclusion of guideline companies lacking sufficient similarity is certain to lead to incorrect conclusions of value under the market approach.

It should be noted that, over several decades, the methods discussed in Chapter II have evolved from being labeled as "comparable company methods" to "guideline company methods" of valuation. This development should not be lost on readers of these materials. The change occurred to reflect the fact that no two companies are exactly alike or comparable. Because of this problem, the description morphed over time to become "guideline," with the general expectation that sufficiently-similar companies identified within the publicly-traded markets and the closed transaction databases may provide, in certain circumstances, reliable indicators of value.

Unfortunately, the exact pretense by which sufficient similarity is determined has never been set forth in governing standards or the available treatises and guidance commonly referenced by business valuators. Moreover, the matter has never been detailed in a major judicial decision. Thus, the process of determining the sufficient similarity between the selected guideline companies and the subject company is primarily one of professional judgment. Given the degree of judgment inherent in any selection process, it is not surprising to find, not only differing opinions as to what constitutes sufficient similarity, but also improper determinations of value due to the use of weak guideline company selections.

Governing Guidance – Same or Similar

Over the last 50 years, the most prolific generator of business valuation theory has been the Internal Revenue Service of the United States Department of Treasury.

In Revenue Ruling 59-60,[16] the consideration of the market approach is strongly advocated:

Valuation of securities is, in essence, a prophecy as to the future and must be based on facts available at the required date of appraisal. As a generalization, the prices of stocks that are traded in volume in a free and active market by informed persons best reflect the consensus of the investing public as to what the future holds for the corporations and industries represented. When a stock is closely held, is traded infrequently, or is traded in an erratic market, some other measure of value must be used. In many instances, the next best measure may be found in the prices at which the stocks of companies engaged in the ***same or a similar*** *[emphasis added] line of business are selling in a free and open market.*

In addition to this language, the Ruling[17] further states:

Section 2031(b) of the Code states, in effect, that in valuing unlisted securities, the value of stock or securities of corporations engaged in the same or a similar line of business, which are listed on an exchange, should be taken into consideration along with all other factors. An important consideration is that the corporations to be used for comparisons have capital stocks, which are actively traded by the public. In accordance with section 2031(b) of the Code, stocks listed on an exchange are to be considered first. However, if sufficient comparable companies whose stocks are listed on an exchange cannot be found, other comparable companies that have stocks actively traded in the over-the-counter market also may be used. The essential factor is that, whether the stocks are sold on an exchange or over-the-counter, there is evidence of an active, free public market for the stock as of the valuation date. In selecting corporations for comparative purposes, care should be taken to use only comparable companies. Although the only restrictive requirement as to comparable corporations specified in the statute is that their lines of business be the same or similar, yet it is obvious that consideration must be given to other relevant factors in order that the most valid comparison possible will be obtained. For illustration, a company with a declining business and decreasing markets is not comparable to one with a record of current progress and market expansion.

The language in this ruling has driven much of the current thinking in the business valuation community as to most appropriate means of selection of valid comparable companies.

No two assets are identical. However, certain assets, including collectibles and real estate, can often be more easily valued with comparisons to nearly identical characteristics. Such is not the case with privately-held businesses and ownership interests in those businesses.

16 Revenue Ruling 59-60, 1959-1 C.B. 237, 1959.

17 Ibid, Section 4.02(h).

Of course, as noted earlier, no two businesses are likely to be found identically comparable. Just as every individual business owner is unique, so is the business itself. The process, then, becomes one of finding sufficient comparability to allow for the provision of meaningful guidance or indicators as to value. Thus, those companies selected by the business valuator as sufficiently comparable will then lend reliable guideline criteria in determining value.

The most critical question in the application of the market approach is what makes comparability sufficient enough so as to enable data gleaned from the guideline companies to be used as guideline indicators of value. By virtue of Revenue Ruling 59-60, and numerous professional treatises authored after its release, the selected companies must be in the same or a similar line of business. However, the Ruling notes, (as do most of these business valuation treaties) "that consideration must be given to other relevant factors in order that the most valid comparison possible will be obtained."

Again, these other relevant factors are most often determined judgmentally by business valuators on a case-by-case basis. However, such determinations can be undertaken in a more objective fashion by turning first to a diligent assessment of the subject company under valuation to fully understand its business. This necessary understanding includes the company's main products and/or services; its customers and clients; those markets currently served and expected to be served in the future; its product distribution capabilities; competition, supplier and employee relationships; and financial performance (past and expected), including expected future growth, profitability, asset utilization, debt relationships and structure, etc.

The Professional Standards[18] published by the American Society of Appraisers (ASA) address the issue of sufficient similarity as follows:

<u>Reasonable Basis for Comparison</u>

A. The business, business ownership interest, security or intangible asset used for comparison must serve as a reasonable basis for comparison to the subject.

B. Factors to be considered in judging whether a reasonable basis for comparison exists include:

   1. A sufficient similarity of qualitative and quantitative investment characteristics

   2. The amount and verifiability of data known about the similar investment

   3. Whether or not the price of the similar investment was observed in an arm's-length transaction, or in a forced or distressed sale

[18] American Society of Appraisers - *ASA Business Valuation Standards, BVS-V Market Approach to Business Valuation,* 2009, Section III, page 12.

Understanding Standards of Value and the Market Approach in Controversy

Again, as noted in earlier programs presented by our firm, the ability to opine on value requires an intimate understanding of all aspects of the subject company. Nowhere in the business valuation process is that necessity greater than in the selection of guideline companies.

An important element of any assessment of a potential guideline company is the financial analysis of the guideline company. While this assessment may make use of any number of economic and financial statement tools, it is ultimately critical that the financial characteristics of the guideline company are reasonably comparable to the subject company. This matter will be discussed later in this chapter.

Note that any financial analysis procedures, including ratio analysis, trend analysis and common sizing analysis, may require the process of making economic "normalization" adjustments. Such adjustments may include the removal of non-recurring or extraordinary items as well as non-operating assets/liabilities/income/expenses, adjustments for discretionary items, or those that are within the control of a majority shareholder. The normalization process was discussed in an earlier presentation and is beyond the scope of this program.

Once the subject company analysis is complete, the valuator can begin to search for guideline companies that offer sufficient comparability to provide valid indicators of value. Invariably, the process begins with a search of companies within similar SIC and NAICS categorizations. Beyond simple code classification, further research must be undertaken to establish that the identified companies are in the same or a similar line of business.

Size and Growth

Size and expected growth are two critical elements of comparability requiring assessment by the valuator. Size can be expressed in terms of gross revenue or sales, total assets or some component thereof, and/or market capitalization. Most often, preliminary size analysis seem to be evaluated in terms of revenue or sales.

Size becomes an important criterion in that trading or pricing multiples are historically lower for smaller companies due to greater perceived investment risk. More risk means investors will require a higher rate of return on their investments. Such higher returns generally equate to lower multiples, leading to lower values.

While no hard and fast rules apply, in the search of sufficiently comparable guideline companies, a commonly accepted practice in the business valuation community is to exclude those identified companies with more than 10 times the measurement variables. In other words, a company with $300,000,000 in revenue might be deemed sufficiently comparable for consideration in the valuation of a company with $30,000,000 in revenue. Ultimately, such decisions are judgmental and at the prerogative of the business valuator.

Note, that in cases where size differs markedly, as illustrated in the previous paragraph, it is probable that any value multiples developed from the larger (or smaller) guideline would require an adjustment to compensate for the size difference.

Growth is inextricably woven into the fabric of value. Future expected growth is implicitly included in the pricing of all stocks and equities that are publicly traded. As such, it is absolutely critical that guideline companies selected under the market approach have consistent and comparable growth rates.

From a valuation perspective, the price of publicly-traded securities must be analyzed and researched to ensure that the growth rate inherent in that pricing is consistent with that of the subject company. In most cases, public company analysts and industry analysts project rates of growth for publicly-traded enterprises. These growth rates are generally short- or near-term, which when applied to the subject company under valuation, may need to be adjusted to those that are consistent with the growth rate envisioned for the typical long-term holding period (unless an exit is planned). Such a fundamental adjustment will generally serve to align the expectations (and specifically, expected future growth) of the publicly-traded guideline companies with the expectations of the subject company as of the date of valuation.

Though beyond the scope of this program, the market approach allows for consideration of these differences, and their adjustment, if necessary. Failure to make adjustments to guideline public company multiples for attributes such as size and growth expectations, leading to blindly applying such multiples, can result in invalid conclusions that are easily challenged.

Sample Size Considerations

To properly apply the market approach, it is necessary for business valuators to identify a sufficient number of guideline companies to reduce the risk of erroneous results arising from specific anomalies. A question that must be addressed in each proper application of the market approach is, "How many guideline companies or transactions are required to draw meaningful and accurate conclusions?"

Unfortunately, there is no definitive answer to this question. It is an obvious statistical reality that the greater the number of guideline companies/transactions, the less influence any single company anomaly will carry. Courts have ruled that a single comparable guideline company is insufficient to define an adequate sample. However, given the limitations in identifying quality comparable guideline companies, the business valuator may be left with little alternative than to use a limited number of guideline companies or transactions in his or her sample or use a larger group of less desirable guideline companies that are, perhaps, less similar.

Another issue that contributes to statistical significance is variation in the underlying population. To measure the degree of dispersion, a statistic called the "coefficient of variation" is calculated. The mechanics of computing the coefficient of variation are beyond the current material. To simplify, in a population of trading multiples based on earnings, most multiples are roughly around the same level, with some higher and lower. However, if you select one random public company trading multiple from the population, chances are that it will be close to the average. This is an indication of a tighter population of trading multiples, which means that the multiples derived from such a population tend to deserve more consideration or weight.

Conversely, if you have a population of trading multiples that vary widely, meaning that the multiples are scattered all over the chart, the average may still be the same. However, if you select one random public company trading multiple for this population, it is highly likely that it is far from the average.

When properly applying the methods under the market approach, the valuator should apply other statistical analyses, including computing the harmonic mean as a measure of central tendency as an alternative to calculating average or median multiples. Ultimately, there should be a process undertaken by the valuator to evaluate the significance or relevance of the sample or population prior to applying the multiples derived therefrom to the selected metrics of the company under valuation. Applying multiples blindly will most often result in invalid and unreliable conclusions – garbage in, garbage out.

Financial Analysis of Guideline Companies

Once an adequate number of guideline companies has been identified (via SIC code, NAICS code and/or size and growth), further refinement of the comparability assessment is conducted by the business valuator through detailed financial and operational analysis of those companies. To allow for direct and specific comparisons to the subject company under valuation, it is necessary that the same financial and analytical procedures and tools applied to the subject company be applied to each of the guideline companies. These tools include ratio analysis, trend analysis and vertical (common sizing) and horizontal integration analysis.

It is also relevant and critical that the historical financial data of each of the guideline companies aligns properly with the date of valuation applicable to the engagement at hand. In all cases, analysis of financial data through the date of valuation is proper, while analysis of data beyond the date of valuation is not as useful for purposes of determining comparability.

Common financial performance measures developed for both the guideline companies and the subject company include activity ratios, balance sheet ratios, liquidity ratios, capital structure ratios, profitability and cash flow and industry specific analysis, if applicable.

Understanding Standards of Value and the Market Approach in Controversy

Fluctuating Multiples

It is important to consider the historical trends in the underlying data used to develop the valuation multiples derived from the public markets. The trends in Revenue, EBITDA, Free Cash Flow, and Cash Flow from Operations multiples reflect volatility. Public companies with recent extremely positive or negative news can result in multiples that may lead to unreliable indicators of value for the subject company under valuation.

Therefore, it stands to reason that meaningful fluctuations in market multiples will result in substantial fluctuations in the resultant valuation conclusion when applied. Application of the multiples, even on a week-to-week basis, could result in very different conclusions of value under application. Historical trends and recent events in the public companies under consideration for use in the market approach can render such company or companies insufficient for comparability purposes.

Other Comparability Issues

With particular applicability to the guideline completed transaction (merger and acquired) method under the market approach, sufficient comparability is more difficult to determine. The key dynamic fueling this problem is a severe limitation in the availability of detailed financial information for transactions involving privately-held business enterprises in the transaction databases.

Due to the lack of detailed information in the transaction databases, some of the questions that should be addressed, but remain unanswered, include:

- ***Are the guideline companies sufficiently similar for a financial statement point of view?***
  - As no financial statements are available on the transaction databases, it is impossible to make normalization adjustments, apply ratio and financial trend analysis techniques or discern the quality of the guideline companies' balance sheets and income statements.
- ***Were there any expected synergies in the price paid for the particular business?***
  - Most commentators assume that specific buyer motivations influence transaction prices in the databases and, often, these influences can have material effects on the valuation multiples developed from the data. Estimates for strategic/specific buyer motivation premiums are generally 20% to 40%.
- ***Were there non-compete agreements, promises of perquisites, terms, or other aspects of the transaction that affected the price paid?***
  - Deal structure is critical to assessing how purchase price equates to value. Without fully understanding the purchase price structure, it is impossible to fully understand how that price equates to value.

- *Did the transaction occur prior to the announcement of the Tax Cuts and Jobs Act (TCJA)?*
  - Transactions that occurred prior to the announcement of the TCJA must be separated from those that occurred after the announcement to determine whether the transactions can be deemed comparable.
- *Were the provisions of the TCJA considered by the buyer and seller in determining a price?*
  - Transactions occurring after the enactment of the TCJA were likely completed with consideration of how the changes in the laws would impact the target business going forward, while those occurring before the announcement likely were not.
- *If the transactions occurred prior to the enactment of the TCJA, is sufficient information available to adjust the tax impacts of the transaction?*
  - If the transaction database does not provide sufficient information to adjust the tax rates of a target company, the business valuator is not able to rely on the multiples derived from the transaction, even if the target company is deemed to be sufficiently similar to the subject company.
- *Is there a sufficient amount of empirical information available for the guideline company selections under either market approach method?*
  - Most often, the completed transaction databases do not include enough information to discern comparability to the degree necessary to prove the indicators of value developed therefrom to be reliable.

In many instances, the lack of required information limitation is so difficult to overcome that the guideline transaction method is only useful for confirming or reconciling conclusions of value developed under alternative approaches and/or methods. Valuators choosing to use the market approach as a primary method, without overcoming the aforementioned difficulties in application, will face significant challenge by opposing experts in matters of controversy and run the risk of having their conclusions rendered unreliable in their entirety.

Conclusion

Sound and reasoned analysis of market data is critical in applying the market approach, as courts and finders of fact are more sophisticated and informed about valuation concepts and approaches. The authors of this material have participated in cases where decisions ultimately depend on the quality of each experts' market approach presentations. Careful selection of guideline companies and transactions is essential. A weak application of the market approach puts the valuator in a vulnerable position and open to challenge in matters of controversy. The proper analysis of market information and proxies will assist the valuator in identifying differences in prices paid by a financial buyer versus a strategic buyer, which will ultimately result in the proper opinion of value.

VII. Conclusion and Practical Considerations

The market approach to business valuation poses significant challenges for business valuators and those in the legal community representing clients who are involved in matters of valuation. As can be gleaned from this session and the materials, complexity in the inter-workings of the methods in application can often lead to misunderstandings and confusion. Other times, the improper application of the market approach and the methods available thereunder rise to the level of fatal flaws and result in incorrect conclusions of value.

At first blush, it would seem that market evidence of the prices at which businesses (or equity ownership interest within those businesses) are transacting is important and relevant information. Like other valuation approaches and methods, however, the market approach is relatively simple in concept and mathematical application, but far more problematic when incorporating quantitative and qualitative factors that require adequate consideration.

Though databases are in a state of continual improvement, valuators applying the market approach remain challenged to identify and analyze sufficient similarity in guideline companies and transactions; properly calculate and adjust the guideline company valuation multiples; and, then, apply the multiples derived to the subject company metrics. Finally, adjusting the results to arrive at the proper standard and level of value is required to conform the results obtained from the application of the market approach in order to ensure that the conclusion of value aligns with the assignment parameters.

Of course, as noted throughout these materials, professional judgment also plays a significant role in many aspects of applying this approach. Professional judgment is required for proper identification and analysis of selected guideline companies and sample size, assessment of qualitative factors, and adjustments for normalization to the guideline companies and the subject company. A lack of focus on these many complexities will impact the conclusion of value if adequate care and diligence is not exercised by the valuation professional.

As noted in this session earlier, however, generally accepted business valuation procedures and protocols should, if properly understood and followed, lead to reasonable and reliable conclusions of value.

With respect to the guideline completed transaction method, we know that each buyer is unique, and transactions are often consummated with unpredictable results. From a practical standpoint, methods employed under the market approach may provide a sanity check on the values obtained using other approaches and methods thereunder. However, due to the challenges and limitations noted herein, it often precludes the approach from being a primary indication of value.

Understanding Standards of Value and the Market Approach in Controversy

The most problematic outcome of a failure to correctly derive indications of value under the market approach in controversy matters is the feeding of unrealistic expectations of litigants on either side of an action. Once numbers are released (even if they border on the absurd), legal actions tend to grind on for extended periods of time – usually until the parties tire of funding ongoing litigation. Such an outcome does not benefit anyone, and focus should turn to quality business valuation professionals who have the right qualifications and who are committed to getting the right answer for counsel.

As always, we hope that today's presentation assists our guests and members of the legal community in understanding the market approach a bit deeper, perhaps, than when we started. A critical take-away is the realization that there are limitations associated with the availability of third-party data. Further, it is important to understand that the value conclusion obtained from application of the market approach should be reconciled with the other valuation approaches. If there is a disconnect in this process, questions should be posed to the valuator to ensure credible and defensible results that are consistent with the value being sought.

Thank you for attending and have a great day!