Financial Valuation *and* Litigation Expert

VIEWS AND TOOLS FROM LEADING EXPERTS ON VALUATION, FORENSIC/FRAUD AND LITIGATION SERVICES

Editor's Outlook

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As winter gives way to spring, we hope to "awaken" your thoughts to an issue that doesn't always get the attention it deserves. Our front-page article delves into the data problems associated with using control premium studies (MergerStat) as well as the many problems that may be incurred when applying them.

Next up, Bill Quackenbush addresses the ever-popular topic of cost of capital. Bill believes the amount of discussion in the BV community regarding this topic reflects the "growing maturity of the BV profession as both theoreticians and practitioners find increasingly reliable, accurate and usable models to identify, or document, private company cost of capital."

Gil Matthews tackles the topic of calculating enterprise value. He explains that there are two different approaches for calculation used in the BV community, and he then explains which method he thinks is best and why.

Nearly two years after the passage of the federal healthcare reform legislation, Mark Dietrich believes people remain confused about its purpose and impact on the economy as well as the value of businesses. Mark says appraisers and valuation analysts need to be aware of this increased

Continued on next page

Control Premiums and Minority Discounts in Operating Businesses

The Facts, the Fiction and the Figments

"We made too many wrong mistakes."
Yogi Berra

While discounts for lack of marketability have received, by far, the most attention in recent years, control premiums and discounts for lack of control/minority discounts (DLOC) are back on the radar screen. The Appraisal Foundation, which produces the Uniform Standards of Professional Appraisal Practice (USPAP), has created a "Working Group" that is studying this area. The American Institute of Certified Public Accountants (AICPA) currently has two "Working Drafts" that also address this area. Later in this article we will present short summaries of what the Appraisal Foundation and the AICPA have issued on this important subject.

Before we get started, let's take a quick test on control premiums and lack of control/minority discounts in operating businesses.[1]

- Is there a good source of data for minority discounts? No.
- Is a minority discount the opposite of a control premium? No.
- Are control premium studies a good source of data for calculating a minority discount? No.
- Are control premiums derived from control premium studies useful and supportable? No.

If the answer is no, then why do some valuation analysts still apply control premiums in operating businesses? Maybe it is because they have "made too many wrong mistakes." Let's take a closer look at why the answer to these four questions is "no."

The *International Glossary of Business Valuation Terms*[2] includes the following terms and definitions:

"Discount for Lack of Control—an amount or percentage deducted from the pro rata share of value of 100% of an equity interest in a business to

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EDITOR'S OUTLOOK, continued

uncertainty resulting from the reform legislation. He discusses the reform's impact on small and large businesses as well as specific implications for the healthcare industry.

Internet research expert Eva Lang shares what she believes are some of the most useful "apps" for financial professionals. She says that iPads and smartphones can certainly be of use in your business, but she also warns that it will take some *work* on the user's part to get the most out of them.

Steve Babitsky of SEAK, Inc., a leading provider of expert witness training, has shared a valuable checklist with our readers. Steve brings us the "Expert Witness New Client Interview Checklist," a tool many of our readers will undoubtedly find useful.

John Walker and Chris Treharne provide us with another thought-provoking court case. In the *Estate of Liljestrand v. Commissioner,* a taxpayer fails to prevail as he relies on his own devices rather than those of a valuation professional.

As always, we conclude the issue with Cost of Capital Corner. ꟿ

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reflect the absence of some or all of the powers of control."

"Minority Discount—a discount for lack of control applicable to a minority interest."

"Control—the power to direct the management and policies of a business enterprise."

"Control Premium—an amount or a percentage by which the pro rata value of a controlling interest exceeds the pro rata value of a noncontrolling interest in a business enterprise to reflect the power of control."

The AICPA has the following term and definition:

> **Control Adjustment.** A valuation adjustment to financial statements to reflect the effect of a controlling interest in a business. An example would be an adjustment to owners' compensation that is in excess of market compensation.[3]

As you can see control premiums, minority interest discounts and discounts for lack of control are all intertwined here. That is because control premium data are often used as a basis to determine DLOCs.

MERGERSTAT DATA

Okay, what do we do now? Go to Mergerstat, correct.[4] We'll just use the inverse of a control premium by using the following formula:

$$\text{DLOC} = 1 - \frac{1}{1 + \text{premium}}$$

For example, a 40 percent control premium would result in a 29 percent minority discount.

MERGERSTAT CAVEATS

Let's dig deeper into the Mergerstat data. We will review information from the 2010 edition.

> While we attempt to collect complete information on each transaction, this is not possible in many cases, particularly with private companies. Therefore, the reader should use caution in drawing conclusions when the number of data points is low relative to the total number of transactions recorded. Furthermore, while we attempt to point out certain trends, each transaction has specific factors which affect its pricing. Therefore, the reader should examine each transaction on its own merit before drawing any conclusions.[5]

The last two sentences are applicable to users of control premium data and DLOCs. Each single transaction is different and is based on the facts of the transaction and the individual motivations of the buyer and seller. The publication also cautions the reader to "…examine each transaction on its own merit before drawing any conclusions." It doesn't say go to the averages for the control premiums for all industries or even to go to the averages of an individual industry.

IMPORTANT MERGERSTAT INFORMATION

While Mergerstat is often used for looking at control premiums, it also presents information on deals.

- Transactions (1,777) disclosing a purchase price (pp. 10-11)
- Mean average transaction price is $313.1 million (MM)
- Median transaction price is $20.0 MM
- 482 (27%) $5.0 MM or less
- 464 (26%) over $5.0 MM through $25.0 MM
- 74% less than $100 MM
- Median purchase price (p. 12)
  - Public sellers $94.1 MM
  - Private sellers $10.0 MM

CONTROL PREMIUM DATA

In terms of control premiums, all the sellers were public companies as control premiums are calculated by looking at the announced or closed deal price and comparing it to the publicly traded price of the company involved in the transaction. Some important information follows:

- Control premiums (based on offering price) (p. 25)
  - Base number of companies is 239
  - Calculations based on seller's closing market price five business days before initial announcement
  - Excludes negative premiums
  - Average is 58.7%
  - Median is 39.8%
  - With negative premiums (base is 269 transactions)
    - Average is 49.6%; median is 34.8%
- Median control premiums based on size (p. 27)
  - $25 MM or less 53.4% (56)
  - Over $25 MM through $50 MM 41.8% (33)
  - Over $50 MM through $99.9MM 51.7% (29)
  - $100 MM or more 34.7% (121)
  - In some historical years the range is closer or reversed (smaller companies with smaller premiums)
- There are 108 going private transactions which are acquisitions of public companies by private investment groups (p. 44)
  - Median price was $65.0 MM
  - Median premium was 36.1%
  - Median P/E was 11.9
- There are 50 industry classifications for control premiums (p. 81)
  - 2009 - Only 13 (26%) had more than five transactions
  - 2008 – Only 12 (24%) had more than five transactions
  - 2007 – Only 25 (50%) had more than five transactions
- Historically only four industries: "Banking and Finance," "Brokerage, Investment and Management Consulting," "Computer Software, Supplies and Services," and "Drugs, Medical Supplies and Equipment" account for a large percentage of the transactions. (p. 81)
  - 2009 97/239 (41%)
  - 2008 152/294 (52%)
  - 2007 211/491 (43%)

Obviously this data reinforces the notion of looking carefully at each transaction. With only 26 percent of the individual industry control premi-

Continued on next page

um averages having more than five observations in 2009, such a small sample must be evaluated differently and with caution. Also, for those who use control premium averages across all industries, the fact that over 40 percent of the transactions in the last three years are from four industries must give you pause and certainly make you think twice about the supportability of using the data this way.

FACTSET MERGERSTAT/BVR CONTROL PREMIUM STUDY

Another similar source of control premium data is from FactSet Mergerstat®/BVR Control Premium Study.™ The FAQs[6] include the following comments:

Mergerstat Control Premium

- "Premium computed by comparing the *price ultimately paid* to the *unaffected stock price.*
  [= (Purchase Price Per Share in Home Currency / Unaffected Price in Home Currency) - 1] (also known as the Mergerstat Unaffected Control Premium…)"
- Time before announcement
  - One day, one week, one month, two months

Mergerstat Unaffected Price

- "Target company's common stock price per share unaffected by the acquisition announcement."
- "Selected by Mergerstat® after analyzing each transaction (see Transaction Information) (this price is in the Home Currency)."
- "The Mergerstat® Review™ covers a much broader spectrum of M&A deals whereas the Mergerstat® / BVR Control Premium Study™ focuses on premiums."
- "…Mergerstat® Review includes both closed and announced deals; FactSet Mergerstat®/BVR Control Premium Study™ only includes closed deals."
- "The premiums in the Mergerstat® Review are only for US public targets. The data for the year comes only from deals announced during that year that meet the criteria (of being a US public company).
- The premium information from the CPS comes from worldwide public targets where a controlling interest was acquired, and the transaction closes during the specific quarter in which it is tracked."

Many of the same problems that are in the Mergerstat Review data are also in the FactSet Mergerstat®/BVR Control Premium Study data. As such, we will not repeat the same cautions.

Okay, with all this knowledge, what do we do now? Go to either Mergerstat product? That is not what is recommended in some of the leading valuation texts. Most endorse the concept that control and minority are adjusted (or not) in the cash flows of the business, i.e., control cash flows result in control value and minority cash flows result in minority value. Most also strongly caution the use of control premium study data to determine control value. They also caution against adjusting the discount rate or capitalization rate for minority or control in an income approach. Also, most, if not all of the U.S. business valuation committees/organizations teach that control and minority value emanates from the cash flows.

***Financial Valuation Applications and Models*, Third Edition, 2011**[7]

> By choosing to make certain adjustments to the future economic benefit (i.e., the numerator), the analyst can develop a control or noncontrol value. (p. 125)
>
> The content of the numerator drives the type of value (control or minority) produced. As such, if the numerator includes adjustments related to control, the value conclusion will be a control value. By excluding adjustments related to control, the value conclusion is a minority value. If control adjustments are included in the normalization and the resulting value is a control value, a minority interest discount may be used to adjust from control to minority value. There are often situations where no control adjustments are necessary and the company's control owners run the company to the benefit of all the owners. In this situation, the value might be the same for minority and control. However, some analysts still apply a minority discount to reflect the risk of a potential change in the control owner or his or her management philosophy. (p. 125)
>
> Adjustments to the income and cash flow of a company are the primary determinants of whether the capitalized value is minority or control. (p. 126)
>
> When there are controlling interest influences in the benefit stream or operations of the entity and a minority interest is being valued, it may be preferable to provide a minority value directly by not making adjustments. Doing this will avoid the problems related to determining and defending the application of a more general level of minority discount. (p. 127)
>
> …it is important to note that many analysts now adjust for control and minority in the cash flows of a business as opposed to more subjective applications of control premiums and minority discounts." (p. 366)
>
> If there is no control premium, then the control value and the marketable minority value may be the same. Some analysts believe that the control standalone value and the as-if-freely-traded minority interest value will often be close. (p. 368)
>
> Control premiums *quantify the value of controlling the destiny of the company and/or the ability to divert cash flows and value to the controlling*

Continued on next page

ownership. Acquisition or strategic premiums *quantify the incremental value of a particular investment as viewed by a specific investor(s).* There is empirical evidence of the size of combined control and strategic premiums. However, these data do not separate the two types of premiums. (p. 370)

Far too often, control premiums have been overstated by the use of these combined data (control and strategic premiums) as a proxy for control premiums only. (p. 371)

The quantification of the amount of the discount for lack of control (or the minority discount) is difficult due to the lack of empirical evidence in this area. (p. 377)

The Mergerstat data include synergistic and acquisition premiums along with the control premium, and segregation of these premiums is difficult. (p. 377)

While many analysts accept that the market approach using guideline publicly traded companies yields a minority value, many other experts believe that the guideline public company method may, in fact, not result in just a minority interest value, that is, minority and control in a public company are the same, *even though the market prices are those of minority interests.* According to Eric Nath:

> I have concluded that demonstrable control premiums are rare in public companies, and that, for the most part, statistics on control premiums provide little or no useful information when attempting to estimate the fair market value of a controlling interest in a private company. Therefore, valuation of a private company using a publicly traded comparative should result in a majority interest value. [Eric Nath, "Control Premiums and Minority Interest Discounts in Private Companies," *Business Valuation Review* (June 1990). Emphasis added.] (p. 378)

It is the responsibility of the management and board of directors of a public company to run the company to the benefit of all shareholders regardless of the size of the holding. As such, as the fortunes of the entire company go, so also go the fortunes of minority shareholders. If the company does well, so does the minority interest. If the company does poorly, so does the minority interest. As such, under fair market value, minority and controlling interests in public companies may be so intertwined that they are essentially similar. (p. 378)

Many analysts also believe that the application of public company valuation multiples to control cash flows results in a control value, while their application to non control cash flows results in a minority interest value. Since a multiple is really an inverted cap rate, this position may not be that different from the same concept for the income approach…which is generally accepted. (p. 378)

The use of minority cash flows in the income approach produces a minority interest value. …minority cash flows are those cash flows *without* any adjustments due to controlling shareholders actions such as excess compensation, rent payments, or perquisites. (p. 379)

When valuing a minority interest, it may be preferable to start work at the minority interest level rather than take on the additional work and risk of error involved in discounting back to a minority value from a control value. Conversely, when valuing a controlling interest, it may be easier to start with a control value than to add a control premium. (p. 379)

***Valuing a Business, the Analysis and Appraisal of Closely Held Companies,* Fifth Edition, 2008**[8]

> Does the Discounted Economic Income Model Produce a Control or a Minority Value? (p. 228)
>
> As noted earlier in the chapter, the discounted economic income model can produce either a control value or a minority value, depending on the model inputs involving the valuation variables. Generally, if the inputs in the valuation model reflect changes that only a control owner would (or could) make (e.g., changed capital structure, reduced owner's compensation, and so on), then the model would be expected to produce a control value. (p. 228)
>
> If the economic income projections merely reflect the continuation of present policies, then the model would be expected to produce a minority value. If every facet of the company is being so well optimized that a control owner could not improve on it, then there is little or no difference between a control value and a minority value. (p. 228)
>
> The argument is often made that, because discount rates typically are developed based on minority trades in publicly traded stocks, the discount rate is a minority interest discount rate, and therefore the value indicated by a discounted economic income model must be a minority value. There are at least two problems with this argument. First, *most, if not all, of the difference between a control value and a minority value in a discounted economic income model results from differences in the projected economic income (the numerator), not from differences in the discount rate.* Second, while the cost of equity capital is estimated from trades of minority

Continued on next page

ownership interests, the capital structure (i.e, the percentage of debt versus the percentage of equity) of the subject company is clearly influenced by the controlling stockholder. And, the capital structure mix is at least as important as the cost of equity capital in the estimation of a company's overall WACC—that is, the discount rate associated with net cash flow. In other words, the cost of equity capital may be the same, or nearly the same, whether a control or a minority interest is being calculated. However, the controlling owner (and, generally, not the minority owner) influences the projection of economic income (the numerator in the model) and the capital structure component of the WACC (the denominator in the model). (p. 228)

While there is a great deal of empirical evidence available to quantify the discount for lack of marketability, the empirical evidence to quantify the control premium or, conversely, the minority discount is, indeed, scant. The only body of empirical evidence that is available is from the public market. Of the several hundred public companies that are taken over each year, most (about 85 percent) are at prices that represent a premium over the previous public trading price. (pp. 384-385)

However, it is difficult, if not impossible, to sort out how much of this premium is for elements of control, and how much is for synergies between the seller and the buyer. (pp. 384-385)

In general, the only measure of a control premium is in the public market, when a public company is taken over. But this measurement includes the value of synergies as well as the value of control. Most analysts tend to draw conclusions from these data that exaggerate the value of control, as analyzed in this chapter. (p. 393)

Also, it is important to emphasize that what is called a "control premium" in this book is in reality an "acquisition premium," including the premium paid for synergies as well as for the elements of control. Therefore, when using these data to estimate minority interest discounts, it is worthwhile to look at the actual transactions and estimate what portion of the premium actually represented synergies; they could be significant. (p. 405)

***Understanding Business Valuation, A Practical Guide to Valuing Small to Medium Sized Businesses*, Third Edition, 2008**[9]

The conventional wisdom in business valuation is that the valuation analyst should not make adjustments to the financial statements that could not otherwise be made by the interest being valued. For example, the minority interest stockholder cannot determine the level of compensation for the officers of the company. However, with that being said, let's be practical when we consider the appropriateness of the adjustments for the assignment at hand. (p. 190)

… it may be necessary to make certain adjustments to make the company appear more comparable to guideline companies. If the controlling shareholder is taking too little salary out of the company and chooses to take S corporation distributions instead, a proper comparison to publicly traded C corporations may require a salary adjustment even for a minority valuation. (p. 190)

What I am saying is use your head. Do not just blindly ignore adjustments because the valuation literature indications [indicates] that you do not make adjustment for the minority. There may be facts and circumstances that require reasonable adjustments to be made. [Note: See explanation on p. 8 on addressing value when the cash flows of the subject company are zero.] (p. 190)

Another problem that exists in using the control premium data is that we cannot determine if there is a true premium being paid for control or if the acquiring company is paying for synergies that cannot be separately measured. We also do not know how many of the Wall Street megadeals resulted in spin-offs after the acquisition. If a company makes an acquisition for $100 million but intends to sell a subsidiary as soon after the acquisition as possible—for, let's say, $10 million—isn't this really a $90 million net acquisition? However, the control premium data used by the studies would be based on the $100 million. Unfortunately, it is the best that we have to work with. (p. 411)

In case you are not nervous about this yet, one of the difficulties in properly measuring the control premium that was paid is that it must be a cash equivalent price to help the valuation analyst determine the fair market value of the appraisal subject. Business transactions are frequently consummated using various payment options, including all cash, cash and noncash, or all noncash consideration. (p. 411)

Putting this data into perspective, if a valuation analyst was to base the control premium or discount for lack of control merely on the data included in the table that we are used to seeing, the premium or discount, or both, would be significantly overstated. This means that the control premium that might be added to the freely traded value

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would be too high. Conversely, if a discount for lack of control was calculated from the normally used data, the discount would be overstated, and the minority interest would be undervalued. So what does all of this mean? It means that we have be aware of the data that we use and its impact on our conclusions. Merely accepting data without understanding what is included is a bad practice. (p. 412)

Morningstar Ibbotson
SBBI, 2011 Valuation Yearbook[10]

> Does the Equity Risk Premium Represent Minority or Controlling Interest? (pp. 61-62)
>
> There is quite a bit of confusion among valuation practitioners regarding the use of publicly traded company data to derive the equity risk premium. Is a minority discount implicit in this data? (pp. 61-62)
>
> Both the S&P 500 and the NYSE include a preponderance of companies that are minority held. Does this imply that an equity risk premium (or size premium) derived from these data represents a minority interest premium? (pp. 61-62)
>
> Since most companies in the S&P 500 and NYSE are minority held, some assume that the risk premia derived from these return data represent minority returns and therefore have a minority discount implicit within them. However, this assumption is not correct. The returns that are generated by the S&P 500 and the NYSE represent returns to equity holders. While most of these companies are minority held, there is no evidence that higher rates of return could be earned if these companies were suddenly acquired by majority shareholders. The equity risk premium represents expected premiums that holders of securities of a similar nature can expect to achieve on average into the future. There is no distinction between minority owners and controlling owners. (pp. 61-62)
>
> When performing discounted cash flow analysis, adjustments for minority or controlling interest value may be more suitably made to the projected cash flows than to the discount rate. (pp. 61-62)
>
> Appraisers need to note the distinction between a publicly traded value and a minority interest value. Most public companies have no majority or controlling owner. There is thus no distinction between owners in this setting. One cannot assume that publicly held companies with no controlling owner have the same characteristics as privately held companies with both a controlling interest owner and a minority interest owner. (pp. 61-62)

Well, as you can see, it's in the cash flows. Minority cash flows are minority value and control cash flows are control value. Pretty simple, right? Not so fast. It's not always that easy. First off, how does that concept fit valuation approaches/methods?

Control and Minority Issues Based on Valuation Methods

Discounted cash flow method – This fits quite well in this income approach method as the projections that are discounted to present value can be adjusted to reflect either control or minority cash flows.

Capitalized cash flow method – This also fits quite well in this income approach method as the amount of cash flow that is to be capitalized can be adjusted to reflect either control or minority cash flows.

Guideline public company method – Many valuation analysts view a valuation multiple, e.g., price to earnings, as nothing more than the inverse of a capitalization rate, albeit in this example, an earnings capitalization rate. As such, again, the economic benefit that a multiple is applied to can also be adjusted to reflect either control or minority cash flows.

Others argue that the subject company must be normalized to bring it closer to publicly traded equivalent value. This is done by making all the adjustments necessary to make the subject company and the guideline public companies more comparable. This usually means making control adjustments. However, if a minority value is desired, then an adjustment must be made to take the company from control value to minority value. Since there is no reliable data to perform such an analysis, we are essentially back to square one.

Guideline company transaction method – Since the companies that make up the transactions are mostly of the entire company, the multiples contain any elements of control. This is okay when the subject company benefit stream is on a control basis. It is much more complicated when a minority value is desired since you would be applying control multiples to minority benefit streams.

Net asset method – Assuming the assets, both tangible and intangible, are properly valued, the resulting value would be on a control basis. If a minority discount is warranted then an adjustment may be necessary. The adjustment could be made by referencing the minority values obtained by the income approach and the market approach and making an economic adjustment. However, that just means that you are putting all the weight on the income and market approaches and not really any weight on a pure net asset method.

Now that we have discussed potential issues based on the valuation method/approach used, let's look at potential problem areas.

Continued on next page

POTENTIAL PROBLEM AREAS

What if the cash flows need no adjustments, i.e., minority and control are the same. Is the value the same for minority and control? The answer is 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.

> There is also some controversy about whether the application of the market approach results in a minority value or a control value. Those who believe it is a minority value argue that the underlying public stocks are minority interests, such that the application of a valuation multiple would result in a minority value. Others argue that the valuation multiples are nothing more than the inverse of capitalization rates derived from the public market. Consequently, they believe that the underlying theory about minority/control being in the cash flows for the income approach should also apply to the market approach. Also, the management of a public company is supposed to do their best to maximize earnings, cash flow, and value to all shareholders regardless of the number of shares they own.[11]

What if there is no one owner in control, e.g., three - 33 1/3 interests. Is the value control, minority or something in between? Assuming, again, that the company is run to the benefit of all the owners and that no one owner is using the company to their personal benefit to the detriment of the other owners, the value would be control if that is expected to continue. Here, control value and minority value would be the same. This also assumes that the cash flows are on a control basis. If there was a discount, it would be minimal. On the other hand, if one of the owners is benefiting themselves to the detriment of the other owners that can be modeled in the cash flows.

What if minority cash flows are zero? Is the value zero?

> Would it be reasonable to ignore an adjustment for officer's compensation in the following circumstance? A parent owns and runs a business, takes $1 million out of the company as salary (when the market rate of salary is $200,000 for those services), reduces the profits of the company to $0, and the purpose of the valuation is for a 10 percent gift for the child of the owner. First of all, the answer is NO. It does not matter under fair market value whether the gift is to the child or not. Under these circumstances, a 10 percent owner, child or not, could probably bring an oppressed shareholder lawsuit in most jurisdictions against the controlling owner. Stripping the business of any dividend-paying capacity for the benefit of the controlling shareholder, and denying the minority of dividends, would constitute oppression in my nonlegal opinion. The legal remedy, at that point, might be for the minority shareholder to be bought out at fair value, providing a value based on the control value of the interest, rather than the minority value. This would require the valuation analyst to make the adjustment for compensation and value the entity based on its true profitability. [12]

What if control cash flows are $500,000 and minority cash flows are $100,000 and the cap rate is 20 percent?

- Control value = $2,500,000
- Minority value = 500,000

Is the minority discount 80 percent? Again, there could be some level of shareholder oppression here and the minority shareholder would have to exercise their appraisal rights under state law. This can be a difficult analysis since you would have to estimate the costs of litigation as well as the probability of winning the lawsuit.

CONTROL PREMIUM FOCUS

In the last few years several groups have studied and reported on the use and sometimes abuse of control premiums and control premium studies and data. The Appraisal Foundation, which issues USPAP, has formed a Working Group on control premiums and on Dec. 9, 2009, issued a request for comments. The American Institute of Certified Public Accountants (AICPA) is also addressing control interests, control premiums and minority interests in two areas. First is the AICPA, Working Draft, Practice Aid, Valuation of Privately Held Company Equity Securities Issued as Compensation, released in draft form in 2011. The second is the AICPA, Working Draft, Accounting and Valuation Guide, Testing Goodwill for Impairment, released in draft form November 4, 2011.

Appraisal Foundation, Working Group on Control Premiums, Best Practices in Valuation for Financial Reporting

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On December 9, 2009 a request for comments was sent out that asked six questions. The first question, which is the main focus of this article, was as follows:

> **Discussion Question 1**
> A matter of debate in the valuation field relates to whether an observed publicly traded market share price should be adjusted to reflect a control fair value. Some parties believe that a price multiplied by quantity equation (PxQ) falls short of indicating the control value of the business, when the business as a whole is the unit of measurement. Others posit that a PxQ analysis already captures control features; thus it indicates a control value without requiring further adjustment.
>
> **View A:** On its own, PxQ typically does not indicate a control value. To determine a control value when

Continued on next page

beginning with PxQ, a control premium should typically be applied. As support for this traditional view, proponents point to:

- the premiums routinely paid in control acquisitions of public companies
- the requirement to pay something more than the current trading price to acquire the number of shares necessary to gain control
- the value of the authority to set policy and make decisions for the business
- ASC Topic 350 and IAS 36 both acknowledge the existence of a control premium

View B: On its own, PxQ typically indicates a control value. As support for this view, proponents argue that:

- the vast majority of companies are operating optimally which is why most companies are not acquired in a given year (i.e., for most public companies there are no incremental opportunities to enhance value)
- empirical studies are unavoidably biased in that they include only companies that were acquired
- companies may remain public when the higher price required to entice the sale of enough shares to gain control does not allow for a reasonable return on the investment to the market participant

Do you believe that view A or view B is only applicable and the other is not? If so, which one and why?
Do you believe that view A or view B is applicable in the vast majority of situations? If so, which one and why?
Do you believe neither view is dominant and that facts and circumstances will dictate in every situation? What are the considerations for determining the applicability of the relevant view?

This working group received comment letters from different firms and individuals. I would like to excerpt several comments from the following valuation analysts:

- Eric Nath, ASA, Eric Nath & Associates, comment letter dated January 14, 2010
- Z. Christopher Mercer, ASA, CFA, ABAR, Mercer Capital, comment letter January 15, 2010
- Gilbert C. Matthews, CFA, Sutter Securities, comment letter dated January 13, 2010

I picked these three individuals because they have been very active in writing and speaking on the issue of control premiums well before the Appraisal Foundation decided to address this topic. It is also important to note that there are other comment letters that disagree with the strong opinions of Mssrs. Nath, Mercer and Matthews.

ERIC NATH

Unfortunately, the control premium concept described in View A is plagued with fatal flaws that make it totally useless for the purpose of developing a controlling interest value for almost any appraisal purpose (or, by reciprocal, to use it to develop a lack of control discount for valuing a partial interest).

There are numerous problems with the commonly accepted interpretation of the statistics generated by the so-called 'control premium studies.' As with so many studies in the business valuation field, they measure what is measurable but not what is relevant and the results are routinely misinterpreted. I will summarize why this approach for determining the control value of the entire business or the impairment of value for lack of control related to a minority interest does not work.

The traditional theory fails to recognize that public investors actually have a great deal of control over their investments because the liquidity of the public markets allows them to sell at will. One of the under-recognized benefits of a smoothly functioning and liquid public market is that shareholders' ability to sell at will eliminates virtually all risk associated with not having any control over the enterprise.

Once it is realized that a sale of a public company is simply a sale from one control group to another control group, it becomes obvious that an acquisition premium for a public company cannot represent the value of control versus minority value. Such an assertion simply ignores the true nature of the public shareholder's position in the transaction.

If a public company is acquired at a premium it is merely responding to the laws of supply and demand, not some theory about a differential in value between control and minority.

Public shareholders are no different than any other control group in the sale of their company: all control sellers hope to be paid a premium. Sometimes this is possible and sometimes not, as with any transaction, but it doesn't require a differential in value between minority and control to drive this result.

In looking at the premiums themselves, the amount of the acquisition premium, if any, will be a function of many factors, including the skill with which the investment banker manages the process. Hubris and stupidity on the part of buyers also play a well-documented role in driving up the price. These factors have nothing to do with the difference in value between control on the part of the buyer and lack of control on the part of the public shareholders.

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It has been found that there is little, if any, difference in premiums paid by strategic buyers over financial buyers of public companies.

Given the liquidity in the public market, and the other factors mentioned above which allow companies to trade up to their intrinsic economic value, most public companies will tend to trade at or near their control value. Were this not systematically true, given the hundreds of billions of buyout dollars waiting for a good investment to make itself known in the market, there would be far more acquisitions of public companies than there actually are.

Not that it is a compelling reason to argue against the use of control premiums in financial reporting, but the SEC apparently takes a very dim view of the use of this type of data to value the types of assets and companies it reviews. As well they should – the use of acquisition premiums will almost always overvalue the assets at issue, which will mislead investors.

I believe that the issue of control premiums and what they *don't* tell us is fairly settled at this point among the more experienced and senior appraisal professionals. Nevertheless, the issue continues to be debated by business appraisers who are either too young to have researched the issues sufficiently or who do not have sufficient intellectual curiosity to move beyond the superficial and rudimentary analysis that once characterized the discussion on this matter.

CHRIS MERCER

Control premiums neither do nor do they not measure control value.

Control premiums measure the percentage difference between two prices of a public company. Simply put, control premiums measure the difference between the price at which a public company is acquired (per share) and the price at which it was trading before the announcement of the acquisition (again, per share).

Assume that Company A is acquired for a price of $14.00 per share. Assume further that the price before the announcement of acquisition (presumably the 'unaffected price') was $10.00 per share. The "control premium" is calculated as follows:

CP = (Acquisition Price Per Share / Pre-Announcement Price Per Share) – 1.0
CP = ($14.00 per share / $10.00 per share) – 1.0
CP = 1.4 – 1.0
CP = 40%

So the control premium of Company A was equal to 40 percent. What does that tell you *about the control value of Company A?* Absolutely nothing. You have to know the components of the equation to know what the control value of Company A was.

So the control premium of Company A was equal to 40 percent. What does that tell you about the 'goodness' or 'badness' of that transaction price in relationship to other companies? Absolutely nothing.

If similar companies are trading freely at around 8x multiple of EBITDA and the 40 percent control premium for Company A reflected a 6x multiple of EBITDA, it may have been a 'bad' price. On the other hand, if the 40 percent control premium reflected an 11.2x multiple of EBITDA (with others trading at 8x), it may have been a 'good' price.

It should be clear that the control premium from a single transaction tells you absolutely nothing about the control value or the goodness or badness (relatively) of the pricing of that transaction.

What about lots of control premiums? *Mergerstat Review 2009* was reviewed for a sample. Since I think I know something about financial institutions, I wrote down all the control premiums for three broad industry groups in 2008, banking and finance, insurance, and brokerage/investment banking/management consulting.

So now, I tell you that of the 29 banking transactions recorded in *Mergerstat Review 2009* had a median control premium of 41.1 percent. What does that tell you about any bank transaction? Absolutely nothing.

The average control premium was 62.7 percent, which should tell you that there must have been some relatively large premiums in 2008. The average premium excluding premiums greater than 100 percent was 33.6 percent. What does that tell you about any bank transaction? Absolutely nothing.

The standard deviation for the 29 transactions was 86.7 percent, which is larger than the median or the average. What does that tell you about the control value of any bank? It tells me that the application of any of these numbers to *any other bank not in the group* is an exercise in futility.

The remainder of the questions posed in the 'Request for Response' presuppose that one plans to use control premiums and then discuss potential guidance for how to apply them. The ASB should back away from these questions. It is impossible to provide

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credible guidance regarding how to apply something that doesn't and cannot work.

The appropriate question is not how to apply control premiums. Perhaps the appropriate question relates to how to develop values on a controlling interest basis. That question can be addressed in economic terms.

GIL MATTHEWS

I strongly believe in View B. I spoke on this issue at the ASA conference in Boston with Prof. Larry Hamermesh, discussing the issue as it relates to Delaware appraisals.

The default premise should be that the market price of an actively traded stock (whether it be the subject company or a guideline company) represents a pro rata share of control value.

I would never apply a control premium based on average premiums, as discussed in my article. If a control premium is to be applied, it should be determined based on multiples of guideline acquisitions compared to multiples of the subject company or guideline companies.

Attached to Mr. Matthews comment letter is a copy of an article he wrote in the American Society of Appraisers *Business Valuation Review,* Summer 2008, Volume 27, Number 2, "Misuse of Control Premiums in Delaware Appraisals." Some excerpts follow which illustrate some of the history of the control premium issue and how several respected valuation experts either rejected the prevailing perspective or were brave enough to change their positions.

Eric Nath, a San Francisco–based valuation expert, was the first to question the presumption of an implied minority discount in publicly traded share prices. Nath presented this view in a pioneering 1990 *Business Valuation Review* article in which he argued that market prices generally already reflected control value. He pointed out that the freely traded market prices of a company already had incorporated in them the company's financial control positives or negatives. [81 - Nath, 'Control Premiums and Minority Interest Discounts in Private Companies,' *Business Valuation Review,* June 1990. He reiterated this position in 'The Tale of Two Markets,' *Business Valuation Review,* Sept. 1994 and in 'How Public Guideline Companies Represent "Control" Value for a Private Company,' *Business Valuation Review,* Dec. 1997.] Nath's theory stimulated a great deal of debate and reconceptualization and, despite much initial resistance in publications and seminars, has become widely accepted by leading valuation experts. Mark Lee, an experienced and well-respected valuation expert, pointed out in 2001: 'If there is no M&A market available to sell a company at a premium to its stock market value, then there is little or no acquisition premium, much less a "theoretical'' premium based on an average of acquisitions of dissimilar companies.' [82 - M. Mark Lee, 'Control Premiums and Minority Discounts: the Need for Economic Analysis,' *Business Valuation Update,* Aug. 2001, 4.]

Lee also pointed out in 2004 that 'the acquisition value of a company may be equal to or below its market value,' explaining, 'While a company may be viewed as very attractive to a purchaser of a minority interest in the public market, the company as a whole may be perceived as too risky at its publicly traded market price.' [83 - M. Mark Lee, 'The Discount for Lack of Control and the Ownership Control Premium,' in *The Handbook of Business Valuation and Intellectual Property Analysis*, Robert F. Reilly and Robert P. Schweihs, eds., (New York: McGraw-Hill, 2004), 37.]

In 1996, when Shannon Pratt wrote that the guideline company method 'usually requires some adjustment from the publicly traded minority stock value equivalent to account for control,' that was the accepted view of the financial community. [86 - Pratt, Reilly, and Schweihs, *Valuing a Business*, 3rd ed., p. 210.] At that time, the Delaware Court rightly relied upon the financial community's accepted view of an implied minority discount since they were following Weinberger's injunction to make their valuations in accordance with accepted financial theory.

Within three years, Pratt had come to modify his view. In a 1999 article he stated, 'Valuation analysts who use the guideline public-company valuation method and then automatically tack on a percentage "control premium" . . . had better reconsider their methodology.' [87 - Pratt, 'Control Premiums? Maybe, Maybe Not— 34% of 3rd Quarter Buyouts at Discounts,' *Business Valuation Update,* Jan. 1999, pp. 1-2. This article is cited in Pratt, Reilly and Schweihs, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies,* 4th ed. (New York: McGraw-Hill 2000), 357.] Pratt included this comment in the Fourth Edition of *Valuing a Business* in 2000…

In 2001, Pratt further clarified his position in *Business Valuation Discounts and Premiums*. After an extensive discussion of various articles and seminars regarding the issue of whether market prices reflect control value, Pratt quoted

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extensively from Lee's incisive 2001 article and then concluded, 'In any case, it is obvious that, given the current state of the debate, one must be extremely cautious about applying a control premium to public market values to determine a control level of value '[89 - Pratt, *Business Valuation Discounts and Premiums* (2001), 40.]

Mercer was also coming to the conclusion that market prices are often close to control value. He addressed the issue directly in 2004 in the important 1st Edition of *The Integrated Theory of Business Valuation.* [92 - Mercer, *The Integrated Theory of Business Valuation* (Baltimore: Peabody, 2004). This book innovatively showed the interrelation among various approaches to valuation, discounts, and premiums.] After having disagreed with Nath in the early 1990s, he conceded that Nath had been right, and that the financial control premium (the difference between Financial Control Value and Marketable Minority Value) could be zero.[93 - *Id.*, p. 101.] Mercer's 2004 book included a modified levels-of-value diagram... that showed Marketable Minority Value overlapping Financial Control Value. [94- *Id.*, p. 110. This diagram is reproduced in Pratt, *Valuing a Business,* 5th ed., (2008), 387.] He uses that model to make the point that 'unless there are cash flow-driven differences between the enterprise's financial control value and its marketable minority value, there will be no (or very little) minority interest discount.' [95 - *Id.*, p. 108.]

AICPA, Working Draft, Practice Aid, Valuation of Privately Held Company Equity Securities Issued as Compensation

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The following caveats are from page 3.

> This practice aid is nonauthoritative and has been developed by AICPA staff and the Equity Securities Task Force.
>
> This practice aid replaces the 2004 edition of the practice aid *Valuation of Privately-Held-Company Equity Securities Issued as Compensation.*
>
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The issue of control vs. minority value is addressed in Chapter 9, "Control and Marketability." While we recommend that our readers read the entire chapter to gain the full context, some relevant excerpts follow:

> **9.01** In the market approach, the guideline public company method is typically regarded as indicating the enterprise or equity value on a minority, marketable basis (Footnote 1: Note, however, that to the extent that the cash flows and cost of capital for the enterprise under current ownership are close to optimal, the enterprise value on a minority basis may be similar or equal to the enterprise value on a controlling basis.), and the guideline transactions method is typically regarded as indicating the enterprise or equity value on a controlling, marketable basis. The backsolve method indicates an equity value that is consistent with the private equity or venture capital investors' expected rate of return, given the degree of control they have over the enterprise and the degree of marketability of their investment. (p. 78)
>
> In the income approach, the discounted cash flow method is typically regarded as indicating value on a controlling, marketable basis, but it may be used to indicate value on a minority interest basis, if the cash flows reflect minority interest cash flows and the discount rate reflects the company-specific cost of capital. (p. 78)
>
> **9.04** In many cases, a *control premium* or *acquisition premium* is estimated based on the prices that market participants may pay to acquire companies. Given the economics of supply and demand, a buyer who wishes to acquire control of an enterprise may have to pay a significant premium over the previous equilibrium price to incentivize current interest holders to sell. These premiums may be justified by the expected improvements to the cash flows, reductions in risk that buyers expect to achieve, or both. (Footnote 2: The owners of an enterprise may increase enterprise value by improving the cash flows directly; for example, by increasing revenues, reducing operating costs, or reducing nonoperating costs such as taxes. The owners of the enterprise may also increase enterprise value by reducing risk; for example, by diversifying the business, improving access to capital, increasing the certainty of cash flows, or optimizing the capital structure. Both of these approaches may be used to justify the premiums paid in transactions.) Valuation specialists frequently estimate the control premium that might be paid for an enterprise by observing the difference between

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public company multiples and the multiples paid in transactions. (Footnote 3: For example, the *Mergerstat Review* provides statistics and analysis of mergers and acquisitions for U.S. companies segregated by industry. However, note that these statistics reflect averages over a wide range, and the actual premium paid in any given transaction depends upon the negotiation dynamics. When estimating an acquisition premium for a specific company, it is important to consider the characteristics of the likely market participants and the level of improvements to the cash flows and synergies available to these market participants. Synergies available to only one potential acquirer typically should not be included in the estimated control premium, because it would be difficult for the sellers to capture the value of these synergies in the negotiation process.) (p. 79)

9.06 In short, the task force believes that it is not appropriate to include a control premium or acquisition premium in the enterprise value used in valuing the minority interest securities within the enterprise, except to the extent that such a premium reflects improvements to the business that a market participant would expect under current ownership. (p. 80)

9.14 The most common method for estimating a discount for lack of control uses the inverse of the acquisition premium observed in transactions as discussed in paragraph 9.04. (Footnote 12: Using this method, the discount for lack of control would be measured as 1 – (1 / (1 + control premium)). However, the task force believes that these premiums overstate the 'pure' difference in value attributable to the difference in the level of influence between primary investors' securities and other securities, because the control premiums measured in merger and acquisition studies include synergies and reflect transaction dynamics at the enterprise value level. (p. 82)

9.15 In summary, as discussed in paragraphs 9.07–.12, when valuing minority interests in an enterprise (including investor securities that lack control), the enterprise value would be measured considering the company's cash flows under current ownership, the company's plans for a future liquidity event (if any), and the premium (if any) that market participants would expect to be realized upon a liquidity event (whether via a sale or an IPO). The enterprise value would not include a significant control or acquisition premium, unless market participants would pay such a premium for an interest in the enterprise under current ownership. Therefore, in such case, it would be unnecessary to back out a premium in estimating the fair value of the minority interests. (Footnote 13: If market participants would pay a significant control or acquisition premium for an interest in the enterprise today, even though the expected liquidity event is some time into the future, that premium should be considered in estimating the fair value of the minority securities as well. The discount for lack of control that may apply to the minority securities relative to the primary investor securities should capture only the differences in risk described in paragraph 9.13.) (p. 82)

AICPA, Working Draft, Accounting and Valuation Guide, Testing Goodwill for Impairment.
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The following caveats are from page iii.

This guide provides guidance and illustrations for valuation specialists, preparers of financial statements, and independent auditors regarding goodwill impairment testing. This guide is nonauthoritative and has been developed by AICPA staff and the AICPA Impairment Task Force.

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The issue of control vs. minority value is addressed in several places in the working draft. While we recommend that our readers read the entire working draft to gain the full context, some relevant excerpts follow:

3.02 FASB ASC 350-20-35-22 states that the fair value of a reporting unit is the price that would be received to sell the reporting unit as a whole in an orderly transaction between market participants at the measurement date. It also states that quoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement, if available. (p. 43)

3.04 FASB ASC 350-20-35-23 further explains that substantial value may arise from the ability to take advantage of synergies and other benefits that flow from control over another entity. Consequently, measuring the fair value of a collection of assets and liabilities that operate together in a controlled entity may be different from measuring the fair value of that entity's individual equity securities. An acquiring entity often is willing to pay more for equity securities that give it a controlling interest than an investor would pay for a num-

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ber of equity securities representing less than a controlling interest. That control premium may cause the fair value of a reporting unit to exceed its market capitalization. The quoted market price of an individual equity security, therefore, need not be the sole measurement basis of the fair value of a reporting unit. (p. 43)

The guidance in FASB ASC 350-20-35-23 (see paragraph 3.09) notes that the underlying share price used for impairment testing may be higher than the observed price because the basis for analysis in step 1 of the goodwill impairment test is that of a control buyer. This control buyer may be able to realize synergistic benefits from the assumed transactions that may include enhanced revenues and cost savings associated with items that are redundant in nature.
(p. 56)

3.79 Another consideration in applying the market approach is the basis of the valuation; that is, whether the resulting enterprise value would be considered controlling or minority. (Footnote 33: In a goodwill impairment test, using an income approach, cash flows are assumed to be on a controlling interest basis.)

- The guideline public company method is typically regarded as indicating the enterprise or equity value on a minority basis.

- The guideline transaction method is typically regarded as indicating the enterprise or equity value on a controlling basis." (p. 68)

3.80 Step 1 of the goodwill impairment test is considered to be a valuation of the subject reporting unit on a controlling interest basis. Therefore, in some cases, a control premium may be applied to convert the guideline company approach to a controlling interest basis. The magnitude of the control premium is based on consideration of multiple qualitative and quantitative factors. In some cases, it may be determined that no control premium would be applied. (p. 68)

3.88 The guideline transaction method is typically regarded as indicating the enterprise or equity value on a controlling, marketable basis. Therefore, no premium for control would be applied to the guideline transaction method. If control premium data are available for the selected guideline transactions, however, these data may be used to help determine a reasonable level of control premium to be applied in the guideline public company method. (pp. 69-70)

CONCLUSION

Most, if not all of the U.S. business valuation committees/organizations teach that control and minority value emanates from the cash flows. It is not based on an arbitrary and unsupportable acquisition premiums paid when a public company is acquired. Why this use of control premiums from control premium studies continues is puzzling given the strong criticisms on the use of such data. If a business is properly valued and includes the applicable expectations of future cash flow, tacking on a 15 percent or 25 percent or 40 percent acquisition-based so-called premium for control will inappropriately inflate the value with no underlying economic or financial support.

[1] This article does not address control premiums and lack of control/minority discounts in asset holding-type companies such as family limited partnerships.
[2] As approved by the American Society of Appraisers, the American Institute of Certified Public Accountants, the Institute of Business Appraisers, the National Association of Certified Valuation Analysts and the Canadian Institute of Chartered Business Valuators.
[3] AICPA Statement on Standards for Valuation Services (SSVS) No. 1, Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset, Appendix C.
[4] *Mergerstat Review,* FACTSET MERGERSTAT, Global Mergers and Acquisitions Information, Newark, New Jersey, www.mergerstat.com or www.factset.com Note: The information for this article is primarily from the *Mergerstat Review* 2010 edition.
[5] Mergerstat Review 2010, p. X.
[6] FactSet Mergerstat®/BVR Control Premium Study™, Business Valuation Resources, www.bvresources.com
[7] James R. Hitchner, editor and coauthor, *Financial Valuation Applications and Models,* 3rd edition, 2011, Wiley & Sons.
[8] Pratt, Shannon P. and Alina V. Niculita, *Valuing a Business, the Analysis and Appraisal of Closely Held Companies,* 5th ed., 2008, McGraw-Hill.
[9] Trugman, Gary, *Understanding Business Valuation, A Practical Guide to Valuing Small to Medium-Sized Businesses,* 3rd. ed., 2008, American Institute of Certified Public Accountants.
[10] Morningstar Ibbottson *SBBI, 2011 Valuation Yearbook,* Morningstar, Inc.
[11] Hitchner, p.1258.
[12] Trugman, p. 190.

Current Issues in Developing the Cost of Capital

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Over the past decade there have been three topics that have consumed the greatest amount of BV ink: (1) valuation for financial reporting, (2) the tax-affecting (or not) of pass-through entity profits, and (3) the cost of capital. Much of the conversation regarding the first two has been driven, or at least instigated, primarily by third parties. In my opinion, however, the discussion of the cost of capital conversation reflects the growing maturity of the BV profession as both theoreticians and practitioners seek to find increasingly reliable, accurate and usable models to identify, or document, private company cost of capital.

Much has been contributed to the BV profession on this topic over the last several years. And no one article can do justice to any particular issue, let alone several, so consider the following both a tease and an encouragement to you to dig further into the relevant professional literature, if you haven't already. In no particular order and in no way exhaustive, some of the theoretical advances regarding cost of capital that practitioners can add to their practice arsenal include the following:

A SUPPLY-SIDE ERP

Until the past few years, practitioners unquestionably availed themselves of Ibbotson's (now Morningstar) historical equity risk premium (ERP) estimate, which was proffered with the belief that a long-term average of historical actual returns would be a reasonable proxy for investors' current expectations. In the 2011 edition of the data, the Ibbotson historical ERP uses data covering the period 1926 to 2010; its use implies the belief that the extrapolated average of the past nearly 85 years is reflective of the future. However, a few years ago some began to question this assumption, noting that it is a big leap to assume that investors' future expectations are equivalent to some (relatively arbitrary) average of the past.[1]

Supply-side ERPs, on the other hand, attempt to estimate long-term expected equity returns by considering factors such as the expected growth in corporate earnings and dividends, arguing for a more reasonable assumption that investors cannot expect a return in the long-run that is different than that which can be produced by businesses in the real economy. The supply-side ERP assumes that actual returns to equity will track real earnings growth, and not the growth reflected in the price to earnings ratio. A recent Delaware Chancery Court case, *Global GT LP v. Golden Telecom, Inc.,* C.A. No. 3698-VCS (Del. Ch. Apr. 23, 2010), outlines the arguments on this specific issue and is well worth the time to read. Morningstar has published both a supply-side and historical ERP for the past several years, and has added some detailed explanation as to the supply-side ERP derivation in its annual *SBBI* books.[2]

SIZE-ADJUSTED PUBLIC COMPANY ERP

For several years Roger Grabrowski has published a detailed study of equity risk premiums (ERPs) of publicly traded companies.[3] The study is currently published by Duff & Phelps and Roger has published and spoken widely on the topic. As contrasted to Ibbotson/Morningstar's breakdown of ERPs by decile via market capitalization, the study breaks down ERPs into 25 size stratifications over eight criteria: sales, book value of equity, book value of invested capital, market value of equity, market value of invested capital, assets, number of employees, five year's average net income, and five year's average EBITDA. The increased granularity of the data allows the practitioner to more closely "zero-in" on a representative size-adjusted ERP for the subject ownership interest.

Many practitioners are using this study to support size-related risk adjustments in their ERP estimates, either by selecting premium data from the percentile premia analysis tables or performing a regression analysis based on the specific metrics of the subject company against the study data. The

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expert TIP

No matter how sophisticated a practitioner's analysis in developing a cost of capital, the conclusion still has to pass the "smell test." At the end of the day, after all the research, number crunching and documentation, the practitioner must answer the question, does the presumed cost of capital make sense in the context of the subject ownership interest and standard of value?

practitioner should be aware, however, of some of the underlying assumptions and data content issues before blindly applying the ERP data. Here's a little quiz on the Duff & Phelps' risk premium data to test your understanding of Roger's work (answers at end).

1) Is the Duff & Phelps' Equity Risk Premium Study useful for developing a cost of capital via a buildup method or a CAPM method?
2) Is the Duff & Phelps' risk premium data levered or unlevered?
3) Are any types of companies excluded from the study?
4) If the subject company is very small – say less than $1million in revenues – can one regress the Duff & Phelps' ERP data down to that small size to develop an equity cost of capital?
5) Can the Duff & Phelps' 2011 Equity Risk Premium Report data be used to develop cost of capital estimates for banks or other financial services companies?
6) Is the Hamada or the Harris-Pringle formula for unlevering applied to the data?

SIZE-ADJUSTED PUBLIC COMPANY ERP REDUX

Many practitioners who rely primarily on the Ibbotson/Morningstar ERP studies also rely on the decile size premia analysis that is part of the annual studies, often looking at the 10th decile (the smallest 10 percent of companies in the study) for representative size-based risk adjustments. Size is measured by market capitalization in the Ibbotson/Morningstar studies, and the 10th decile in the current edition of the study includes companies with market capitalizations of between $1.2 million and $236 million. Ibbotson/Morningstar continues to segment the 10th decile into "10a" and "10b," and even more recently further segments these two down to even smaller groups ("10y" and "10z") within the "10b" segment. But even the "10z" segment includes companies with market capitalizations as large as $86 million.

Practitioners should be asking whether or not this segmentation at the bottom end of the market capitalization spectrum provides sufficiently useful size premium information for developing size adjustments to market ERPs relative to their smaller subject companies. There are at least two considerations.

First, the bottom decile includes companies that are much larger than many of the companies practitioners value. If one is valuing a small company, how does he or she connect the logical and analytical dots between the companies that are significantly larger in the data than the subject company?

In addition to the concern about relative size comparison, the practitioner might want to be concerned regarding what companies are in these lowest percentile segments. After all, when size is measured only by market capitalization the data could include some very large, but very poorly performing companies that have very low market capitalization – particularly in the current and recent economic environment. I am not proposing that this data is not good or useful, only that the practitioner should use it with the understanding of what the data actually represents.

TOTAL COST OF CAPITAL MODELING

While there have been decades of research on various components of equity returns, there is little direct evidence for the company-specific risk premium (CSRP) component (or alpha in CAPM) which generally requires a more qualitative approach to identification and measurement. In the past some have proffered methodologies for quantifying the qualitative issues associated with the CSRP, but the models themselves tend to offer up a false precision that masks the underlying subjective analysis. For example, if one were to build a factor rating model for various company-specific risk issues (depth and quality of management, internal systems and controls, geographic or product diversification, etc.), on what empirical basis are these and other relative factors chosen and weighted against one another? Is the quality of management a more weighty issue than geographic diversification, or is it of equal importance or less important when estimating CSRP? How do any of these issues rank in importance relative to financial liquidity? You may have a solid opinion, but it is likely not based on peer-reviewed empirical evidence from the marketplace in general.

Enter Peter Butler and Keith Pinkerton who, using total beta measurements of publicly traded companies, developed (and market) a methodology for estimating total cost of equity by considering market returns and, by inference, company-specific risk premiums.[4] Essentially the model they proffer allows the practitioner to estimate the required equity return rate for private companies by identifying comparable public companies and analyzing market data to evaluate the market's perspective on both the systematic and unsystematic risk of these companies to estimate the total cost of capital, as opposed to building up a return rate by adding size premiums and a subjective, company-specific risk premium.

This hotly debated modeling has gained some traction of late and many articles have been published, both pro and con.[5] As with any of these models, make sure you understand the theory, computations, and issues underlying the model.

INTERNATIONAL COST OF CAPITAL

While most practitioners in the U.S. are not valuing foreign companies, those that do suffer from a dearth of cost of capital data as contrasted with volumes of data generated from U.S. markets. Nevertheless, with the implementation of IFRS and the increasing globalization of the economy, the conversation regarding country (political) risk premiums, default risk premiums, and exchange rate risk issues is becoming more relevant to a larger portion of the profession. For those interested in

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delving into international cost of capital, I offer the following two sources of research, articles, and data.

- *Damodaran's industry and country-specific risk premia:* New York University's Aswath Damodaran, who has spoken at several BV conferences, is a widely published[6] theoretician and observer of market valuation and has freely provided his data on international ERPs and industry betas (both U.S. and in various international markets) on his website, *www.damodaran.com.*
- *Budyak's articles and modeling of country risk premia:* Jim Budyak has written on international cost of capital, offering chapters on the subject in larger BV works and in various journals. His "Company, Country, Currency, and Sector Method" attempts to pick up where Professor Campbell Harvey's "Country Risk Rating Model" ends.[7]

TO WHOM MUCH IS GIVEN, MUCH IS REQUIRED

The modeling of observed market behavior consists of complex computations on significant amounts of data. For the practitioner, the potential dangers of this complexity are to (1) treat major components of the cost of capital computation as black boxes, from which the practitioner may not fully understand how the output is derived, and (2) so over-analyze the development of each of the cost of capital components separately as to lose sight of the purpose of the calculations – to estimate the market's required rate of return for the subject business or intangible asset interest.

Conversely, the benefit of these and other advances in our understanding of market evidence when developing a cost of capital is that the practitioner has more tools to support his or her opinion of such. As a profession, BV has made great strides from the days where the rationale for a cost of capital was based primarily upon a discussion of bands of investment returns[8] estimated on general descriptions of business risk without documented empirical evidence. Nevertheless, the conversation regarding bands of investment is still very useful and revealing as to market behavior and perspective on risk. It is (perceived) future risk, after all, that drives required market returns. The greater the perceived risk in a return not occurring, the greater the return a market participant will want for making that investment, all other things held constant.

No matter how sophisticated a practitioner's analysis in developing a cost of capital, the conclusion still has to pass the "smell test." At the end of the day, after all the research, number crunching and documentation, the practitioner must answer the question, does the presumed cost of capital make sense in the context of the subject ownership interest and standard of value?

Answers to Quiz:

1) The data is presented in such a way that it is useful for both a buildup method and a CAPM method. The data is analyzed and presented in multiple formats, so that a size-adjusted ERP (over a riskless rate) can be derived for use in a buildup method, or a size premium over CAPM can be applied. The discussion starts on page 22 of the Duff & Phelps' 2011 Equity Risk Premium Report.
2) The Duff & Phelps' 2011 Equity Risk Premium Report includes unlevered average risk premiums and sum betas for each portfolio (see discussion on page 101 of the study).
3) Yes. ADRs, non-operating holding companies, and financial services companies are excluded (see page 10 of the study). Additionally, high risk companies (as defined by Duff & Phelps) are also removed, but their ERPs are separately calculated and presented for use when and where appropriate. The discussion of high risk companies starts on page 80 of the study.
4) Possibly not, and if so, only carefully. The company at the 5th percentile (95 percent of companies are larger) in terms of net income reports $0.495 million in five-year average net income. Certainly it is not "good statistics" to regress beyond the end data point (beyond the minimum or the maximum).
5) No. Since financial services companies (defined as SIC Code 6) have been removed from the data, the data is not useful for estimated cost of equity capital for those entities (page 10 of the 2011 study).
6) Since 2008, the Harris-Pringle formula has been employed. Prior to 2008, the Hamada formula had been used. It is important to know which formula is used and how it is employed in order for you to consider unlevering and relevering your data to match the market evidence.

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[1] Roger Grabrowski provides an introductory overview of the historical vs supply ERP issue in the August 2010 *Financial Valuation and Litigation Expert*.

[2] Starting on page 64 of the *Ibbotson SBBI 2011 Valuation Yearbook*, the latest edition as of this writing.

[3] The January 2007 issue of *Financial Valuation and Litigation Expert* provides an article by Rob Burkert on the topic.

[4] The July 2009 issue of *Financial Valuation and Litigation Expert* provides an interview of Mr. Butler and Mr. Pinkerton on the topic.

[5] Peter Butler's website *(www.valtrend.com)* is a source of many of these articles. The ASA's *Business Valuation Review* published several articles which are available on its website, *www.bvappraisers.org*. In addition BV Resources, which hosts and markets the Butler/Pinkerton model, provides many articles.

[6] Some of Damodaran's more resent books include, *Damodaran on Valuation,* New York (2006); *Applied Corporate Finance: A User's Manual* (2005); *Investment Valuation* (2002); *The Dark Side of Valuation*, (2001). His website, *www.damodaran.com*, provides access to articles, research, and presentations.

[7] Budyak, James T. "Getting Your Head Out of the Model: Due Diligence and Developing Cost of Capital," *Business Valuation Update*, Vol. 12, No. 5, May 2006, pp. 5-8.

[8] The conversation regarding bands of investment documented in BV literature was as early as (I can find) June 1982 by James H. Schilt in an article, "Selection of Capitalization Rates for Valuing a Closely Held Business" published by *Business Valuation News* (now *Business Valuation Review*, by the American Society of Appraisers, www.bvappraisers.org). For those newer to the profession, it is a good article to review.

An Investment Banking View of Enterprise Value

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SHOULD CASH BE DEDUCTED WHEN CALCULATING ENTERPRISE VALUE?

The valuation community currently uses two different approaches to calculate Enterprise Value (EV) as the numerator for multiples in the guideline company and acquisition methods. EV is sometimes defined as debt plus equity and sometimes as debt plus equity *minus cash.* We believe that in calculating EV, cash should be deducted. The valuation literature reflects this disorder: some writers exclude cash from the definition,[1] while others (including the author) state that cash should be deducted.[2] Pratt writes that both are acceptable approaches.[3] We set out to see what investment bankers actually do in practice. We then set forth our reasoning as to why the valuation profession should adopt what is the overwhelming investment banking practice: to deduct cash when calculating EV. We also discuss other factors to be considered in the determination of EV.

To determine how investment bankers and others rendering fairness opinions defined EV and, particularly, how they treated cash, we reviewed the published descriptions of fairness opinion methodologies used in cash acquisitions of U.S. companies. Under S.E.C Rule 13e-3, summaries of fairness opinion analyses must be included in the proxy statements or tender offer documents sent to shareholders. We examined documents filed with the S.E.C. for 315 acquisitions that contained 351 fairness opinions.[4]

We reviewed the 351 opinions to identify those which contained investment bankers' definitions of EV. Of the 351 opinions, 282 used multiples of revenues, EBITDA and/or EBIT with EV (by any name) in the numerator.[5] Of these 282 opinions, 210 described how EV was defined while 72 did not. Only one definition (not by an investment banker) did not deduct cash, one definition deducted only "excess cash,"[6] and a total of 208 (99 percent) of the definitions deducted all cash on the balance sheet.[7] The definitions called for the deduction of cash from the sum of debt and equity regardless of whether cash exceeded the amount of debt.

Our review shows clearly that the practice of investment bankers is to deduct cash and cash equivalents when calculating multiples.

WHY CASH SHOULD BE DEDUCTED

The investment banking practice of using net debt (interest-bearing debt minus cash) rather than gross interest-bearing debt reflects economic reality. The appropriateness of deducting cash in an EV calculation can be demonstrated by looking at the impact on EV of both a material debt repayment and a material debt issuance.

Consider a company with an equity market value of $200 million, debt of $200 million, and cash of $100 million. Its EV net of cash would be $300 million, but its EV would be $400 million if cash were not deducted. If we assume that the company were to use half its cash to repay debt, both debt and cash would be reduced by $50 million and, when cash is deducted from debt, its EV would still be $300 million. However, if cash were not deducted, EV would be reduced from $400 million to $350 million.

Alternatively, if the company were to borrow an additional $100 million, it would then have an incremental $100 million in debt and an incremental $100 million in cash, so that its EV would still be $300 million if cash were deducted; however, EV would increase from $400 million to $500 million if cash were not deducted.

When cash is deducted, the company's EV stays at $300 million in both the repurchase case and the debt issuance case. If the definition of EV were to provide that cash should not be deducted, the company's calculated EV would fall from $400 million to $350 million when it repays debt and would rise to $500 million after a debt financing. Such disparities in the EV value of a company whose net debt is unchanged throws into question any calculation of multiples based on EV. If a company's calculated EV were to change materially as a result of a debt retirement or of a financing, its EBITDA multiple would be materially affected even though the economics of the company would remain substantially unchanged.

A company's value is not reduced by retiring debt nor is its value increased by borrowing. Since cash is, in effect, negative debt, the logical and accurate method is to deduct cash in the computation of EV. Valuators who calculate multiples for guideline companies and acquisitions with EV unadjusted for

Continued on next page

expert TIP

When calculating enterprise value, cash should be deducted from the sum of interest-bearing debt and equity.

cash end up making invalid comparisons that lead to questionable valuations.

OTHER FACTORS TO CONSIDER IN CALCULATING ENTERPRISE VALUE

Our review of the data shows that investment bankers sometimes include additional data when calculating EV. The inclusion of minority interests and preferred stock is customary when these items are on the balance sheet. Marketable securities are usually considered to be cash equivalents and are therefore deducted. Depending on facts and circumstances, other items may be considered; e.g., capital leases may be added and non-operating assets and the present value of loss carryforwards may be deducted. We cite several examples of definitions:

> [E]nterprise value … is the market value of common equity plus the book value of debt and minority interest less cash and the value of unconsolidated assets.[8]

> Firm value of a particular company was calculated as market value of that company's common stock based on fully diluted shares using the treasury method … plus the value of that company's indebtedness, minority interest and preferred stock, minus that company's cash and cash equivalents and marketable securities.[9]

> Enterprise value of a particular company was calculated as market value of the company's equity . . . plus the value of the company's indebtedness, capital leases, minority interest and preferred stock minus the company's cash and cash equivalents, and marketable securities.[10]

> [Firm value] … [is] equity value … plus straight debt, minority interest, straight preferred stock and out-of-the-money convertibles, less cash and long term equity investments valued at the current market price where available, and at book value where market price is not available.[11]

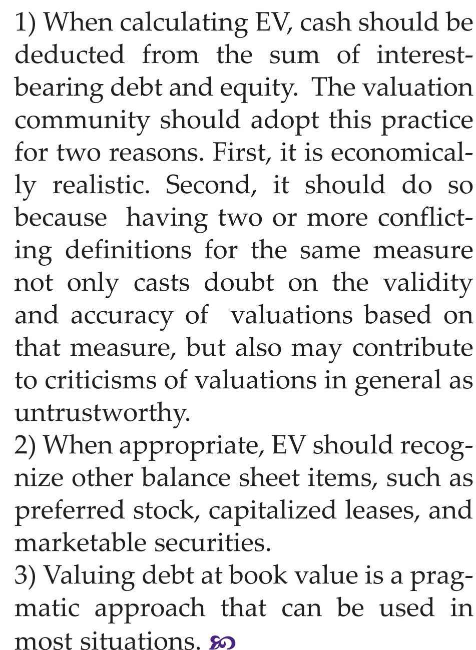
> The enterprise value of each company was obtained by adding its short- and long-term debt to the sum of the market value of its common equity, the value of any preferred stock (at liquidation value) and the book value of any minority interest, and subtracting its cash and cash equivalents and the present value of the net operating loss carryforwards, if any.[12]

INVESTMENT BANKERS COMMONLY INCLUDE DEBT AT BOOK VALUE

Based on a separate, ongoing review of more than 100 fairness opinion presentations, investment bankers include debt in EV at book value rather than at market value, which is the academically preferred but impractical approach. Book value is used because the difference between the market value and book value is seldom material and because it is often difficult to obtain prices of illiquid debt securities.

Because zero-coupon debt and any other debt issued at a discount are carried on a company's books at accreted value, market value is usually in line with accreted book value. Since accounting rules require that zero-coupon debt and other debt issued below par be carried at accreted value, the book value for reporting purposes should be reasonably close to market value.

If a company's debt has an average market value of 95 percent or 105 percent of book and debt is 40 percent of EV, the impact on EV is only 2 percent. This is effectively a rounding error when the EV/EBITDA ratio is calculated to two significant figures, so that it is seldom worthwhile to expend the time and effort necessary to mark a company's debt to market.



CONCLUSION: AN INVESTMENT BANKER'S VIEW

1) When calculating EV, cash should be deducted from the sum of interest-bearing debt and equity. The valuation community should adopt this practice for two reasons. First, it is economically realistic. Second, it should do so because having two or more conflicting definitions for the same measure not only casts doubt on the validity and accuracy of valuations based on that measure, but also may contribute to criticisms of valuations in general as untrustworthy.
2) When appropriate, EV should recognize other balance sheet items, such as preferred stock, capitalized leases, and marketable securities.
3) Valuing debt at book value is a pragmatic approach that can be used in most situations. ꟿ

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1 E.g., James R. Hitchner, *Financial Valuation Applications and Models*, 2nd. ed. (Wiley, 2006), p. 241; Philip J. Clements and Philip W. Wisler, *The Standard & Poor's Guide to Fairness Opinions* (McGraw Hill, 2005), p. 40.

2 E.g., Patrick A. Gaughan, *Mergers, Acquisitions, and Corporate Restructuring,* 4th ed. (Wiley, 2007), p.12; Matthews, "Fairness Opinions: Common Errors and Omissions" in *The Handbook of Business Valuation and Intellectual Property Analysis*, Robert F. Reilly and Robert P. Schweihs, eds. (McGraw Hill, 2004), p. 212.

3 Shannon P. Pratt, *Valuing a Business,* 5th ed. (McGraw Hill, 2008), p. 265.

4 This report is part of a larger study in which the 351 fairness opinions in cash acquisitions were reviewed to analyze valuation methodologies used in fairness opinions. That study is still in progress.

5 The numerator was called "enterprise value" in 88% of the disclosures. "Firm value" or "company value" was used in 8%, "aggregate value" in 3%, "market capitalization" (which is also sometimes used as a synonym for "market value of equity") in 1% and "total value of invested capital" once. It has been suggested in the past that "enterprise value" might also mean "market value of equity," but this study shows that investment bankers do not view the phrase to be ambiguous.

6 "Excess cash" was not defined. The same investment banker deducted all cash in 20 other opinions.

7 Most expressly deducted cash, while some used the phrase "net debt," which in industry practice means debt minus cash.

8 California Pizza Kitchen, Inc. Form 14D-9 dated June 8, 2011, p.31; fairness opinion by Moelis & Co.

9 EnergySouth, Inc. proxy statement dated August 20, 2008, p. 22; fairness opinion by JP Morgan.

10 United Retail Group, Inc. Form 14D-9 dated September 25, 2007, pp. 25-26; fairness opinion by Bear Stearns.

11 Anheuser-Busch Companies, Inc. preliminary proxy statement dated August 15, 2008, p. 39; fairness opinion by Citigroup Global Markets.

12 Mediacom Communications Corporation, p. 21; fairness opinion by Barclays Capital.

Michelle Patterson, J.D., Ph.D., participated in the preparation of this article.

Sizing Up Healthcare Reform's Impact on Business

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More than 18 months after the passage of the federal healthcare reform legislation, people remain confused about precisely what it is supposed to accomplish and what the effect of the legislation will be on the economy and by extension, the value of businesses. If nothing else, appraisers and valuation analysts should be aware of the increased uncertainty resulting from the reform legislation.

IMPACT ON SMALL BUSINESS

Perhaps the least understood of all the legislation's provisions are the required changes in the manner in which health insurance premiums are determined in the small group and individual market. The small group market is where small businesses – and most CPA and valuation firms – obtain their health insurance. Typically, this market consists of businesses of less than 50 employees, but the reform legislation raises that level to 100 employees for reasons that will become clear later herein.

The individual market, as the name would suggest, is where health insurance is obtained by those who cannot get it through their employer, along with the self-employed. This is the market where the most problems or outright abuses existed with respect to the practices of certain health insurers in certain states. This market also contains both the highest amount of underwriting risk as well as the highest administrative costs for the insurance companies. Due to those two factors in particular, it is also where premiums have been high and the extent of available coverage has been low.

The federal legislation requires insurers to "rate" or use the same factors in setting premiums in both the small group and individual markets, and therein lies the rub for small business! The combined markets will have much higher premiums than the existing small business market, so small business will experience a dramatic increase in insurance premiums for a given benefit level.

This is precisely what happened in Massachusetts[1] after the 2006 Health Insurance Reform in that state, which served as the model for the federal legislation. When the impact of the merger of the two markets is combined with the new rating rules required by the federal legislation, the impact is even more dramatic, particularly for businesses with fewer than 10 employees. The two most significant rating rules that will impact the small business are the requirement that there be no more than a three-to-one difference in premiums based upon age (e.g., a 62-year-old cannot be charged more than 3 times what a 25-year-old is charged for the same benefits), and the requirement that smokers cannot be charged more than 150 percent of what a nonsmoker is charged.

These maximum permitted differences bear no relationship whatsoever to the relative cost of insuring the age groups or smokers, and therefore create an enormous cost shift from young to old and smokers to nonsmokers in addition to the cost shift from the individual market to the small group market. Other significant cost factors include the prohibition against annual limits and lifetime limits on the amount of payments for certain categories of benefits defined in the federal legislation and the prohibition against exclusions for preexisting health conditions.

Other aspects of the legislation will also increase the present cost-shifting to privately insured patients that takes place as a result of the Medicare and Medicaid programs. There were supposedly $500 billion in cuts to be made to Medicare to pay for the cost of the legislation, before the additional cuts required as a result of the debt ceiling deal in the summer of 2011. Expansion of Medicaid— the program for the poor— to more than 20 million additional individuals[2] is expected to cost nearly $500 billion of the $1 trillion cost of the legislation. Both Medicare and Medicaid pay hospitals and physicians poorly – Medicaid especially so – leading them to seek significantly higher payments from private insurers to make up for the shortfall. This will create yet another major upward pressure on premium increases.

It is important to understand that the changes do not affect all parts of the country equally. Massachusetts, of course, had already dug its own grave and will see comparatively little change as a result of the federal changes. States like New York and New Jersey had implemented reforms similar to the federal legislation in their small group markets, for example. States which had already implemented many of the federal reforms of

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expert **TIP**

Appraisers and valuation analysts should be aware of the increased uncertainty resulting from the healthcare reform legislation.

their own volition already had much higher premiums than states which had not. In contrast, many southern states such as Texas and the largest state, California, will see very significant impacts on their state's insurance practices and therefore the premiums charged to small business will skyrocket— unless benefits are cut or deductibles increased.

IMPACT ON LARGER BUSINESS

In the insurance area, larger businesses escape the dramatic cost-shift from the individual market that small business must bear. Larger employers will either be in the large-group insured market or in the *self*-insured market. Self-insurance is yet another element of health insurance not well known or understood outside the health insurance and healthcare consulting communities.

Many larger businesses actually do not purchase insurance from health insurers. Rather, they purchase access to the insurer's network of hospitals, physicians and other healthcare providers along with administrative services like processing of claims and insured (customer) relations services from the insurer and they pay their own claims out of pocket; thus, the expression "self-insured." Nationally, nearly 60 percent of all businesses are self-insured and more than 90 percent of large businesses self-insure. The self-insured business will pay a budgeted "premium" to the insurer which looks like a real premium, but if the actual costs of caring for their employees are greater than the budget, the employer has to pay the difference.

Similarly, if the cost is less, the employer gets the savings. From the employee's standpoint, it will all look pretty much the same whether their employer is insured or self-insured since they will have an insurance card and the same interaction with the system as an insured individual. Valuation analysts should consider understanding whether the business they are valuing is insured or self-insured and any outstanding obligations of a self-insured employer for unexpected claims or perhaps a credit for lower claims than expected. These would likely fall into the category of nonoperating assets and liabilities.

In short, the federal legislation promises to drive the cost spiral in health insurance premiums ever higher for small business as it absorbs the reduced costs of the individual market and mandated benefit expansions. This can be a significant cashflow forecasting issue for the appraiser and management. Appraisers should ascertain whether management intends to pay the increased premiums out of profits, cut benefits to maintain premiums, shift the cost to employees via deductibles, co-pays and premium share or any other alternative that comes into play. Dropping the cost bomb on employees could have adverse employee retention consequences depending upon the response of competitors.

Employers with 50 or more employees will also be subject to the "play or pay" penalty starting in 2014. The so-called 40 percent "Cadillac excise tax" on "high cost" policies is not effective until 2018 and appears unlikely to survive. That said, if it does survive it will have a dramatic impact on health insurance costs in high cost states like Massachusetts where virtually any standard policy presently on the market would already be in the excise tax range.

SPECIFIC IMPLICATIONS FOR THE HEALTHCARE INDUSTRY

Primary care physicians (PCPs) were the big winners in the reform legislation, with Medicare paying a 10 percent bonus to primary care physicians who earn 60 percent or more of their revenues from specified CPT©[3] codes. Given Medicare's already poor payment levels as compared to private insurance payors in many markets and the severe shortage of primary care physicians, it is unclear how much impact this bonus will have on either incenting PCPs to see Medicare patients or inducing new physicians to go into primary care. That said, it represents something appraisers should quantify.

More significantly, the opportunity for PCPs to change to so-called "concierge" or members-only practices charging patients $1,500 to $2,000 per annum may further restrict the supply of PCPs. It seems clear that financially, having a 600-member patient base with a membership revenue stream of $900,000 or more per year in addition to insurance payments for covered services is preferable to 1,500 or 2,000 patients with long hours required to generate a revenue base of $500,000 +/-. These supply restrictions will drive up the salary expectations of PCPs and as is already the case in many markets, drive up the payment for PCP services.

Hospitals were supposed to pay most of the $500 billion of Medicare savings through limitations on annual increases in their Medicare payments along with new methodologies including quality-incented value-based purchasing and no payments for so-called "never events" where patients are hospitalized for medical errors. Medicare payment mechanisms will reflect an increasing emphasis on patient experience measures as well.

Accountable Care Organizations (ACOs)— joint financial risk-bearing entities comprised of physicians and hospitals— are another major element of the Obama reform package. The ACOs are supposed to voluntarily agree to accept financial risk for fee-for-service Medicare beneficiaries in a complex arrangement that includes scoring based upon 65 quality measures. The proposed regulations released in April of 2011 were widely panned by the target audience of physicians and hospitals, leading to an administrative decision by the Centers for Medicare and Medicaid Services (CMS) to create something called the Pioneer ACO, a by-application program limited to 30 participating entities that closed in the summer of 2011. As such, appraisers are unlikely to encounter a pioneer— unless camping

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It's all about the APPs

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- **Is an iPad a toy or a tool?**
- **How much more than a phone is a smartphone?**
- **How can you make these devices work for you?**

It's all about the apps!

Financial professionals are increasingly looking to mobile devices to supplement or replace bulky laptop computers. Can these new tools, which may seem at first glance to be best suited for video games and texting, really work for business?

The answer is *yes*— but be aware of limitations and understand that it may take some work to outfit your device as a business tool.

CREATING DOCUMENTS

In most cases, any device with a hope of replacing a laptop for business use will need to be able to create and edit documents. For a valuation engagement, that may mean bypassing the Apple suite of office tools— Pages, Numbers, and Keynotes— for apps that will allow you to manage Microsoft Office documents. Because Microsoft did not immediately offer **Office** for the iPad, a number of apps have popped up to help users manage these documents.

Two such apps are **Quickoffice Pro HD** and **Documents to Go**. While both of these apps allow you to create and edit Office documents, their compatibility with Office documents created on a Windows PC or a Mac isn't always perfect.

In early 2012, the **OnLive Desktop** app was released. This app brings the full genuine Windows versions of Word, Excel, and PowerPoint to the iPad, and they work the same way they do on your desktop. While this is a leap over the other "Office Lite" type products, there are some limitations. Because **OnLive** is a cloud-based product, you must have a live (and reasonably fast) connection to the Internet for it to work. And you have to save any documents emailed to you to the OnLive Cloud before you can open them.

Mobile device keyboards are notoriously tedious to use for creating long documents, so it is a good idea to add a wireless keyboard to your iPad if you're planning to use it as a laptop replacement. Another option is to use a voice recognition app like **Dragon Dictation**. This will allow you to bypass the keyboard altogether.

OTHER APPS

Once you have these basic document editing tools, what other apps will help make your iPad or smartphone into a valuable business tool? Here are 20 apps that will get you on your way:

- **Omnifocus** – A task-management program that allows you to keep up with appointments and lists.

- **Scan2PDF Mobile** – Use your phone's built-in camera to scan documents and convert them to PDF files. Similar to Genius Scan.

- **My Eyes Only** – This app uses 512-bit AEX encryption to protect personal and business data such as credit card numbers, passwords and financial information.

- **Dropbox** – Store and sync your files.

- **FileMaker Go** – Allows you to access databases on the go.

- **Evernote** – Allows you to save and organize everything in your life.

- **Citrix GoToMyPC** – Get remote access to your desktop computer from the same company who makes GoToMeeting which will allow you to attend online meetings on your iPad.

- **Skype** – Make free voice and video calls on your device.

- **Fastcase** – Research legal cases and statutes on your mobile device for free.

Continued on next page

expert TIP

IPads and smartphones *can* work for your business, but it will take some *work* to outfit your device as a business tool!

- **CamCard** – Scans and organizes all your business cards.

- **RedLaser** – Barcode scanner that allows you to check prices on the spot.

- **Expensify** – Allows you to keep track of expenses by logging mileage, filing expense reports, and uploading receipts using your phone's camera .

- **Tripit** – Allows you to track your travel. Keep up with multiple flights, car rentals, and hotel reservations.

- **OmniGraffle** – Create a quick diagram, process chart, page layout or graphic design on your iPad2.

- **iThoughtsHD** – Mind mapping app.

- **Print Central** – Allows you to print to most WiFi/wireless printers without additional software.

- **Time Master+Billing** – This is an easy-to-use timekeeping app.

- **iAnnotate PDF** – Allows you to edit and mark up your PDF files. You can sign a contract and return it without having to print it out and scan it back in.

- **YouSendit** – Allows you to securely send files, share folders, synchronize devices and digitally sign documents with mobile applications.

- **AudioNote** – Allows you to record the conversation while simultaneously taking notes. Great for recording meetings.

Many of the apps listed here are free or available at a nominal cost. Apple has dedicated a section of its website to using the iPad in business, *www.apple.com/ipad/business*. Here you will find examples of how businesses are using Apple devices, how to integrate the devices into your workflow and information on how to use encryption and maintain security on your devices.

The move to mobile devices will only accelerate in the coming year. This is especially true in small to medium size businesses. According to a study by the NPD Group published in December 2011, nearly three quarters of U.S. businesses with fewer than 1,000 employees have plans to purchase tablets over the next 12 months.

With this list of apps, you will be set to make the most of the move to mobile computing in 2012.

in the wilderness – or too many regular ACOs for that matter, but they will have a significant impact on the cashflows of physicians and hospitals who participate in them.

SUMMING IT UP

There are numerous other provisions in the reform legislation that affect virtually every segment of the healthcare industry. Professionals engaged in valuing healthcare entities should be sure to study the changes for a particular segment in forecasting cashflow and establishing risk premiums. For general valuation engagements, health insurance costs represent a significant element of many employee fringe benefits and a significant element of cashflow forecasts. Based upon the experience in Massachusetts, small business will be severely, negatively impacted by the various reform provisions which disproportionately shift costs onto the small employer community.

[1] Where the author resides and whose small business premium increased 64 percent in 2010.

[2] More than 20 percent of the U.S. population will be covered by Medicaid post-Reform!

[3] CPT or Current Procedural Terminology is copyrighted by the American Medical Association.

Expert Witness New Client Interview Checklist

Expert witnesses can expect to be "interviewed" by an attorney during his or her initial call about a new potential case. The experts who are prepared to ask key questions of the attorney will:

- Stand a better chance of being retained and
- Obtain crucial information they can use to determine if they should accept the new assignment

CHECKLIST

1. What kind of a case is this?
Practice point: Just obtain a general description, i.e., product liability defective ladder and do not accept confidential information that could potentially conflict you out if the other side calls to retain you.

2. Who are the parties?
Practice point: This will enable you to do a conflict check to make sure you do not have a conflict of interest.

3. Where is or where will the case be filed?
Practice point: You will want to know if the case will be filed in state or federal court. In addition, you will want to know in which state the litigation will take place.

4. What deadlines should you be aware of?
Practice point: You will want to know the deadline for designation of expert witnesses and for submission of the experts report.

5. What is the issue(s) that you will be asked to address?
Practice point: You will want to determine if you are qualified to opine on these issues and are comfortable that your qualifications, experience and expertise are a good match for the issue(s) at hand.

6. How much is in dispute?
Practice point: This will enable you to get a rough idea of the overall litigation budget and resources counsel will be utilizing to litigate the case.

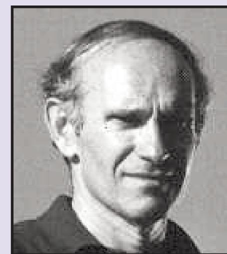
7. How many pages of documents will you be sent for your review?
Practice point: This will enable you to estimate your retainer. The more voluminous the materials you will be sent, the higher your retainer will likely be.

8. Have the other experts been selected yet and if so, who are they?
Practice point: Knowing who you might be working with and the experts retained by opposing counsel may be helpful for you in determining if you are a good fit for the case at hand.

9. Will a report and/or a deposition likely to be requested?
Practice point: You will want to know if counsel will ask for a report, a rebuttal report or no report at all. Knowing whether your deposition will likely be taken is helpful as well.

10. What has counsel's experience been with these types of cases?
Practice point: You will want to "gently" determine how much experience counsel has had litigating and trying this particular type of case. Counsel with little or no relevant experience will likely require more assistance.

11. Where did you get my name?
Practice point: Tracking referrals helps experts determine which marketing techniques are working. ঌ



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expert TIP

Expert witnesses will want to ask counsel precise, informed questions during their initial call interview.

T.C. Memo. 2011-259, Docket No. 29397-08

Estate of Liljestrand v. Commissioner

by
John Walker and Chris D. Treharne, ASA, MCBA, BVAL
Gibraltar Business Appraisals, Inc.

OVERVIEW

In yet another bad facts case (from the taxpayer's perspective), the value of assets contributed to an FLP were includable in the Decedent's estate under IRC § 2036(a). In particular, the Decedent failed to provide a non-tax reason for the FLP's formation, ignored partnership formalities, commingled funds, did not maintain sufficient assets outside the FLP for personal use, and made disproportionate distributions of Partnership assets to himself.

THE FACTS

Paul H. Liljestrand ("Dr. Liljestrand" or the "Decedent") formed Paul H. Liljestrand Partners Limited Partnership ("PLP" or the "Partnership") on May 30, 1997. The Decedent, through a trust, transferred more than $5.9 million of real estate to PLP in December 1997. Of particular note:

- Dr. Liljestrand was both trustee and beneficiary of the trust, and he had access to all trust income and corpus during his life.
- The mortgage associated with one property was not transferred to PLP.
- Leases associated with the transferred properties were not transferred to the Partnership.

The Decedent – through his trust – received a 99.98-percent interest in the Partnership (all of the general partner units, all of the Class A limited partner units, and 5,545 out of 5,546 Class B limited partner units), while his son, Robert, received one Class B limited partnership unit. No record of Robert's contribution of capital to PLP was found.

Class A limited partners were granted a preferred return. Interestingly, the preferred return – along with the total number of PLP partnership units, the number of partnership units each partner would receive, and the required contribution of each partner – was left blank on the Partnership Agreement when it was initially signed by the Partners.

Dr. Liljestrand formed the Partnership on the advice of his attorney, who believed the entity was the only way for Dr. Liljestrand to protect against the restrictions of two Hawaii statutes (one permits certain property owners to seek partition; the other allows beneficiaries of trusts to void the actions of interested trustees). The Decedent further wished to gift interests of PLP to his four children, although only Robert was involved with the formation or running of the Partnership. Finally, Dr. Liljestrand wished to ensure Robert's continued management of the real estate properties owned by the Decedent through his trust.

During 1998, the Decedent's trust gifted Class B units to four irrevocable trusts for the benefit of the Decedent's children. The children's trusts each received an additional 33 Class B units during 1999. Although gift tax returns were required, none were filed until after Dr. Liljestrand's death in 2004.

No bank account was opened for PLP until August 1999, even though the Partnership was formed in 1997. Additionally, Dr. Liljestrand reported PLP's income and expenses on his personal tax return. As a result, there was significant commingling of trust and Partnership funds. The Decedent's accountant (rather than Dr. Liljestrand or Robert) noticed that PLP had no employer identification number or a separate bank account. Instead of amending the Decedent's 1997 and 1998 tax returns, the Decedent's advisors agreed to treat the Partnership as having begun on January 1, 1999, even though property titles were transferred in December 1997.

Although Dr. Liljestrand maintained some assets outside of PLP, the retained assets were insufficient to maintain the Decedent's lifestyle. As a result, Dr. Liljestrand received disproportionate distributions and the Partnership frequently paid personal expenses directly. Included in the personal expenses paid by PLP were Dr. Liljestrand's housekeeping staff, personal assistant, grandchildren's tuition, personal line of credit, and personal mortgage. Additionally, the Decedent's children used PLP's funds to pay personal expenses but did not execute promissory notes for repayment of the purported loans.

Further, the preferred return portion of the Partnership Agreement was filled in at some point and allowed for a 14-percent return. Based on a $310,000 value for the preferred Class A limited partner units (a value deter-

Continued on next page

E-FLASH TAKEAWAY

Among the many reasons the taxpayer failed to prevail was his reluctance to rely on a business appraisal prepared by an independent business appraiser. Instead, he chose to rely on his own estimate of fair market value to establish the rate of return on his Class A limited partnership units. The court viewed his actions as self serving and not what would transpire in an arm's-length transaction.

mined by the Decedent and not by an independent outside expert), the $43,400 annual preferred return was almost exactly the amount of income generated by the Partnership's property, which inferred the two were driven by the Decedent's personal income requirements and not an arm's-length marketplace.

When she began separately tracking business activities in 1999 (again, two years after the Partnership was formed), PLP's accountant set up capital accounts for each partner. However, according to the statement of partners' capital, there was only $24,203 of capital as of December 31, 1999, even though more than $5.9 million of real property had been contributed.

After Dr. Liljestrand's death, the Partnership's accountant was informed that disproportionate distributions and personal expense payments were being accounted for incorrectly. The distributions and expenses should have been treated as receivables for the Partnership rather than draws against capital accounts. However, there was no evidence any of the partners made any attempt to pay the allegedly borrowed amounts.

After Dr. Liljestrand passed away in 2004, his estate filed an estate tax return. To pay the federal and state tax obligations of $2.37 million and $130,000, respectively, his estate refinanced property owned by PLP and used the proceeds from the refinancing to fund the tax liabilities.

The IRS determined a federal estate tax deficiency of $2.57 million in August 2008 and included in its notice of deficiency the assets transferred to PLP.

DISCUSSION

Although the estate attempted to shift the burden of proof to the IRS under § 7491, the Tax Court decided that its ruling would be based on the preponderance of evidence. Therefore, the court did not address the burden of proof argument.

SECTION 2036(a) – *Bona fide* sales
§ 2036(a) does not apply if the transfer meets the *bona fide* sale exception; that is, the transfer must be an arm's-length transaction, for full and adequate consideration. Accordingly, the *bona fide* sale portion of the requirement was considered by the court.

NON-TAX REASONS FOR PARTNERSHIP FORMATION

The Estate

The estate argued that PLP had been formed for several non-tax reasons (as outlined in the Court Analysis below).

Court Analysis

The tax court considered the estate's reasons for forming the Partnership:

A) Ensure Robert would continue to manage the real estate

The court determined that Robert's role as manager was not a central reason for the formation of the Partnership.

Robert's roles as trustee of the trust and manager of the real estate created a conflict of interest that could potentially allow a beneficiary of the trust (i.e., one of Dr. Liljestrand's other children) to invoke a state statute voiding his actions as trustee. The estate argued that resolving this conflict was a primary reason for the formation of PLP.

The court disagreed, determining that the formation of the Partnership merely changed the assets in the trust but did not change Robert's roles. After the formation of PLP, Robert was still trustee of the trust and manager of the property. Because the conflict still existed, the court determined Robert's continued management of the property was not a non-tax reason for the formation of PLP.

B) Ensure real estate was not subject to partition

The court decided that a partitioning action was not a significant non-tax reason for the formation of the Partnership.

In particular, the court noted most of the real estate in question was outside of Hawaii and thus not subject to the state's partitioning law. Because the Decedent's attorney made no effort to research partitioning laws in the states in which the real estate sets, the court determined a partitioning action was not a primary reason for the Partnership's formation.

The court further noted that the trusts to which the LP interests were gifted (and those which would be created upon the Decedent's death for the benefit of his children) would never allow his children to be joint tenants nor tenants in common.

Finally, no partitioning action was considered on the date of Dr. Liljestrand's death nor had partitioning come up before his death. Although the estate attempted to rely on precedent set in *Estate of Shurtz v. Commissioner,* T.C. Memo 2010-21 (see FCG *E-Flash* 12-2), the court determined *Shurtz* was inapplicable. More specifically, the litigation environment in Hawaii was different than that of Mississippi. Furthermore, the estate's attorney had never been involved in a partitioning action and had never advised other clients to form an FLP to avoid a partitioning action.

C) Protection from creditors

Although the estate claimed creditor protection was a reason for the Partnership's formation, it provided no evidence any of the partners were worried about creditor claims. The court faulted the estate for failing to name a single creditor and for failing to determine how the protections provided by the formation of a partnership were different from a trust. Accordingly, the court found creditor protection was not a significant non-tax reason for PLP's formation.

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The court also determined there were factors indicating the transfers were not *bona fide* sales.

DISREGARD OF PARTNERSHIP FORMALITIES

The court faulted the Partnership for failing to open a bank account during its first two years of existence and for commingling funds. PLP held only one partnership meeting, failed to keep meeting minutes, and had no other formal meetings between partners. The partners used Partnership funds for personal expenses, made disproportionate distributions to Dr. Liljestrand, and failed to execute loan documents with partners for purported loans. More emphatically, the final two characteristics violated the Partnership Agreement, which required pro rata distributions.

STANDING ON BOTH SIDES OF THE TRANSACTION

Dr. Liljestrand contributed all of the capital to the Partnership, received 5,545 out of 5,546 units of Class B limited partnership interests, all of the Class A limited partner units, and all of the general partner interests. While Robert did receive a limited partner interest, he failed to receive outside counsel independent of his father. Further, the Decedent did not consult with three of his children – although he indicated he wanted them to be partners – before forming the Partnership. As a result, the court determined the transfers were not arm's-length.

As a result of the preceding, the court determined that the transfers of assets to the Partnership failed the *bona fide* sale prong of the *bona fide* sale exception.

The court further determined that the transactions were not for full and adequate consideration. In particular, the interests credited to the partners were not proportionate to capital contributed because Robert never proved he contributed capital. It also faulted the Partnership for a valuation of its interests with a value much greater than the value of the assets contributed and then ignoring that value (as determined by an outside, independent appraiser) and determining a value (in a manner not reflected in the court record) much less than the value of the property contributed. Additionally, the court found that the assets contributed by each partner were not properly credited to their capital accounts.

Finally, the court determined that Dr. Liljestrand retained possession of, enjoyment of, or the right to income from the property he transferred to PLP. The court noted that the Decedent failed to maintain enough assets outside the Partnership to maintain his lifestyle. PLP's payment of many of Dr. Liljestrand's personal expenses (including his estate tax obligations), the Decedent's commingling of trust and Partnership funds, and PLP providing Dr. Liljestrand with disproportionate distributions were the major determinative factors for the court.

The court ultimately decided that the Decedent's motivation for forming PLP was primarily testamentary and that his relationship with the assets did not change as a result of the Partnership's formation. As a result, the assets were includable in his estate under § 2036(a).

CONCLUSION

Poor estate planning advice coupled with inattention to partnership formalities doomed the use of the FLP as an estate planning vehicle in the present case. Because the Decedent's relationship with the assets did not change as a result of PLP's formation and because the partners failed to follow through with partnership formalities, the Partnership's assets were includable in Dr. Liljestrand's estate. ✤

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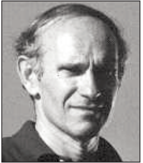

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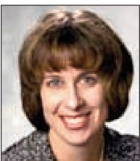

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GUIDE TO ABBREVIATIONS

ABV	Accredited in Business Valuation, American Institute of Certified Public Accountants (AICPA)
ASA	Accredited Senior Appraiser, American Society of Appraisers (ASA)
BV	Business Valuation
CBA	Certified Business Appraiser, Institute of Business Appraisers (IBA)
CDFA	Certified Divorce Financial Analyst, Institute for Divorce Financial Analysts
CFA	Chartered Financial Analyst , CFA Institute
CFE	Certified Fraud Examiner, Association of Certified Fraud Examiners
CFF	Certified in Financial Forensics, AICPA
CFFA	Certified Forensic Financial Analyst, NACVA
CFP	Certified Financial Planner, Certified Financial Planner Board of Standards, Inc.
CIRA	Certified Insolvency and Restructuring Advisor
CM&AA	Certified Merger & Acquisition Advisor, Alliance of Merger & Acquisition Advisors
CPA	Certified Public Accountant
CVA	Certified Valuation Analyst, National Association of Certified Valuation Analysts (NACVA)
DABFA	Diplomate of the American Board of Forensic Accounting
FASA	Fellow of the American Society of Appraisers
JD	Juris Doctor
MBA	Masters of Business Administration
MCBA	Master Certified Business Appraiser, IBA
MST	Masters of Science in Taxation
MVS	Masters in Valuation Sciences

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  - Is a minority discount the opposite of a control premium?
  - Are control premium studies a good source of data for calculating a minority discount?
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	Ibbotson decile [1]	
	10	10
R_f [3]	2.8%	2.8%
RP_m [4]	6.7%	6.0%
RP_s [5]	6.4%	6.4%
Cost of Equity [6]	15.9%	15.2%

	Duff & Phelps 25th portfolio [2]		
	Equity	Invested Capital	Sales
R_f [3]	2.8%	2.8%	2.8%
Risk Premium [7]	14.1%	13.9%	12.4%
ERP Adjustment [8]	1.1%	1.1%	1.1%
Cost of Equity [9]	18.0%	17.8%	16.3%

	Inflation	Gross Domestic Product
Historical (1926-2010)[10]	3.0%	3.2%
10 yr. forecast [11]	2.5%	2.6%

(1) Source: Ibbotson *SBBI 2011 Valuation Yearbook.* © 2011 Morningstar, Inc. All rights reserved. Used with permission. To purchase copies of the *Valuation Edition,* or for more information on other Morningstar publications, please visit *global.morningstar.com/DataPublications.*

(2) Source: Duff & Phelps (D&P) *2011 Risk Premium Report,* average premiums over risk-free rate ©Duff & Phelps LLC. All rights reserved. Used with permission. Available through Morningstar: http://corporate.morningstar.com/ib and Business Valuation Resources, www.bvresources.com, and ValuSource: www.valusource.com.

(3) Risk-free rate, 20-year Treasury Bond Yield, Federal Reserve Statistical Release, 2/13/12 (not adjusted).

(4) “Risk Premium in the Market,” *SBBI,* inside back cover historical and supply side.

(5) “Size Premium,” *SBBI,* inside back cover.

(6) Build up method illustration only; excludes industry risk premium and specific company risk, if any. Uses unadjusted data for ERPs.

(7) Report includes premiums where size is measured by market value of equity, market value of invested capital, 5-year average EBITDA, 5-year average net income, total assets, sales, book value of equity, and number of employees. Each measure for size organized by D&P, gain to 25 portfolio ranks, with portfolio rank 1 being the largest and portfolio 25 being the smallest. Smoothed average premiums are presented here because they are considered a better indicator than actual historical observation for most portfolio groups. Exhibits A-1, A-4 and A-7.

(8)(9) Adjustment for difference in historic equity (market) risk premium from 1963-2010 of 4.39% and forward estimate of ERP as of early 2012 equal to 5.5%. Source: Duff & Phelps Client Alert, January 27, 2012. Also see Roger J. Grabowski, “Developing the Cost of Equity Capital: Risk-Free Rate and ERP During Periods of ‘Flight to Quality,’” *http://www.duffandphelps.com/expertise/publications/pages/ArticleDetail.aspx?id= 214&list=Articles* and presentations by Jim Harrington of Duff & Phelps.

(10) Lawrence H. Officer and Samuel H. Williamson, “Annualized Growth Rate of Various Historical Economic Series,” *www.measuringworth.com*, 2010. Inflation as of 2010; GDP as of 2010.

(11) Consensus Median Average, *The Livingston Survey,* Federal Reserve Bank of Philadelphia, December 2011.

Editor’s Note: I highly recommend that all financial experts who rely on Morningstar and Duff & Phelps data purchase these books/studies and thoroughly understand how the data are compiled and the data choices available.