JIM HITCHNER'S VALUATION PRODUCTS AND SERVICES

Q&A

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

Email your question to: jhitchner@valuationproducts.com

TIME PERIOD FOR TRANSACTION MULTIPLES

Question 1: When using multiples from Pratt's Stats, should you apply the multiples to the subject's TTM data or the most recent annual reporting period? Your thoughts would be most appreciated.

Answer 1: As with so many things in business valuation, the answer is, "it depends." One of the things we have to keep in mind, particularly in this economic environment, is the growth rate inherent in the multiples we select. Where the growth of your subject company may be different from the selected peer group, or from that which is represented by the last fiscal year of your subject company, then it may be more appropriate to use TTM data, or something different altogether. Just as in the application of the income approach, the transaction approach involves two variables: on the one hand, either revenue or income; and on the other hand, a multiple, which is really an inverse of a capitalization rate.

When market participants use a multiple of five or any other multiple, they are inherently considering the growth prospects for the subject company at the time of the acquisition when they select the multiple. It *may* be that the growth inherent in transaction multiples from earlier years does not represent the same expectations as that which buyers today would have. How can the analyst reflect that? In the only two places we have-- either in the selection of the income or revenue flow we use (i.e., getting back to the original question-- by using last year's income, next year's, or some other representation), or in the multiple selected. Obviously, there are a whole host of other issues that affect multiple selection and application as well, but we tend to think of growth prospects when we think about the question posed here.

Answer by: Nancy Fannon, ASA, CPA/ABV, MCBA, Fannon Valuation Group, (Portland, ME), Coauthor of *The Comprehensive Guide to the Use and Application of the Transaction Databases,* nancy@fannonval.com.

Editor's Note: *Pratt's Stats,* in its Frequently Asked Questions "FAQ" section, defines income statement data as follows, "Data is 'Latest Full Year Reported,' which 'Indicates that the income data reflects the latest reported full year financial statement.'" In the "Pratt's Stats Sample Transaction Report" on the BV Resources website www.bvresources.com, the sale date of the company was 1/10/07. The Income Statement data was from over a year earlier at 12/31/05 and the Balance Sheet data was from 9/30/06. As such, the sales dates can be quite different from the financial statement data dates. Bottom line is that the transaction dates may not be synched with trailing 12 months or even a latest fiscal year. For more information, see our next issue of *Financial Valuation and Litigation Expert.*

VALUATION ISSUES IN BIOTECH R&D FIRMS

Question 2: I may be engaged to do work for a bio tech firm that is primarily a R & D firm. However, the firm is funded by a public firm to do research and has several patents and patents pending. The firm needs a valuation for an FLP. The company does have some cash flow, but it is only from the public company at this time. There are no hard assets since it is a service company.

My Questions are:

2a: To begin with, I think I am valuing a few elements of the company: the cash flow of the funding from the public company (subject to review of the underlying documents supporting it) and the patents. I believe

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that I may be able to use a discounted cash flow model for that. What do you think?

2b: Regarding the patents and patent-pending items, can you suggest where I can obtain information relative to same?

2c: Regarding the discounting of the FLP, what is the most current school of thought or information that I can review to assist in a determination of the discount?

Answer 2a: A DCF may or may not be applicable, depending on the funding attributes. A contract research organization ("CRO") like the one described above is a common structure for many biotechnology companies. However, most CROs that I have been involved with have a variety of projects ongoing with a variety of funding sources. If the CRO has been in business for a number of years and has a stable income stream, usually represented by long-term contracts or master service agreements, then a DCF can clearly be constructed and utilized in the valuation.

I would also incorporate a market approach, as there are a number of publicly traded CROs. On the other hand, if the CRO is "sole-sourced" to the funding company, then an analysis of the likely continuation of funding needs to be done. In times of economic slowdown, CRO activity is the first to be cut since most pharma houses and bio-techs have in-house research capabilities. Again, you will need to assess the underlying research contracts and capabilities of the CRO's funding partners to ascertain if the funding company(ies) can take the R&D in house. The more unstable the cash flows, the less reliable a DCF will be.

Answer 2b: There are a number of sources where one can obtain royalty rates for patents to utilize in a DCF, including Royalty Source and Licensing Economic Review. However, the first question to be answered before you go down the valuation road is "Who owns the patents: the CRO or the funding house?" Usually, the funding house has a claim to any patents developed by the CRO, but any such ownership should be spelled out in the CRO contract or agreement, so make sure you request and analyze any agreements.

Answer 2c: Depending on what the FLP's asset makeup is, data and information for discounts can vary. First, let's assume that the CRO has a stable income stream and was valued using a traditional DCF with proper adjustments, resulting in a "controlling interest" valuation. Let's also assume a 10 percent interest in the CRO was contributed to the FLP and that is the only asset. Under these circumstances, I would suggest using the various restricted stock and pre-IPO studies we all are so familiar with. In addition, a closed-end mutual fund study can provide a starting NAV discount. On the other hand, if other assets are contributed to the FLP, e.g. real estate or stocks, then the Partnership Profiles data can be utilized as well as the closed-end mutual fund data noted above.

It goes without saying, but make sure you understand the provisions of the FLP agreement to determine the appropriate application of any discounts.

Answer by: Neil Beaton, CPA/ABV, CFA, ASA, Partner in Charge of Grant Thornton LLP's Valuation Services Group, (Seattle), former member of AICPA BV Subcommittee, AICPA Valuation of Private Equity Securities Task Force, and FASB's Valuation Resource Group, neil.beaton@gt.com.

AICPA BV STANDARDS

Question 3: Our firm is working on a 706 for a first-to-die decedent. The decedent owned a closely held company. Based on the earnings of the company and what the company does (capital and equipment intensive manufacturing) it is probably a book value/adjusted net asset method value; however, we have not done the work to determine this. Since the wife of the decedent is going to sell the company anyway and it's a first-to-die 706 anyway, we were initially going to put the book value on the 706. Now, with the AICPA BV standards (SSVS#1), I am worried if we did that without issuing some type of report, we may have broken the standards. What do you think?

Answer 3: If the book value is provided by the client then it should fit one of the exceptions to the SSVS#1 and not require any further compliance from the standpoint of the 706 preparer. However, if the value determined in the 706 also sets the tax basis for the asset going forward, thought should be given to performing a full valuation engagement if another value is indicated. It would be wise to document the exception in the tax workpapers in case a question or an issue arises at a later time.

Answer by: Jim Alerding, CPA/ABV, ASA, CVA, Clifton Gunderson, LLP, (Indianapolis), one of only four members of the AICPA Business Valuations Standards Writing Task Force and served for the entire six years up to the June 2007 official release of the standards. Jim.alerding@cliftoncpa.com.