Jim Hitchner's Valuation Products and Services

VPS Q&A

A free Q & A periodical to promote education, build consensus and answer your questions in the financial valuation and litigation services industry.

ISSUE 11 - MARCH 2009

Email your question to: jhitchner@valuationproducts.com

SIZE RISK PREMIUMS FOR LARGER COMPANIES

Question 1: Size risk premiums - do you use them for larger companies?

Answer 1: : If applicable, the answer is yes. Size is obviously relative to something else and some of the largest companies may not warrant a size premium. That being said, let's take an example using Ibbotson. If we're valuing a company that fits in the parameters of the 7th decile (out of ten deciles), which is pretty big company, we'll make a size adjustment based on the Ibbotson 7th decile category. In the Morningstar Ibbotson SBBI 2008 Valuation Yearbook, the size premium for the 7th decile is 1.50% vs. 5.82% for the 10th decile and -0.34% for the 1st decile (p.137). Keep in mind that the range of market capitalization for a 7th decile company is approximately $1.1 billion to $1.6 billion (Ibbotson p. 131). The smallest size company in the tenth decile is $1.9 million and the largest company in the 1st decile has a market capitalization of approximately $473 billion (Ibbotson pp. 130-131).

We use the Duff & Phelps data in a similar fashion, although Duff & Phelps has 25 size categories.

Answer by: Jim Hitchner, CPA/ABV, ASA, Valuation Products and Services, Financial Valuation Advisors, Inc. and The Financial Consulting Group (Atlanta) jhitchner@valuationproducts.com

LEVEL OF RELIANCE ON THE GUIDELINE COMPANY TRANSACTION METHOD

Question 2: Jim, I have been using the book you edited and coauthored entitled *Financial Valuation Applications and Models* (*FVAM*, 2nd edition, Wiley) as a reference guide. Would you mind responding to a question regarding discounts for lack of control (DLOCs) and discounts for lack of marketability (DLOMs)?

I'm preparing a business valuation for an imaging center owned 50% by a radiology group and 50% by a tax exempt hospital. The operating agreement gives the hospital the right to acquire the radiologists share at FMV, based on one of several triggering events. Neither side has control over the day to day operations, i.e., they both have to agree. Free cash flow (minimum equal to pay the taxes at a 40% rate) must be paid out each year. The radiologists have exclusive professional service agreements. The agreement does not allow a transfer to third parties.

I wanted to get your take on how you would respond if asked whether there should be a DLOC or DLOMI. You noted in your book that "as with minority discounts, many HC partnerships are structured with provisions that minimize the issues associated with a LOM". The example you gave in Addendum 1 for Rose Surgery Center, indicated that based on your consideration of the factors regarding the facts and circumstances.....it was your opinion that a discount related to the minority ownership interest and marketability was not applicable to the FMV...."

Continued on next page

Answer 2: As the quote you cite from FVAL-2d Ed suggests, lack of control and lack of marketability discounts in healthcare entities are often quite low relative to the generic expectations. The most common reason for this is that the specific terms for items such as cash distributions that would impact a discount for lack of control are spelled out in contractual agreements including the LLC Operating Agreement, a Stockholders' Agreement or Employment Contract. Other common provisions include super-majority voting requirements for decisions such as sale of the assets or liquidation of the entity. As FVAL also indicates, this is in part due to the fact that the universe of eligible holders of such interests is limited. Thus, the "hypothetical" buyer consists of a limited class of individuals. As indicated below, this class often (not always) has a common set of expectations.

In the instant case, you indicate that (apparently) cash must be distributed at least equal to 40% of the taxable income allocated to the LLC members. This provision is different than the one cited in FVAL that requires cash flow in excess of reasonable working capital needs to be distributed. Thus, all other things being equal, if no DLOC were indicated in the circumstance cited in FVAL, a DLOC might be indicated in your particular situation. Such a discount in my experience would be far less than the generic 29% we (used to) see in the charts of the hierarchical structure of Control and Noncontrol, Nonmarketable values.

The DLOM is a bit more challenging, particularly in the current environment where perceived risk is significantly higher and access to capital significantly more difficult than any time in recent memory. Although the prime rate is quite low for example, an entity may be unable to borrow money at that rate or any rate. Inability to access debt capital in turn requires increasing amounts of equity capital. These factors are supposed to be captured in the discount rate, but traditional methods of developing that discount rate often do not capture the combination of increased risk and decreased availability of capital. Thus, the ability to sell any interest, dependent as it is on ability to raise cash, has created marketability issues in the current economic situation.

The exigencies of the current situation notwithstanding, I look to the specific terms of the Operating Agreement with respect to sale of an interest. It is not uncommon for the Agreement to contain what amounts to a "put" requiring the entity to buyout a departing member at a fair market value appraised price. Your fact pattern indicates "the operating agreement gives the hospital the right" but does not mention an absolute obligation to acquire the radiologists' interest. Particularly given your later statement that "The agreement does not allow a transfer to third parties" the lack of an absolute obligation could leave the radiologists with no place to go if they are unable to agree on a price with the hospital. If the hospital is obligated to buy at the appraised price upon the occurrence of the triggering event, a put with respect to those events exists. I recently was engaged to consider precisely such a provision in an LLC Agreement where a minority owner desiring to sell could only offer the interest to a limited universe of potential buyers and had no recourse other than continuing to hold if none of those buyers was interested.

Assuming the triggering event(s) has occurred, I believe that the specifics of the rights of the subject interests with the effects of the triggering event considered is relevant to the determination of fair market value. If you were appraising the same interest and the triggering events had not yet occurred, I think the DLOM might well be different - it would be higher all things being equal. The triggering event's consideration in fair market value is no different in my mind than any other factor that might influence the value of an interest such as external economic conditions or entity-specific conditions like loss of key management or a key customer - it is a fact that exists at the valuation date.

I made the observation recently that appraisers are often confused by what the "fair market value" of a specific interest in a specific privately held entity actually means. While a publicly traded common stock of one company may have the same rights (if not the same risks and rewards) as any other public company's stock, the same can virtually never be said of the stock or equity interest of a private company. A private equity interest is a specific basket of legal and contractual rights and obligations and economic risks and rewards, much like the preferred stocks of public companies but infinitely more varied. Each characteristic of that basket must be evaluated to determine at what price a member of the limited universe of hypothetical buyers and sellers would transact.

One other thing I would caution is that drafters of Operating Agreements are often unfamiliar with the nuances of DLOCs and DLOMs and particularly so in the healthcare industry. Owners of healthcare interests typically think of "fair market value" as being a prorata share of fair market value at the control level, not a noncontrol, nonmarketable value. In a recent consulting engagement with respect to the buyout provision in a healthcare entity owned through several tiered LLCs, I found that the upper level entity contained no provision for buying out the interest of a lower tier entity while the lower tier entity had a provision that gave its members a put option against that lower tiered entity! Thus, the lower tiered entity had no liquidity option available to it but was compelled to provide liquidity to retire the interest of terminating members. Although it may be inconceivable to many, not surprisingly, even after being apprised of the situation, the members of the lower tier LLC voted to leave the put option in place at a prorata share of their lower tier LLC's fractional interest in the control value of the upper tier LLC, with no DLOC or DLOM!

Answer by: Mark O. Dietrich, CPA/ABV (Framingham, MA), member of the AICPA Healthcare Expert Panel and Editor/Technical Editor of BVR's Guide to Healthcare Valuation, http://www.bvresources.com/bvstore/book.asp?pid=PUB200 ,dietrich@cpa.net

Continued on next page

ESTATE TAX VALUATIONS AND VALUATION DATES

Question 3: I have been engaged to prepare a valuation report for a decedents 25% interest in an FLP. On the date of death (March 2008) the only significant asset was a huge block of a single bank stock. The alternative valuation date for the estate is September 2008 and of course the value has gone down. To complicate matters because of the declining value in the bank, the partnership sold about 1/3 of the stock in August and purchased shares of several equity and bond mutual funds with the proceeds.

For my valuation I will be doing an income approach on discounted cash flow as well as a market approach using NAV of the underlying assets using Partnership Profiles data and methods. Here is my question regarding the market approach:

In doing a valuation of the 25% of the FLP at 9/30 (the alternate value date) do I do the NAV calculations based on the number of shares of each security held at 3/08 as if they were not sold? Or do I just do a valuation as of 9/08 using the assets as they stand on that date?

I know that for stock held individually by a decedent the alternate valuation date is the six month date or the date of sale if sooner. But does that concept flow up into the FLP since the estate did not cause the sale? I also notice that the IRS issued a proposed change to the estate tax regs in April of 2008 (in response to the Kohler case) to clarify that the option to select the alternate valuation date is merely to reflect changes in market value. But in the end I'm really valuing the FLP not the underlying assets, so does the Kohler principal go through the FLP or does the FLP insulate you from it?"

Answer 3: I believe that the questioner is correct that what is being valued here is the FLP and not the assets within the FLP. That, to me, is in keeping with the philosophy that the FLP wrapper is a reality for tax purposes and not just a fiction. Therefore, the changes that occurred within the FLP during the six month period are reflected in the outside look at the value of the FLP at the alternate valuation date. At least one estate attorney has confirmed to me that he has used that approach for an alternate valuation date value of an FLP and the IRS did not object.

Answer by: Jim Alerding, CPA/ABV, ASA, CVA, Clifton Gunderson, LLP (Indianapolis) jim.alerding@cliftoncpa.com

[***Editor's Note:*** I strongly encourage our readers to seek guidance from trust and estate attorneys and planners for the correct answers to questions like the one above.]