

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

COMPANY-SPECIFIC RISK PREMIUMS

Question 1: What is a general range for company-specific risk premiums for most companies that are not in trouble and are estimated to have an average long-term growth rate of, say 4 percent or 5 percent and are reasonably profitable, some years higher and some lower? Please give an outside range and an inside range. Assume the company is worth between \$10 million and \$20 million.

Answer 1: One of the things that you must consider is what your starting point is. Are you using the Morningstar (previously Ibbotson) equity risk premium (ERP) and size premium, or are you using Duff & Phelps' size-adjusted equity risk premium? The reason this is important is because depending on which set of data you are starting from, you will have two different ERPs. Without going into specifics about the two sets of data (see *Financial Valuation and Litigation Expert*, Issue 4, Dec. 06/Jan. 07 www.valuationproducts.com keep in mind that with the Morningstar data, you have a size adjusted premium for a company that has average capitalization of over \$100 million with some companies over \$300 million (10th decile). This premium does not consider any specific factors relating to the subject company.

The Duff & Phelps' data, on the other hand, considers eight different factors that relate directly to your subject company. These include book value of invested capital, five-year average EBITDA, sales, number of employees, market value of equity, book value of equity, five-year average net income, and market value of invested capital. Because of these differences, the specific company risk premium that you select could differ. More than likely, it will be lower if you use the Duff & Phelps' data. Keep in mind that a company has one cost of capital, so if your ERP is different, your

specific company risk premium will be different. *[Editor's Note: Some analysts keep the same specific company risk premium for all the models, e.g., build up or modified CAPM, D&P vs. Morningstar, etc. They then calculate a discount rate range from which they choose the rate.]*

The problem with providing ranges for a specific company risk premium is that the range does not consider all of the specific risk factors that are unique to the particular valuation. For example, is there supplier or customer concentration or key person risk? The facts provided say the company is reasonably profitable, but does it generate sufficient cash flow? This is only the tip of the iceberg when the valuation analyst looks at the facts and circumstances of a specific valuation and analyzes specific company risk.

One factor that you would not necessarily consider in the selection of specific company risk is the growth rate. You select a specific company risk premium to get to a discount rate for net cash flow. The growth factors comes into play either in preparing a forecast for the discounted future benefits method or in the calculation of a capitalization rate. The consistency in past results may have an effect on your specific company risk premium (it would be lower because the company has a track record of producing stable

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results), but the specific growth rate would be factored into other parts of the valuation. [*Editor's Note: The discount rate must reflect the risk in achieving projected cash flow. In some situations, the discount rate may go up or down depending on whether the projection is viewed as aggressive or conservative.*]

Generally speaking, the specific company risk premium can be as low 0 percent and as high as 50 to 75 percent. I think for a smaller stable company, 3 to 10 percent is a reasonable range. The valuation analyst has to remember what is being measured in the discount rate. It is the company's ability to meet its cash flow projections in the future. If the company has sta-

ble earnings and cash flow, good management and more positive features than negative features, then why would an investor expect an excessively high rate of return?

Answer by: Linda Trugman, CPA/ABV, MCBA, ASA, MBA, Trugman Valuation Associates, Inc. (Ft. Lauderdale, FL), Member, ASA Business Valuation Committee; Chair, ASA Business Valuation Education Committee; Member, AICPA Forensic and Valuation Services, Executive Committee, Editor of the AICPA ABV E-Alert, Linda@trugmanvaluation.com

A BUSINESS BROKER'S VIEW OF INVESTMENT VALUE vs. FAIR MARKET VALUE IN SMALL BUSINESS TRANSACTIONS

Question 2: I heard in VPS's last webinar (March 18, 2008: "Transaction Databases: Can You Rely on Them?") that each transaction in a transaction database, e.g., the IBA and/or BIZCOMPS databases, represents investment value since they are negotiated deals between the seller and a buyer, with specific buyer and seller motivations and risk perspectives. Can they also be fair market value as well?

Answer 2: I'll start with a quote by football coach Lee Corso, college game day: "Not so fast, my friend." I may be wrong, but it doesn't seem quite that simple to me. Even though the smaller transactions may be investment value by definition, I feel that they are close to fair market value.

Smaller transactions have an asking/listing price that is often based on a business valuation with the fair market value standard of value. Buyers also occasionally engage appraisers for a valuation with FMV as the standard of value. It's true that formal valuations are not performed for a majority of these smaller transactions but business brokers know that listing a business near the price (fair market value?) that typical (maybe hypothetical) buyers will pay will produce the best results for both the seller and the broker.

In addition, many such acquisitions are funded with SBA-guaranteed loans which require a business

valuation with fair market value as the standard of value. If the valuation determines that the FMV is lower than the contract price, the deal is renegotiated. Investment value can be either higher or lower than FMV. However, I have never seen a buyer offer more than the asking price because they had synergies, etc. It seems to me that when deciding whether or not these transactions represent investment value one needs to consider more than just the fact that there is a specific buyer. One needs to consider the whole business transfer process including: how the business was priced/valued, willing seller, willing buyer, how it was financed, etc.

Answer by: Wayne Quilitz, Murphy Business & Financial Corporation, Murphy Valuation Services, Inc., (Clearwater, FL)

To ask YOUR question,
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MARKETABILITY/LIQUIDITY DISCOUNTS FOR CONTROLLING INTERESTS

Question 3: If I am valuing a controlling 100 percent interest in a company and am using only an asset approach as the best method, how do I apply the discount studies to this type of valuation engagement? Some appraisers say no marketability discounts. Many others think a discount to reflect transaction costs to sell the company and exposure to risk during the marketing period justify a 10 percent or so discount. What do you think and why? The texts I have searched don't address this issue quantitatively, and I need to.

Answer 3: The answer depends on a lot of things. If the assets were valued under specific definitions, such as replacement cost new or reproduction cost new, such valuations may already include a "time to market" component and an argument could be made that a DLOM wouldn't apply. Also, under which standard of value were the assets of the company valued? What is the asset composition? All of these considerations must be answered and assessed in order to determine if a DLOM would apply. So, some appraisers may be correct that no discount applies while under other circumstances, a 10 percent discount may not be enough.

Let's address some specific situations and flesh this out a little more. Let's assume a 100 percent controlling interest is valued for a potential sale of the assets to another company who is currently awaiting the appraisal in order to finalize the acquisition. The standard of value used is "fair market value," and the appraiser utilized generally accepted valuation principles in valuing the individual assets. In this case, I would say no DLOM would apply.

Changing the facts a little, let's assume the value of the 100 percent controlling interest is being valued

for estate purposes as the owner recently died. In this case, the standard of value is still "fair market value," but there is no ready buyer waiting in wings. The appraisal estimates it will take six to nine months to market the company as a whole and that marketing the individual assets would most likely result in a 25 percent reduction in expected proceeds. In this case, I would say a DLOM would apply.

In summary, the facts and circumstances will dictate the appropriateness of a DLOM. Make sure you understand the underlying factors before blindly applying a DLOM to any valuation. *[Editor's Note: See Financial Valuation and Litigation Expert journal, Issue 11, February/March 08, "A Look At Alternate Views on Discounts For Lack of Marketability," for a discussion on the distinction between liquidity and marketability and why the underlying valuation approach/method may affect whether a DLOM for controlling interests applies.]*

Answer by: Neil Beaton, CPA/ABV, ASA, CFA, Partner in Charge, Valuation Services Group, Grant Thornton (Seattle, WA).

WEIGHTS IN THE WEIGHTED AVERAGE COST OF CAPITAL

Question 4: For your WACC, where do you obtain industry capital structure information for the breakdown of percent equity versus percent debt? What are the options in this regard?

Answer 4: First of all, the weights should be market value weights, not book value weights. There is also the issue of minority vs. control since the minority interest cannot force a change to the capital structure. That being said there are some options in choosing a capital structure and the weight of debt (interest bearing debt, capital leases, etc.) and equity. Also, let's talk here about determining the "optimal" amount of debt, i.e., results in the lowest cost of capital and the highest value.

You can use public company data, based either on individual companies or an average of those companies or some composite industry average or grouping.

Many analysts assume that public companies will try to run their companies at an optimal capital structure to maximize the value to their shareholders. This sounds good but may have some difficulties. For example, what happens when you have six public companies and the percent of invested capital attributable to debt is as follows: 0 percent, 10 percent, 25 percent, 45 percent, 45 percent and 65 percent? The median average is 35 percent; the mean average is 32 percent. Many analysts would probably pick around 35 percent as the "optimal" percent debt. However, if you choose 35 percent, that is a percentage that is shared by none of

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the six companies. In fact, only three companies come in at plus/minus 10 percent from the selected debt percentage.

This also assumes that the private company can achieve the same capital structure as the public companies, which is not always the case. Public companies have greater access to the capital markets than private companies and may be able to obtain greater amounts of debt. Also, be careful that the debt that is within a public company is operating debt and not acquisition related debt.

You can also employ iterative models with existing debt. As stated in *Financial Valuation Workbook, 2nd edition*, Hitchner, James R. and Mard, Michael J., Wiley, 2006, p. 67, "The analyst will choose the capital structure to value the company, then determine the percent of debt based on that value using the actual debt of the company. If that is different, then you redo

the capital structure until it iterates to the proper capital structure that is in existence. This is easily accomplished by the use of spreadsheets." There is also a detailed example in *Financial Valuation Applications and Models, 2nd edition*, Hitchner, et al., Wiley, pages 143-149.

Now, let's get a little more practical. One of the best ways to determine the amount of debt that is "optimal" for a private company is to simply look at a balance sheet like a banker does. There is a certain amount that a banker will lend based on cash, receivables, fixed assets, etc. That will typically be all that the company can borrow and, as such, could be considered optimal by some analysts.

Answer by: Jim Hitchner, CPA/ABV, ASA, Valuation Products and Services and The Financial Valuation Group (Atlanta, GA).

Jim Hitchner's

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June 17, 2008 ~ 1:00 pm EDT

Ed Dupke, CPA/ABV

Jim Alerding, CPA/ABV, ASA

Jim Hitchner, CPS/ABV, ASA

All were members of the AICPA BV Standards Writing Task Force for the six-year period prior to their release.

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Rod Burkert, CPA/ABV, CVA; Alina Niculita, CFA
and Bob Duffy, CPA/ABV, ASA, CFA
Moderated by Jim Hitchner, CPA/ABV, ASA

TRANSACTION DATABASES: CAN YOU RELY ON THEM?

Presented by Jim Hitchner, CPA/ABV, ASA
Sam Wessinger (The Financial Valuation Group)

DISCOUNTS FOR LACK OF MARKETABILITY: QUANTITATIVE VS. QUALITATIVE MODELS

R. James Alerding, CPA/ABV, ASA, CVA
Neil Beaton, CPA/ABV, ASA, CFA
Moderated by Jim Hitchner, CPA/ABV, ASA