BANISTER FINANCIAL, INC.
Business Valuation Specialists
www.businessvalue.com

1338 HARDING PLACE • SUITE 200
CHARLOTTE, NORTH CAROLINA 28204
PHONE: 704-334-4932 FAX: 704-334-5770
Contact: George B. Hawkins, ASA, CFA, President

FAIR VALUE™

Reprinted from the April 1995 Issue

MARKET IMPACTS AND INFLUENCES ON THE VALUATION OF CLOSELY-HELD COMPANIES

By: Michael A. Paschall, ASA, CFA
Managing Director

Extra, Extra, Read All About It! "Dow Breaks 4,200, Is Poised To Go Higher." "Prime Rate Hits 9%, Was 6% One Year Ago." "Inflation Holds Steady At 3%." Common headlines in today's business sections but what do they have to do with the value of your closely-held business? Depending on the reasons underlying the market data and your particular private company, such market indicators can have a significant impact on the value of your business.


Michael Paschall

Take the Stock Market. Revenue Ruling 59-60 lists the following as one of the factors to consider in the valuation of closely-held companies: "[t]he market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter." The theory behind this comparison is that a private company operating in the same industry and under the same market and economic conditions should react similarly as the publicly-traded companies in the same industry. Therefore, before considering the marketability and specific risk differences between the companies, the market's valuation of the publicly-traded shares should be a reasonable indicator of the value of a small minority interest in the privately-held company.

The Bull Market. This all sounds good in theory, however, there may be significant problems in applying market comparables in reality. Suppose a minority interest in your closely-held company is valued under a comparable company method using three publicly-traded companies. In year 1, the value of your private company, before discounts, is calculated to be $10 per share. Now assume in year 2 that the Dow has skyrocketed and the public comparables have fully participated in the bull market. The P/E ratio for the comparables has risen from 10.0x in year 1 to 20.0x in year 2, and the value of your private company, before discounts, is calculated to be $20 per share. Although your company may be benefiting from a positive economic environment, is it really worth twice as much now as it was one year ago?

P/E Ratios and Cap Rates. One way to examine this situation is to look at the P/E ratio. In effect, the P/E ratio is really an inverted capitalization rate. For example, a company with a P/E ratio of 20.0x has an imputed cap rate of 5%. This means that the market places a value on the company equivalent to 20 times current earnings. To oversimplify, the magnitude of the P/E ratio is due largely to the growth and risk expectations for that particular company. In general, if the investor anticipates lower growth and/or higher risk from an investment, a higher rate of return (and lower market multiple) would be expected. Conversely, if an investor expects higher growth and/or low risk, a lower rate of return (and higher price-based multiple) would be expected. Aside from the obvious difference in marketability, private companies usually are far more risky investments than are public companies due to differences in size, management depth, product and geographical diversification, access to financial and capital markets, availability of financial and other company information, and a host of other reasons (see related article). Therefore, in applying a market multiple

to the subject private company, it is usually necessary and appropriate to adjust for the differences between the companies.

Intangible Factors. In addition to these differences, there also may be intangible reasons driving the price multiple of a particular public company. Emotional reasons or market hype and hysteria may drive a publicly-traded company to a level where comparison with the private company makes little, if any, sense. Therefore, an analysis of a privately-held company using a public comparable method requires consideration of a number of factors, both tangible and intangible.

Now Consider Interest Rates. Revenue Ruling 59-60 also lists the following as factors to consider: "[t]he earning capacity of the company" and [t]he dividend paying capacity." The use of various income approaches is appropriate in trying to estimate a value for a business and can be based on the capitalization of historic, current, or projected earnings, cash flows, or dividend streams of the company. Whether this capitalization is done on an all-equity or weighted average cost of capital basis or is derived using the build-up, capital asset pricing model (CAPM), or some other method, the market level of interest rates will play a key factor in the development of a cap rate.

Deriving a Capitalization Rate. For example, assume the build-up method is used in computing a cap rate on an all-equity basis. Assume that in year 1 the 10 year treasury rate (a measure of the risk-free rate) is 6%. Assuming an additional market and specific-company risk premium of 14%, a final cap rate of 20% is implied. Disregarding any adjustments for growth, applying the 20% cap rate to a hypothetical earnings stream of $1,000,000 yields a value (before discounts or premia) of $5,000,000. Now assume in year 2 that the 10 year treasury yield is 11%. All other factors remaining equal, the new cap rate of 25% applied to the $1,000,000 earnings stream now yields a value of $4,000,000 for your company. Where, you may ask, did that $1,000,000 in value go?

The Risk-Free Component. We can begin to answer this question by analyzing the risk-free rate and what it means and represents. The risk-free rate is the starting point for either the build-up or the CAPM methods and measures the amount of compensation demanded by an investor who is lending money to a borrower. Such loans to the U.S. Government are said to be "risk-free" because of the federal government's broad power to coin money and raise revenue through taxes. Therefore, an investor in a treasury instrument is not compensated for bearing any risk, however, the investor *is* compensated for the potential loss of his purchasing power by inflation.

The Fear of Inflation. So how does this relate to the value of your closely-held business? Remember that in year 1, a hypothetical investor was willing to pay $5,000,000 in exchange for an annual income stream of $1,000,000 (a 20% return). In year 2, however, interest rates are higher as a result of higher inflation and investor concern over the loss of purchasing power. Therefore, the hypothetical investor in your company is now willing to pay only $4,000,000 for that $1,000,000 annual income stream. The investor is willing to pay less in year 2 because as he realizes that income stream over the future, its purchasing power will have diminished at a greater rate. The risk-free rate is not the only factor impacting your company's total capitalization rate, however. It may well be that other factors influence separate components of the cap rate and warrant adjustment to current market conditions. Although the risk-free rate can directly impact the cap rate, it is necessary to keep a big picture outlook and account for all contingencies affecting the value of the business.

Conclusion. Market forces, although seemingly isolated from privately-held companies, can potentially affect the value of the closely-held business. Depending on the differences and similarities behind the public indexes and the specific company to be analyzed, market-driven measures can and do affect the valuation of the privately-held company. The difficult part in utilizing the market information is the required analysis of the specific public components as they relate to the subject private company. Only through a detailed and well-researched valuation report can the experienced business appraiser adequately address the various market factors impacting the closely-held company. ♦

Michael A. Paschall is co-author of the *CCH Business Valuation Guide* and a Managing Director of Banister Financial, Inc., a business valuation firm in Charlotte, North Carolina. He can be reached at mpaschall@businessvalue.com or 704-334-4932.

This article is an abbreviated discussion of a complex topic and does not constitute advice to be applied to any specific situation. No valuation, tax or legal advice is provided herein. Readers of this article should seek the services of a skilled and trained professional.