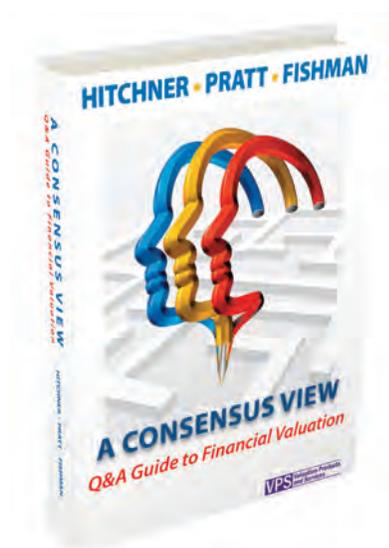


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## Editor's Outlook

**Jim Hitchner**

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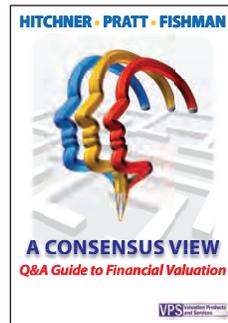
Happy Holidays from all of us here at Valuation Products and Services! I hope you will have the chance to slow down a bit and enjoy the beauty of the season with those you hold dear.

For me, the new year brings to fruition an idea that emerged several years ago—the opportunity to join with two esteemed friends and colleagues in a collective publication effort. Shannon Pratt, Jay Fishman, and I have collaborated many times on presentations, articles, courses, and books. Considering the myriad of valuation topics, methods, applications, and models that have surfaced over time, we found we are united in our assessment of most of them. We also discovered that where we disagreed, we were able to work through those disagreements to form a consensus view. Our new *Q&A Guide* presents our consensus view on important topics by answering the questions we have been asked over all these years. I hope you'll enjoy the front-page article, which presents a sample Q&A from each of the *Guide's* four chapters.

Next up in this issue, Robert Reilly guides analysts through the process of distinguishing between a corporation's entity goodwill and an individual shareholder or employee's

*Continued on next page*

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personal goodwill. This can be especially important in valuing closely held corporations.

Kris Boushie examines the challenge of valuing intellectual property, particularly in a bankruptcy situation. Mike Crain next guides our readers through the fundamental aspects of data sampling.

Rounding out this issue, Harold Martin presents a primer on economic damages in business litigation. As always, we welcome your reaction and comments to *FVLE* as well as suggestions for future topics. Email me at [jhitchner@finvaluation.com](mailto:jhitchner@finvaluation.com). Again, Happy Holidays! 🎁

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**Chapter 1 Income Approach**

**Discounted Cash Flow Model: Terminal Year and Mid-Year Convention**

**Question:** What period should you use for purposes of determining the present value of the terminal year value when using a mid-year convention discounted cash flow model?

**Answer:** We have been dealing with this for decades and the answer is always the same. The terminal year value is present valued back at the mid-year, not the end of the year.<sup>1</sup> For example, assume that you have a five-year projection and you decide to use the mid-year convention because cash flows come in steadily during the year and not all at the end of the year. As stated in *Financial Valuation Applications and Models*, “It is important to note that the terminal year begins at 4.5, not 5.”<sup>2</sup> The mid-year convention formula applied to net cash flow (NCF) is shown below (this includes the use of the Gordon Growth Model in the terminal year).

**Mid-Year Convention Discounted Cash Flow (DCF) Model<sup>3</sup>**

Present Value of NCF’s during Explicit Period

Terminal Value

$$PV = \frac{NCF_1}{(1+k)^{n=0.5}} + \frac{NCF_2}{(1+k)^{n=1.5}} + \dots + \frac{NCF_n}{(1+k)^{n=4.5}} + \frac{NCF_n \times (1+g)}{(k-g)(1+k)^{n=4.5}}$$

Let’s calculate a value using the above formula, a 20% discount rate, and a 4% long-term growth rate.

Discount Rate                      20%  
 Long-term Growth Rate        4%

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>	<u>Terminal Year*</u>
Cash Flow	\$1,000	\$1,150	\$1,228	\$1,417	\$1,516	\$9,854
Period	0.5	1.5	2.5	3.5	4.5	4.5
PV Factor	0.9129	0.7607	0.6339	0.5283	0.4402	0.4402
PV of Cash Flow	\$913	\$875	\$778	\$749	\$667	\$4,338

**Sum = \$8,320**

\*The terminal year value is (1,516 X 1.04)/(.20-.04) = 9,854.

<sup>1</sup> Note: Some valuation analysts assume end-of-year periods because, while cash flows may come in during the year, they are not distributed to shareholders until the end of the year. The example here presents mid-year cash flows in the interim period and the terminal year period.

<sup>2</sup> James R. Hitchner, editor and coauthor, *Financial Valuation Applications and Models*, 3rd edition (Hoboken, NJ: John Wiley & Sons), p. 147.

<sup>3</sup> Ibid.

*Continued on next page*

Now, let's calculate the value with the interim cash flows at mid-year and the terminal year at end of Year 5.

Discount Rate                      20%  
 Long-term Growth Rate            4%

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>	<u>Terminal Year*</u>
Cash Flow	\$1,000	\$1,150	\$1,228	\$1,417	\$1,516	\$9,854
Period	0.5	1.5	2.5	3.5	4.5	5.0
PV Factor	0.9129	0.7607	0.6339	0.5283	0.4402	0.4019
PV of Cash Flow	\$913	\$875	\$778	\$749	\$667	\$3,960

**Sum = \$7,942**

\*The terminal year value is  $(1,516 \times 1.04) / (.20 - .04) = 9,854$ .

Complex mathematical proofs confirm that the first formula is correct. However, we also like the simple proof, which is to present value the cash flows for 75 years (Note: In this example it takes only 66 years) at the mid-year convention to calculate value. It is \$8,320, not \$7,942.

## **Chapter 2 Cost of Capital/Rates of Return**

### **Duff & Phelps Valuation Handbook - Guide to Cost of Capital Size Premium Regression Line and Small Companies**

**Question:** I have heard that when using Duff & Phelps size premium data the extrapolation beyond the regression line (the lower end) should not be used for smaller companies. What is your stance on using the extrapolation? What do you do when the subject company you're valuing is smaller than the smallest company in the 25th portfolio of the Duff & Phelps Risk Premium Report data?

**Answer:** This is an important question that Duff & Phelps addresses at some length in the *2015 Valuation Handbook – Guide to Cost of Capital*:

The short answer is 'Yes.' It may be appropriate to extrapolate the risk premium for companies whose size characteristics are less than the average characteristics of the companies comprising the bottom half of Portfolio 25 using the regression equation method. While extrapolating a statistical relationship far beyond the range of data used in analysis is generally not recommended, in cost of capital analyses (or any analysis for that matter), there is always the question of 'compared to what?' Put simply, while it may not be ideal to extrapolate a statistical relationship beyond a certain range, one may be confronted with a situation in which no better measure is available.

Specifically, in cases where the size characteristic of the subject company is significantly less than that of the average company included in Portfolio 25 for any given size measure, the valuation analyst may report the individual, average and the median premia (and corresponding cost of equity capital estimates) using both the guideline portfolio method and the regression equation method (using all of the subject company size characteristics that are available). However, we recommend that the valuation analyst consider disclosing that the subject company's select-

*Continued on next page*

ed size metric is less than, for instance, the smallest of companies included in Portfolio 25 of a particular size measure. Once again, reporting all of the information in a transparent way is preferable to not reporting it at all, especially in cases where no better alternative is available.<sup>4</sup>

The *2015 Valuation Handbook – Guide to Cost of Capital* does provide information about the largest and smallest companies in the 25th portfolio for each of the eight size measures (the 25th portfolio is comprised of the smallest companies).<sup>5</sup> The size characteristics of the smallest companies comprising the 25th portfolio can be used as a guide that the size premia is supported for companies that small.

While Duff & Phelps says “it may be appropriate” to extrapolate beyond the last point in the regression line, we believe that you should be cautious about extrapolating too far beyond that last point because you may be going into untested territory. Often we deal with smaller companies by adjusting for the company-specific risk component in either the modified CAPM or the build-up model. That adjustment is based on judgment. This is as opposed to going beyond the last point in the regression line. If you do extrapolate beyond the regression line, we also agree that you should compare it to your results using a company-specific risk adjustment.

### **The Build-Up Model, Combined Market and Size Risk, and Industry Risk Premiums**

**Question:** Is it correct to apply an industry risk premium to a build-up model when using the Duff & Phelps Risk Premium Report data from the A exhibits where the equity risk premium and the size premium are combined?

**Answer:** This is not recommended. If you add the adjusted IRP to the combined ERP and the size premium from the Duff & Phelps A exhibits, this could result in some double counting of the beta effect. The risk premiums from the A exhibits already include a beta risk based on size, but across all industries. The preferred method would be to use the size data from the B exhibits and a separate ERP. Let’s take an example.

Assume that the appropriate size premium (risk premium in excess of the CAPM expected return) derived from exhibits B-1 through B-8 for the subject company is 6.0%. One can then use this size premium in conjunction with the recalculated IRP. In this example we will assume a normalized risk-free rate and the Duff & Phelps recommended ERP of 5.0%, and the appropriate SIC code and recalculated IRP.<sup>6</sup>

Risk-free rate	4.00%
Plus: ERP estimate	5.00%
Plus: IRP adjusted	1.35%
Plus: Size premium	6.00%
Indicated cost of equity capital (before consideration of RPC, if any)	<b>16.35%</b>

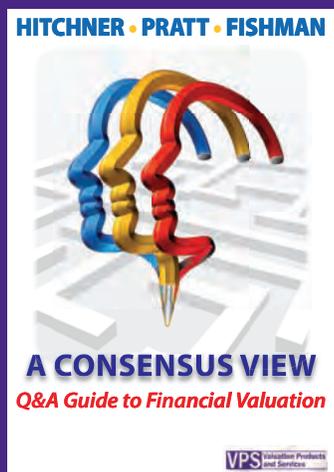
This use of the IRP and the B exhibits eliminates any double counting of beta risk that might be included in the risk premiums in exhibits A-1 through A-8.

<sup>4</sup> Duff & Phelps *2015 Valuation Handbook – Guide to Cost of Capital* (Hoboken, NJ: John Wiley & Sons), pp. 9-10.

<sup>5</sup> Ibid., Exhibit 10.3, “Size Characteristics of the Companies that Comprise Portfolio 25, by Percentile,” p. 10-7.

<sup>6</sup> The IRP is based on a CAPM-type formula that is sensitive to the ERP that is used, whether the CRSP historical ERP, the CRSP supply-side ERP, or the Duff & Phelps recommended ERP. These three types of IRPs are also calculated and presented in Exhibit 5.7 of the *2015 Valuation Handbook – Guide to Cost of Capital*.

*Continued on next page*



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## **Chapter 3 Discounts and Premiums**

### **Minority Cash Flows = Control Cash Flows**

**Question:** What if the cash flows need no adjustment (i.e., minority and control cash flows are the same)? Is the value the same for minority and control?

**Answer:** Yes, assuming that the control owner(s) are expected to continue running the company to the benefit of all the owners regardless of the size of the holding. However, when valuing businesses into perpetuity, there is always some risk that the policy of running the business to the equal benefit of all investors could change in the future. As such, when valuing a minority interest, some analysts will apply a small discount to the value to reflect this risk, often by increasing the discount rate.

This addresses the issue of discount for lack of control/minority interest. It does not account for the marketability differences between a controlling interest and a minority interest. So while there may not be any adjustment for control, there may still be adjustment for their respective lack of marketability.

### **Mergerstat Control Premium Industry Concentration**

**Question:** Is there any industry concentration in the *Mergerstat Review* control premium information?

**Answer:** Yes. There is a high level of industry concentration. From 2008 to 2012, over 40% of the transactions occur in five industries (out of 50 industries total).<sup>7</sup> The five industries are:

1. Banking and Finance
2. Brokerage, Investment and Management Consulting
3. Computer Software, Supplies and Services
4. Drugs, Medical Supplies and Equipment
5. Miscellaneous Services

Only 10% of the identified industry groups generated over 40% of the transactions. Analysts who rely on the average control premiums for transactions in all industries are overweighting their reliance on a handful of industries that are likely dissimilar to the subject company. Analysts should reconsider the supportability of relying on high-level averages of all the data.

<sup>7</sup> *Mergerstat Review*, 2013, Factset Mergerstat, LLC, Newark, New Jersey, p. 81.

*Continued on next page*

## **Chapter 4 Business Valuation Standards and Ethics**

### **ASA Calculations and Compliance with USPAP**

**Question:** Can a member of the American Society of Appraisers perform a calculation engagement in compliance with the *Uniform Standards of Professional Appraisal Practice*?

**Answer:** Yes, a member of the American Society of Appraisers (ASA) can perform a calculation engagement in compliance with the *Uniform Standards of Professional Appraisal Practice* (USPAP). The article, “The Question of Calculations and USPAP – Another Round,” written by Carla Glass, CFA, FASA, deals with this issue concisely.<sup>8</sup>

*A calculation engagement can be performed in compliance with USPAP. In USPAP terms, it is simply called an appraisal with a lesser scope of work. The most important differences are that, under USPAP, the reduced scope of work must be appropriate for the intended use (purpose) of the assignment and the responsibility for this decision rests with the appraiser. A calculation report can, with relatively few changes, be made compliant with USPAP.*

### **Reporting Exemptions for the ASA and USPAP**

**Question:** Do ASA and USPAP allow a reporting exemption in dispute matters like the standards of the AICPA, NACVA, and the IBA?

**Answer:** No. While AICPA, NACVA, and the IBA allow a reporting exemption for valuation/appraisal practice and services within dispute engagements, the ASA and USPAP have no such exemption. They are silent on this issue. As such, ASA/USPAP-compliant reports are required to be in compliance with their reporting standards when performing an appraisal as an appraiser. Obviously, this assumes you are a member of the ASA, which requires its members to follow USPAP. This is an area that has caused some tension, especially between attorneys and ASA appraisers. While some attorneys request written reports in litigation, some attorneys do not want a written report. What we have seen in practice is that some appraisers choose to simply ignore the report requirement because they want the engagement. However both ASA BV Standards and USPAP do allow the appraiser to provide oral reports. Under some circumstances that may alleviate the perception that causes the tension referenced above. USPAP Standards Rule 10-4 is helpful here:

To the extent that it is both possible and appropriate, an oral appraisal report for an interest in a business enterprise or intangible asset must address the substantive matters set forth in Standards Rule 10-2(a).<sup>9</sup>

The critical language here is “To the extent that it is both possible and appropriate.” This gives the analyst great flexibility in delivering an oral report. 

<sup>8</sup> Carla Glass, CFA, FASA, “The Question of Calculations and USPAP – Another Round,” *Financial Valuation and Litigation Expert*, Issue 47, February/March 2014, Valuation Products and Services, LLC, pp. 7-10. Note: These are Carla Glass’s personal views and are not the official position of any firm, board, society, or foundation.

<sup>9</sup> *Uniform Standards of Professional Appraisal Practice*, 2016/2017 edition, The Appraisal Standards Board, The Appraisal Foundation, p. 71.

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