*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.

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*Email your question to: jhitchner@valuationproducts.com*

## THE TOTAL BETA MODEL FOR DETERMINING COMPANY-SPECIFIC RISK

*Question 1:* What's going on with the Total Beta model and the Total Cost of Equity that is promoted by Peter Butler and Keith Pinkerton?

***Answer 1***: A lot is going on. On May 18, Bob Duffy. CPA/ABV, CFA, ASA, Partner in the Valuation Services Group of Grant Thornton, and Jim Hitchner, CPA/ABV/CFF, ASA, CEO of Valuation Products and Services and President of the Financial Consulting Group, interviewed Peter Butler, ASA, CFA, and Keith Pinkerton, ASA, CFA. Butler and Pinkerton brought the total beta model (TBM) and the total cost of equity (TCOE), which they call the Butler Pinkerton Model (BPM), to the attention of the valuation profession. They have been teaching and presenting the TBM and the TCOE for determining Company Specific Risk (CSR) and the Company Specific Risk Premium (CSRP) for several years.

The entire ten-page interview will be published in Financial Valuation and Litigation Expert journal, in the June/July 2009 issue which will be available June 8 www.valuationproducts.com This article is an edited excerpt from the live interview.

While some well known appraisers have adopted the model, many others have been looking at it but were hesitant to jump in. However, there has been a recent critique by Larry J. Kasper, CPA, CVA, CBA in the Winter 2008 edition (Volume 27, No. 4) of the quarterly journal of the Business Valuation Committee of the American Society of Appraisers, Business Valuation Review, titled "The Butler Pinkerton Model for Company-Specific Risk Premium - A Critique," (Critique Article).

Butler and Pinkerton have responded to the Critique Article and have written a paper titled "A Total Repudiation of Mr. Kasper's Critique of the Butler Pinkerton Model." This paper is available, for free, at http://www.bvmarketdata.com/pdf/BPMRebuttal.pdf
We also understand that there will soon be a rebuttal of the rebuttal published.

**Bob Duffy:** So, what I thought I would do is make a couple of statements that I believe are applicable here. But my opening comments-and I've said some of this before-I think the premise of the total beta isn't controversial at all. I think we use it in every option analysis, and if you're using a protected put or a collar type analysis in a discount for lack of marketability analysis you're using a very similar model.

I don't think it's controversial that alpha risk exists. It's not controversial that we apply company specific risk premiums when we're valuing a private company. What the argument seemed to boil down to for me is, can you categorically reject the diversification argument that comes along with beta, rather than a total beta, when you're dealing with a private company valuation? Which seems to be, as a corollary, how do you define who your hypothetical buyer pool is?

I think we all know that betas, no matter how you capture them or calculate them, are historical for the most part. Alpha is primarily an additional, sort of backward-looking thing, but something that we can use to capture the forward expectation of risk, rather than just the historical risk associated with the asset or the stock. Part of what we're doing in security analysis is referencing history to help us predict future risk. Please respond.

**Peter Butler:** I don't disagree with anything you've said. As appraisers, we observe the market, and using total beta, we observe a total risk metric for certain guidelines that we believe we can apply to the valuation of privately held companies. Relating this comment back to the Critique Article, one of the criticisms is that we were trying to describe public stock returns with total beta and TCOE, which is not the case. We merely use the TCOE-while not priced in the public markets, it certainly does exist-and therefore we believe we can use it as a proxy for the valuation of privately owned companies.

**Keith Pinkerton:** I don't think there's anything controversial here. Now, if there is an argument to be made that the valuation industry is doing something incorrect, and that CSR should not be considered, I guess I'd love to participate in that debate. But as it

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stands right now, I don't think that's controversial.

Pete and I have said repeatedly that we don't believe the CAPM is all that great, but it does seem to be the most widely used model out there, and when you "fix" it-and I say that with double quotes around it-when you go to a total beta metric, you're picking up total risk, and there just doesn't seem to be anything controversial about that. What comes out of the use of total beta is it is still somewhat subjective in terms of trying to specifically define CSR in a CAPM equation. But you can at least go to line item by line item, and compare facts and circumstances, and use them against these benchmarks that we have, to better describe the cost of capital for a closely held company.

**Bob Duffy:** Are you saying that the total beta, if you find good comps and you compute total beta, are you saying that eliminates the need to add a CSRP, or does it just narrow that judgment gap somewhat?

**Peter Butler:** In the Butler Pinkerton calculator, if you just key in on total beta and TCOE, there is no need to divvy up the risk or allocate the risk. However, there are other uses of our calculator where we can allocate the risk by assigning the systematic risk with beta, and/or actually calculating or using a guideline-specific size premium. So, you can completely allocate the risk, not allocate the risk at all, or partially allocate the risk with a combined size and CSRP.

So it's really up to the user of the calculator. We don't say necessarily one technique is better than the other. Certain appraisers just key in on the TCOE, and that's fine; we don't say that's wrong, and, in certain circumstances, that might be best. Keith and I, however, are trending towards somewhat of an allocation of the risk or maybe a partial allocation of the risk, just to have a better idea about the risk. So we divide it between the systematic risk of beta, and then the combined size and CSRP, because the more research we do on this, we believe it's very difficult to separate CSR from the size risk.

## SSVS NO. 1 - REPORTS AND LITIGATION

***Question 2:*** **I would like to find out what you think about the SSVS and its applicability to litigation. Do you think it was the intention of SSVS to have all reports exempt from litigation? We are currently working on a divorce case. The opposing side's expert, who is a CPA, sent us a memo instead of a valuation and he is claiming that SSVS does not apply to litigation.**

***Answer 2:*** The AICPA Statement on Standards for Valuation Services (SSVS) No. 1, Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset, in paragraph 50 states the following: "A valuation performed for a matter before a court, an arbitrator, a mediator or other facilitator, or a matter in a governmental or administrative proceeding, is exempt from the reporting provisions of this Statement. The reporting exemption applies whether the matter proceeds to trial or settles." As such the reporting provisions do not apply. However, should a valuation analyst decide to prepare a report in a litigation setting, they may do so. The statement does not disallow the issuance of a report.

Furthermore, paragraph 50 also states: "The exemption applies only to the reporting provisions of this Statement (paragraphs 47-49 and 51-78). The developmental provisions of the Statement (paragraphs 21-46) still apply whenever the valuation analyst expresses a conclusion of value or a calculated value (Valuation Services Interpretation No. 1)." As such, the development standards do apply and the opposing expert must conform to them. There is no exemption for the development of a valuation in a litigation setting, only the reporting provisions.

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