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 13 - JUNE 2009

Email your question to: jhitchner@valuationproducts.com

EQUITY RISK PREMIUMS - DUFF & PHELPS VS. IBBOTSON

Question 1: What do you thing is better for supporting an equity risk premium in the cost of equity using either the build up method or the modified capital asset pricing model: Duff & Phelps or Ibbotson?

Answer 1: I use Duff & Phelps which has historically has been around 5%, and I continue to use Ibbotson, which is usually around 7%, if you use the historical traditional, and a little bit less than that-less than 100 basis points less than that-if you're using the supply side. For me, that's a pretty tight range for smaller companies with equity returns that may be in the high teens or low 20s. The range is more relevant, though, when valuing very large companies with single digits cost of equity or low double digits.

Let me give an example: Let's take a large company and assume 5% growth, $100 million in cash flow and a range of discount rates between-let's take Ibbotson and Duff & Phelps-of 9 to 11%. For this illustration, let's ignore size premiums or specific company risk. Well, the resultant value using the 9% discount rate is 50% larger than the resultant value when using the 11% discount rate. That's pretty big and this has a lot to do with compounding, particularly with low discount rates and cap rates.

100/ (.11 - .05) = 100/.06 = $1,667

100/ (.09 - .05) = 100/.04 = $2,500

Now, let's take a small company and assume 5% growth, $10 million in cash flow, and a range of discounts of 19 to 21%. Again, only a 2% difference. For this illustration let's assume the same size premium and, again, let's ignore specific company risk. Well, the resultant value using the 19% discount rate is only 14% larger than the resultant value when using the 21% discount rate.

10/ (.21 - .05) = 10/.16 = $62.5

10/ (.19 - .05) = 10/.14 = $71.4

So, for a lot of the smaller businesses that we value, it doesn't have as large an impact. However, if you're valuing very large companies, again, with discount rates in the high single digits or low double digits, a couple points can indeed make a difference.

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: What level of reliance do you place on the guideline company transaction method of the market approach and the transaction databases that are available? (The following answer is based, in part, on an exchange between Shannon Pratt, Jay Fishman and Jim Hitchner on the Valuation Products and Services and Financial Consulting Group STRAIGHTtalk webinar: Hardball with Hitchner, Pratt and Fishman, February 10, 2009. www.valuationproducts.com)

Answer 2: **Jim Hitchner:** …this is something all three of us talked about quite a bit when we were doing the book PPC Guide to Business Valuations, 19th edition, (2009, Thomson Reuters). Does the lack of transaction details trouble you? What level of reliance do you put on the guideline company transaction method, when you don't have a lot of detail about the transactions? You don't know much about the transaction. What do you think, Jay?

Jay Fishman: It's a trade-off, you know. It's a trade-off given the number of transactions and where the multiples cluster versus the number - the amount of information.

Continued on next page

Shannon Pratt: The tighter the cluster of the multiples, the more reliance you put on them.

Jay Fishman: Especially in litigation, if you don't have details, then I think it's a toss-up whether I would just use it as confirmatory.

Jim Hitchner: Think of the questions I would ask Jay if I was a lawyer. Do you know the motivations of the buyer for this sale? No. Do you know the motivations for the seller on this sale? No. So you don't know why they bought this company and you don't know why they sold this company? No. Do you know what the projections for this company are next year? No. How many financial statements did you look at? I had financial information for one year. Is that how you normally value companies? Only looking at one year? In some situation you do only look at one year, okay?

Jay Fishman: And multiply that times five transactions. So now you got 25 questions.

Jim Hitchner: And by the end of the 25th question, what's your credibility?

Jay Fishman: Not.

Shannon Pratt: It depends a lot on the quality of the data for your other approaches, too. If the quality of the data is weak for the private company transaction data, and strong for the other approaches, you might not use private company data - transaction data at all. But if it's weak for all your approaches, you may use it partly.

Jim Hitchner: What I do, basically, and Shannon, I think you and I agree - if I have the detail - depends on the strength of your other methods and approaches - but if have the detail, I use it as a primary method. When I don't have the detail, which is often, I may use it as a corroborating method or a sanity check, but not a primary method. And often, I don't use it at all. And again, it is driven by facts and circumstances.

Discussion Participants:

Shannon Pratt, CFA, FASA, MCBA, CM&AA, Shannon Pratt Valuations (Portland), first ever recipient of the AICPA and ASA leadership excellence award, author, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th edition, coauthor, Cost of Capital: Applications and Examples, 3rd Edition

Jay Fishman, FASA, Financial Research Associates (Philadelphia), first professionally designated appraiser named to IRS Advisory Council (IRSAC), chair, ASA Governmental Relations Committee, coauthor with Shannon Pratt and William Morrison, Standards of Value: Theory and Applications

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

DISCOUNTS IN HEALTHCARE ENTITIES CONTINUED (SEE VPS Q&A 11, MARCH 2009)

Question 3: I read your answer today in the VPS Q&A. Your answer at the end observes that many medical groups do not think in terms of DLOM's and DLOC's when conceptualizing the idea of FMV. I agree, but I also think the answer is much simpler. A discount for lack of marketability is an issue of lack of liquidity. Why would there be a lack of liquidity in the circumstances, as there is a mandated buyout, hence there is a buyer and hence liquidity?

Answer 3: I think to have liquidity you need access to cash - that is accepted in the literature (see below). In the instant case, the lower tier partnership had no way to create liquidity despite partners having a put option to the partnership. The lower tier partnership had no put against the upper tier partnership. And although not in the fact pattern, it is unlikely that the subject interest in the upper tier partnership would be meaningful collateral absent personal guarantees of the partners. If you introduce a requirement of personal guarantees, you have both a liquidity issue and a cost of capital issue.
http://cpanet.typepad.com/cpanet/2007/05/cash_equivalenc.html
Here is a section of a report I wrote a while back with citations to an earlier edition of Valuing a Business, (Shannon Pratt, Robert Reilly and Robert Schweihs, McGraw-Hill, 2000, p. 540.)
In fact, a Put Option of the type specified in the Shareholders' Agreement (see discussion infra) is "… a common characteristic of closely held preferred stock. … When a preferred stock can be put back to the company at par value, its value usually is, at a minimum, its par value assuming the company has the financial ability to honor the put." (Emphasis added). The Agreement creates in effect a par value for these shares equal to a ratable share of the underlying net assets' fair market value. A minority owner dissatisfied with the actions of a control owner would therefore have the option to receive his ratable share of the cash, without reduction for discounts. In effect, the minority owner is afforded the same right as a control owner to "liquidate" the assets of the corporation with respect to the minority owner at a par value.

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