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FAIR VALUE™

Reprinted from Volume XIII, Number 1 Summer 2004

In Defense of the Merged and Acquired Companies Valuation Method

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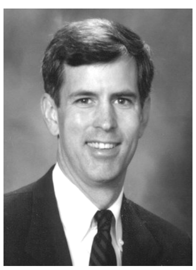
Introduction. A commonly used methodology in valuing the closely held business is the merged and acquired companies method (formerly called the "comparable companies method"). This technique uses data on the prices paid in the sale of companies in the same or similar line of business to derive valuation multiples (price to earnings, price to EBITDA, price to sales, etc.) that can then be used to value the private company. Despite its elegant simplicity, however, the method is not without its shortcomings, and it is those faults that have led to its criticism by some business appraisers and to the method becoming a principal target for cross-examination by attorneys in litigated valuation cases.



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This article will first summarize the ways in which business appraisers unearth data about transactions that have occurred and the shortcomings of the various approaches. Next it will briefly summarize why the method is often the focal point of attack and provide some counterbalancing views. While the method is not without its weaknesses and is not always appropriate for use in every valuation report, this article will show why one of the main attacks leveled at the method- that it is less reliable than the income valuation approach (e.g., capitalization of earnings, discounted cash flow) because not enough is known about the acquired companies- is often wrong.

Finally, it is helpful to read this article in the context of mistakes made by some business appraisers in using the method. Another article in this issue of *Fair Value* ("The Top 10 Errors Made in Using the Merged and Acquired Companies Method") deals with those mistakes and provides useful information on how to critically assess the actual use of the method.

A Little Background. To understand the attacks leveled at the merged and acquired companies method, it is first necessary to understand where and what kind of data is available to business appraisers in its use. In short, how do business appraisers find data on prices paid for companies that have sold and what is the nature of the statistics they do find?

Although it is generally difficult to find detailed information on merged and acquired company transactions, there nonetheless are several good sources of data available to the valuator. These include online and subscription databases available to the business appraiser, as well as the old fashioned method of using hard work, ingenuity and perspiration to seek out and find transaction data in a particular industry. The following section discusses several examples of electronic databases available to business appraisers. This is followed by a discussion of the "dig and explore" method of finding transaction data.

Transaction Databases. There are various transaction databases available that have varying degrees of information on sales of entire companies. Several such databases are described below:

- ***Pratt's Stats***- Available online, *Pratt's Stats* is a transaction database that contains information on thousands of transactions, searchable by industry grouping. Information contained in *Pratt's Stats* includes data on the Standard Industrial Classification (SIC) code of the buyer and seller, the location of the acquired company, the sale date, whether the sale was a stock or asset purchase, the sale price, and various balance sheet and income statement measures. *Pratt's Stats* contains a variety of statistics about the acquired company that are often very valuable in determining the broad similarity of the acquired companies. Sometimes, the acquirer is a public company and is named, potentially allowing the appraiser to search public company SEC filings to find out even more details about the transaction and the acquired company. In using the data, it is important that the terminology used and the way the information is presented be fully understood to be able to draw valid conclusions. For example, the transaction may involve a stock or an asset purchase, assumption or non-assumption of all or certain liabilities, involvement of real estate, some seller financing, non-competes, and so on. In order to sort out the specific details of a transaction, the appraiser must first read and understand the terminology and presentation conventions used by *Pratt's Stats*. Failure to carefully understand definitions and presentation of statistics can result in misuse of the data and incorrect valuation findings as a result.

◆ ***Done Deals***– Another online transaction database, *Done Deals* also provides information on transactions by SIC code. While some detail is provided, a shortcoming of the *Done Deals* data is that it is often much less encompassing than the information found in *Pratt's Stats*.

◆ ***IBA Database***- This database of the Institute of Business Appraisers may provide useful information, however, in general we have found it often contains far less detail about the acquired companies than sources such *Pratt's Stats* or *Done Deals*. Also many of the transactions listed are often older, with more contemporaneous data sometimes available from other sources. Finally, it appears that many of the transactions reported are of very small businesses. While the *IBA Database* has its uses and adherents and is not to be dismissed, our firm usually finds that better sources of transactions are available.

◆ ***Bizcomps***- This database is very similar to the IBA Database and suffers from some of the same limitations. Nonetheless, this source of data can and should be considered when relevant.

◆ ***Goodwill Registry***-The *Goodwill Registry* is published by The Health Care Group on an annual basis. As of its most recent printing, the *Goodwill Registry* contained information on thousands of medical and dental practice transactions from 1988 to the present. The *Goodwill Registry* classifies information by specialty and provides details on transactions such as the state of location, the reason for valuation, the valuation method used, the gross revenue of the practice, the overhead percent of the practice, the price paid for the practice, the amount of purchase price allocated as goodwill, and the goodwill amount as a percentage of gross revenue. The *Goodwill Registry* is a good source of data for use in medical practice valuations; however, there are some shortcomings to the data, including the following:

a. Reported results are for the amount paid for "goodwill," expressed as a percentage of revenues. Goodwill is not inclusive of other assets, such as receivables, equipment, real estate, etc., which need to be added to the goodwill value indicated.

b. The study's findings are presented as a percentage of revenues. However, revenues are not necessarily synonymous with profit performance and physician earnings, so those distinctions cannot be made in comparing the transaction prices. By including the overhead expense ratio, the study enables some conclusions to be drawn, however, "overhead" is not clearly defined for participants submitting information to the survey. Interpretation could therefore vary widely among practices.

c. It is not possible to analyze the revenues as related to productivity on a per-physician basis as the number of physicians in each practice is not reported.

d. The information is of a highly summary nature with the terms of the transactions not known. Items such as the amount of cash payment up front, non-competes, consulting agreements and other factors can have a major impact on the total value of the transaction, yet cannot be computed from the reported data.

e. It cannot be determined if minority or controlling interests are involved in each transaction report. Nor can impacts that these factors might have had on the values paid be analyzed.

Despite these shortcomings, the information contained in the *Goodwill Registry* is valuable to test the reasonableness of other methods and should be considered. It is one of the few widely available sources of data on practice sales and includes a large number of transactions.

Other Methods of Finding Information on Transactions. The transaction databases noted above can be excellent resources to obtain data on merged and acquired company transactions, however, the valuator may also find data by other means, and which can sometimes be of higher quality and of a more detailed nature. For example, contacts made with merger and acquisition professionals in an industry may sometimes result in detailed transaction data. The problem is that these advisors are often unwilling to share data if they have it. Also, the company owner may be aware of companies in the industry that were sold and which can then be researched by the appraiser. However, knowing a company was sold and being able to obtain the details in what was essentially a confidential transaction are two different things. Therefore, both of these approaches unfortunately rarely bear fruit.

Mining the SEC filings of Public Companies. Undoubtedly, the most useful source of data is information on acquisitions made by public companies as reported in their required filings with the U.S. Securities and Exchange Commission (SEC). These filings, which are available on the Internet and can be searched by SIC Code, industry, or company, often enable the valuator to find a number of filings that contain detailed financial information on acquisitions. If a transaction is large or material enough, the SEC requires the public company to file a document (usually a form 8-K) outlining the details of the transaction. Included in the 8-K is information on the price paid, the structure of the transaction (whether it is cash, stock, debt, or a combination of the above), and (sometimes) detailed financial information on the company acquired. Often times, the company acquired was privately-held and therefore did not have publicly-available financial information. With the SEC-required filings, the valuator can frequently have access to information that previously was unavailable or was difficult to access.

By analyzing the price information and the financial information on the acquired company (such as revenues, income, cash flow, EBITDA, book value, etc.), the valuator can determine the multiples at which the company was acquired. Then, making any necessary adjustments between the acquired company and the subject private company (such as for differences in accounting methods, size, liquidity, leverage, risk, etc.), the valuator can apply the multiples observed in the reported transaction to the subject company.

More is Often Known About Acquired Companies than About the Rate of Return Data Used in the Income Approach. In litigated valuation issues, cross-examining attorneys love to grill the valuator on the validity of the acquired companies to the subject company being valued, demonstrating through questioning how little the appraiser knows about the various operations of the acquired companies. The attorney maintains that this "proves" that the merged and acquired method is not reliable (or less reliable), and instead suggests that his or her expert's use of (or full weight on) some other methodology, such as the income approach (e.g., capitalization of earnings), is more reliable and ought to be accepted by the court. This is not necessarily true. In reality, it can easily be the case that the valuator in fact knows far more about the acquired companies, information that is sufficient to show broad similarity to the company being valued. In contrast, the valuator likely knows virtually nothing about the similarity of the public companies used to develop the rate of return data that is the basis for developing the discount and capitalization rates used in the income valuation approach.

In using the income approach, the valuator must convert an income stream (whether through forecasts using the discounted cash flow method or based on historic results using the capitalization of earnings method) to a value estimate using a discount rate, an annual rate of return for risk. This discount rate is typically derived from long-term historic rate of return data based on thousands of public company stocks from such sources as *Ibbotson Associates* or *Standard & Poor's*.

In reality, the valuator making use of that data cannot tell the court how many of those public companies were in the same industry as the company being valued, were of similar size (other than perhaps in a range), offered similar products, had similar territories, suppliers, competitors, had reliance on key employees, experienced similar financial performance and trends, and so on. In fact, the data contains companies from an almost limitless number of industries, sizes and types, many in segments as different as night and day from the subject company being valued.

At least in the market approach the business appraiser can narrow down the data selected for use to a same or similar market segment or industry, and often knows the broad financial results, size and location of the acquired companies. By comparison, these are factors that the appraiser never knows about the universe of companies that comprise the average rate of return data used in the income approach. All the appraiser can tell the attorney or court is that "the investor in an average public company realized annual returns of X% over the last 70 years." Therefore, which method is more reliable and provides more useful information?

Selection of the Appropriate Method Still Requires Judgment. The foregoing is not meant to serve as a blanket support or condemnation of the market or the income valuation approaches. In fact, every company situation is unique and the appraiser will need to use judgment to determine which method(s) are appropriate. For example, suppose the company being valued is rapidly growing and has high profit margins that are well above the averages of peers in its industry. Therefore, it may be the case that the income approach best captures the extra value creating benefit of this high degree of profitability. Also, the appraiser may decide that the acquired company data is not useful for other reasons. For example, the only transaction data identified might be from a different time in the acquisition environment which is no longer the case at present in that industry. In any event, the quality appraisal will normally articulate the logic used by the business appraiser as to why the particular method(s) were used and why certain ones were not. Another article ("The Top 10 Errors Made in Using the Merged and Acquired Companies Method") in this issue of *Fair Value* provides insight into some of the mistakes appraisers should avoid in using the merged and acquired companies method.

Synergistic Elements of Value Do Not Rule Out The Use of Market Data. Some appraisers and attorneys caution that the prices paid in acquisitions can incorporate synergistic elements of value unique to the transaction and the specific buyer and, therefore, violates the fair market value standard, which they say is based on a hypothetical buyer with no unique motivations. These factors require the transaction to be excluded or require an adjustment to the multiple to account for the difference between fair market value and strategic value. In equitable distribution matters, most states follow a standard of value that is equal to or very similar to fair market value. Therefore, in arguing the case or in cross-examining the valuation expert, attorneys will argue that since transaction data cannot be clearly shown to be fair market value (versus strategic or investment value to a specific buyer) that it violates the valuation standard and must be excluded.

It can indeed be true that an isolated transaction that is strategically motivated might result in an entirely different value than what a "hypothetical buyer" might pay under a fair market value standard. However, if there are a meaningful number of transactions occurring in an industry, this reasoning may be entirely flawed, wrong, and naïve regarding how real buyers and sellers operate in a competitive marketplace.

Synergistic and Investment Value Can be the Same as Fair Market Value. For example, when there are a number of buyers acquiring companies in a fragmented, but consolidating industry, even if the buyers are paying strategically or synergistically motivated prices, this becomes known and may well influence what all buyers have to pay to compete for and win a purchase- even financial buyers who do not benefit from synergies. This is particularly true in consolidating industries where large companies in the industry are growing in part through the acquisition of smaller, closely held counterparts. Large companies can often increase the profitability of the small company on a post acquisition basis through the elimination of duplicate overhead and a realization of greater profit margins than the small company could through volume purchasing and other efficiencies. Since multiple larger companies with the same attributes are competing for the universe of sellers, this forces buyers to bid up their pricing to reflect the value of these synergies to win the purchase. In essence, fair market value rises to and becomes synonymous with synergistically motivated pricing.

It is great in theory to say that this is not fair market value. Try telling that to the seller. Why would the seller turn down a variety of higher, synergistically based offers in a consolidating industry to instead wait for the "hypothetical buyer" to come along and pay a non-strategically motivated, financial buyer price? Of course they would not.

Supply and demand are at work in buying and selling businesses, just like in any product or service. The average, non-motivated fifteen year old girl (I am not meaning to pick only on girls- it is just that as the father of three girls I see this in action) might only pay $10 for the autograph of the latest pop star. If one isolated girl decides that star is the "coolest" and is willing to pay $1,000, that might be an isolated transaction that may not force the market value of the autograph to rise to and stay very long at $1,000 since there are no other buyers around to pay the same thing for more autographs. But if a growing number of teenyboppers create a trend of seeing that pop star as cool, they force the price to rise to and stay at $1,000. Even though my daughter might not have the same motivations, if she wants to have a shot at buying the autograph she must now pay the going price, $1,000 (hard to do on my daughter's allowance). Conversely, if she bought one earlier for $10 and there is now a trend of a material number of buyers paying $1,000, why would she be willing to accept $10? She wouldn't. Business values in consolidating industries are no different. Business appraisers must continually remind themselves that they not only operate in the theoretical world of valuation, but in the real world of how buyers and sellers really think, act and feel.

In a related vein, some appraisers argue that even if there are a large number of transactions in an industry, each transaction involves the unique motivations of the buyer and seller. Therefore, even if there are 10 transactions, this should give no comfort that they equal fair market value because each one is based on unique motivations. This is nonsense. If there are 10 transactions and they tend to involve a similar range of pricing, regardless of the motivations of each particular buyer and seller, a pattern is starting to emerge of how buyers and sellers in the industry price transactions that strongly points to the multiples as an indication of fair market value.

Summary. The merged and acquired companies valuation method is not without its faults. Yet it is not the business appraisal equivalent of alchemy that some cross examining attorneys would have the courts believe that it is. While the details known about the business activities of the acquired companies may be more limited than is ideal, this is not necessarily enough to rule out the use of the method in contrast to the use of other techniques, such as the income approach. In fact, even with the limitations of the data, more may in reality be known about the acquired companies than about the companies which are the basis of the data used in developing the rate of return or capitalization rate incorporated in the income valuation approach.♦

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