

# Viewpoint on Value



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# Transaction databases can be powerful tools

A logical starting point for valuing a private business is the price someone paid for a competitor's business. Appraisers use the guideline merger and acquisition (M&A) method, a subset of the market approach, to do just that — derive the subject company's value from a sample of comparables (or guideline companies).

## Finding the right database

Private businesses aren't required to publicly announce the details of their sales. Instead, valuers have several databases at their disposal. Popular choices include BIZCOMPS® Studies, the Institute of Business Appraisers (IBA) Market Database, ValuSource's DoneDeals®/Mid-Market Comps, Pratt's Stats®, Public Stats™, and Mergerstat® / BVR Control Premium Study™ databases.

Each source has its pros and cons. For example, Pratt's Stats' private transaction database offers up to 88 data fields per transaction, while BIZCOMPS offers only 21 searchable fields. The latter specializes in smaller firms with selling prices under \$250,000. By comparison, Public Stats contains only transactions involving public companies.

Each database also has its own reporting nuances. For example, IBA Market Database reports "annual earnings" as earnings before taxes, interest expense and owner's compensation. Pratt's Stats refers to "discretionary earnings" as earnings before taxes, interest expense, owners' compensation *and noncash charges*. Finally, BIZCOMPS uses the term "seller's discretionary cash flow" to refer to earnings before taxes, interest expense, owners' compensation, noncash charges, *and nonbusiness-related expenses* (normally to one working owner).

In addition, what's included (or excluded) from value differs among the databases. For example, the IBA database defines sales price as "total reported consideration" and doesn't disclose the

terms of sale. Often sales price isn't a cash-equivalent value for private businesses. By comparison, Pratt's Stats discloses more information about the details of a sale, including installment payments and value of noncompetes and consulting (or employment) contracts.

## Finding an adequate sample

From these databases, valuers select a sample of comparable (guideline) transactions using customized selection criteria. (See "Beyond product lines" on page 3.) The sample is the most controversial part of the guideline M&A method. If a court decides a sample isn't adequately comparable, all (or part) of the valuator's analysis may be excluded from evidence.

There's no perfect sample size. In general, valuers require fewer comparables if:

1. More data is available on the transactions, and
2. The comparables are relatively similar.

Too many comparables can be just as egregious an error as too few. The goal is to collect a manageable sample of strong comparables. In *Estate of Hall*, for example, the U.S. Tax Court accepted a value



## Beyond product lines

The most obvious criterion for picking comparable transactions is the subject company's industry, often represented by its Standard Industrial Classification (SIC) or North American Industry Classification System (NAICS) code. The logic is that the factors driving value are consistent for all participants in the same industry.

But sometimes industry codes provide a sample that's too broad. Other factors valuers typically consider when using the guideline merger and acquisition (M&A) method include:

**Size.** Large entities tend to have professional management, more sophisticated financial reporting and controls, and more cash reserves to help them weather a downturn.

**Geographic location.** A business's location may affect competitive forces, such as regulatory requirements and the number of competitors and suppliers.

**Financial performance.** Examples of possible financial performance criteria include debt ratios, profit margins and working capital.

In addition, the transaction date is increasingly relevant in today's volatile marketplace. Old transactions may not be relevant if market conditions have changed. This may be true when the effective date of the valuation is during (or right after) a recessionary period, for example.

for Hallmark Cards Inc. based on just a single comparable — American Greetings Corporation.

## Choosing appropriate pricing multiples

After the valuator identifies comparables, he or she computes pricing multiples from the sample. Selling price may be a multiple of several independent financial variables, such as revenues, pretax earnings, cash flow or book value. A pricing multiple is the inverse of a capitalization rate (in the income approach). For example, a pricing multiple of five times earnings is the same as a 20% cap rate.

Choosing the appropriate pricing multiple is subjective. In general, price to *earnings* before interest, taxes, depreciation and amortization (EBITDA) is more relevant in industries with high or variable depreciation rates, such as manufacturing. Conversely, price to *revenues* is more relevant in service industries, such as insurance, where participants face a homogenous cost structure. However, it's important to consider both multiples.

After selecting a pricing multiple (or multiples), the valuator may need to adjust for differences between the subject company and its comparables. For example,

a company with exceptional growth prospects may warrant a premium over the median pricing multiple. These adjustments add another layer of subjectivity to the valuator's opinion.

## Providing meaningful support

Many appraisers support their conclusions with statistics, such as variance or regression analyses. Graphs can also help visually illustrate the relationship between selling price and the independent variable.

They also have the benefit of being easier for laypeople to understand than detailed statistical analyses. The more tightly the data points appear on the graph, the less variance in the sample, which suggests a more meaningful sample.

## Finding the right expert

Although the guideline M&A method doesn't apply in every case, real-life deals can provide meaningful indicators of value for many private companies. But it's not as straightforward as it may first appear.

To ensure the guideline M&A method is applied correctly, seek out a trained, experienced, competent and credentialed professional. ●

# Estate of Black: Another notch in taxpayers' FLP belts

Family limited partnerships (FLPs) are proven estate planning tools. But the IRS sometimes tests the waters by attacking an FLP's discounts or its business purpose. Many of these attacks come under Internal Revenue Code Section 2036, "Transfers with retained life estate."

## Who benefits?

According to Sec. 2036(a), an estate's value includes the value of all property the deceased at any time transferred via a trust or some other form of transfer (except in a bona fide sale for an adequate and full consideration) under two conditions:

1. If the deceased continued to own, enjoy, or receive income from the property, or
2. If he or she retained the right, either alone or in conjunction with another person, to designate those who would own or enjoy the property or receive its income.

When the IRS succeeds in proving that the deceased retained ongoing economic benefit — either express or implied — it assesses gift and estate taxes for the full value of the partnership's underlying assets. In other words, in such a case the IRS specifically excludes valuation discounts for lack of control and marketability.

The IRS argued that the partnership lacked a legitimate nontax business purpose.

## When is a gift not a gift?

In *Estate of Black*, Sam Black had actively acquired Erie Indemnity Company stock during his 67-year tenure with the company. From 1988 to 1993, Black



gifted stock to his son and trusts for his grandsons. In 1993, he worried that his heirs might pledge or sell the stock, so he established an FLP to preserve his "buy and hold" investment philosophy.

Black and his heirs contributed almost all of their Erie shares to the newly formed FLP. And in 1998, Black transferred a 1% general partner interest to his son, who became managing partner. When Black died in December 2001, his limited partner interest was worth about \$165 million. His wife died five months later — before the limited partner interests had funded the estate's marital trust.

## What is legitimate?

Rather than attack the sizes of the discounts for lack of control and marketability, the IRS sought to exclude *all* discounts on the limited partner interests in the Blacks' estates. The IRS argued

that the partnership lacked a legitimate nontax business purpose. In addition, the IRS held that partnership distribution clauses constituted an implied agreement that Black would retain control over partnership assets.

But the U.S. Tax Court ruled in favor of the estate. Citing *Estate of Schutt*, the court decided that preserving a “buy and hold” philosophy is a legitimate and significant nontax purpose. Centralized long-term management of the family’s holdings also protected the family’s collective swing vote rights as a major shareholder in Erie.

### What makes an FLP work?

*Estate of Black* demonstrates ways to structure and administer an FLP to thwart a Sec. 2036(a) claim. But each case is unique. If the IRS persuades the Tax Court that you (or your client) retained an economic interest in the FLP’s assets, tax-saving valuation discounts may be lost. Even the world’s best valuator can’t overcome improper FLP administration or lack of bona fide business purpose. ●

## Great expectations: Finding the value of startups

How can a valuation analyst value a startup business when it has no track record? Many startup ventures have never generated positive cash flow — or even revenues. With mature businesses, valuers may rely on historical performance to estimate value. But startups have only limited operating histories. Without history to lead the way, startups often derive value from exceptional growth expectations.

Value is all about the future — unfortunately, focusing on the future complicates the valuation process. Valuation analysts must rely on business entrepreneurs’ forecasts to estimate value. Because no one can see into the future, the projections are often subjective and risky.

### Financial projections are both an art and a science

Valuators know how to spot the clues that can help them more accurately estimate future performance. For example, whether or not an entrepreneur has put together formal financial projections can provide



insight into the most important determinant of a startup company's ability to succeed: management. Other important considerations include the startup's competitive advantage, business type, market size, and potential growth opportunities.

The stage of development is also an important factor — each stage has different implications for the company's value:

**Stage 1.** In the seed stage, the entrepreneur simply creates an idea and venture capitalists and other investors provide seed capital or first-round financing.

**Stage 2.** At this early stage, the company continues to develop a product or service to test the concept and seeks further financing.

**Stage 3.** The startup graduates to a later stage when key development milestones have been met and the product or service is fully developed but not yet earning revenues.

**Stage 4.** Here the company is earning some revenue but is still seeking mezzanine rounds of financing, possibly leading to negotiations for an initial public offering (IPO).

**Stage 5.** At this point the company is earning revenues and has achieved some positive cash flows, possibly (but not always) leading to an IPO or sale.

**Stage 6.** The fully fledged company has established profitable operations.

## Investors are usually skeptical and will want to discount management's projections.

As a startup evolves through these stages, entrepreneurs and investors agree that the company's value grows. But their perceptions of value often conflict, because each has different ways of estimating value.

## The benefits and drawbacks of employee stock options

Employee stock options (ESOs) can be an effective way for companies to attract and retain key employees, and they're popular among startups and technology firms, which tend to be cash-poor but offer significant growth potential. Giving employees interests in the startup can serve two functions:

1. Improve morale and help retain valuable employees, and
2. Be part of an incentive compensation plan and supplement base salaries, which are often low because startups' cash is usually tight.

But accounting for ESOs is complicated because of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*.

SFAS 123(R) requires companies using ESOs to estimate the fair value of the options and incur a proportionate expense over the options' requisite vesting period. This means that companies issuing employee stock options take an immediate earnings charge. Additionally, SFAS 123(R) necessitates the use of outside valuation experts.

## Owners vs. investors

Put simply, a company's entrepreneurs want the highest possible value. They believe they should be compensated for their "sweat equity," research and development costs, and forgone compensation. The further along a company progresses in its evolution, the more entrepreneurs invest — which translates into a higher value.

Conversely, outsiders want to pay the lowest price possible for the largest piece of the pie. Investors are usually skeptical and will want to discount management's projections. They want to minimize risk — not only through lower initial values, but also through liquidation preferences, conversion options, preferred dividends,

redemption rights and restrictions on the entrepreneur's actions. They may also require a seat on the board of directors.

### A valuator sees it both ways

An independent valuator takes an unbiased look at the company's financial projections. Using

objective sources — such as marketing data, industry benchmarks and comparable companies — the valuator blends the owner's financial projections with the investor's rational concerns. Discussions with investors, partners and potential buyers can begin only when the entrepreneur knows the startup's value. ●

## Would you, *should* you, reuse an appraisal?



A business appraisal provides a snapshot of a company's value on a specific date and for a specific purpose. Although it may be tempting to reuse old valuations to save time and money, recycled valuations sometimes lead to poor decisions that may cost more over the long run.

### A moving target

Value is a moving target because volatile market conditions or emerging technology can change business value quickly. And "value" depends on your point of view. For instance, investors usually demand a higher price when selling to a third party than when transferring ownership to their heirs.

Valuation discounts for lack of control and marketability also have a significant impact on value. But discounts don't always apply — and may differ depending on the size of the block. Adjustments to the company's income stream also depend on the size of the block and the valuation purpose.

For example, suppose Elise and Gerald gifted a 10% minority interest in the common shares of their business to each of their twin daughters in 2005. An appraiser valued each gift at \$25,000 on a minority, nonmarketable basis. The couple files for divorce in 2010. They need to value the business so Gerald can buy out Elise.

Based on the 2005 appraisal, Gerald contends that Elise's 40% interest is worth \$100,000 ( $\$25,000 \times 4$ ). Elise disagrees — she wants her pro rata share of the business's current fair market value. She hires an appraiser who values the business at \$1 million on a controlling, marketable basis. He contends that Elise's interest is worth \$400,000 ( $40\% \times \$1 \text{ million}$ ).

Her expert identifies several reasons for the discrepancy. First, revenues have grown significantly over the past five years. In addition, the first valuation included discounts for lack of control and marketability, while the updated value is undiscounted. And economic uncertainty has actually *lowered* the company's current value, which her expert factored in with a higher discount rate.

Obviously, the valuation's purpose is key. It's important for business owners to disclose all previous valuations to their attorneys and appraisers. Appraisal reports can address whether or not old appraisals are relevant to the case at hand.

### Updates or more may be needed

Before recycling a valuation, discuss the situation with an appraiser. In some cases, recycling may work out. But often the appraiser will need to update — or even redo — the appraisal, depending on how much the two assignments differ.