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HOW COMPARABLE ARE YOUR COMPARABLES?

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Introduction. Revenue Ruling 59-60 lists as one of the factors to consider in valuing stock of a closely-held corporation: “the 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 assumption behind this approach is that the earnings and cash flows of two companies in the same industry should react to similar market forces and therefore will be highly correlated.



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Sounds easy enough, however, some real and practical difficulties often come into play in determining which publicly-traded companies are truly

“comparable” to the subject company to be valued. This article will first survey recent case law involving attempts from the bench to define the parameters of the “same or similar” line of business. Next, this article will outline the appropriate selection criteria necessary to consider in determining an appropriate group of public comparables. Finally, an examination of the comparative analysis between the public comparables and the subject company will be considered.

Judicial Limits on Comparables. Courts historically have applauded the use of the comparable company (or “guideline”) method as a valid and reliable technique yet often have found problems with the actual comparables selected. In *Central Trust*¹, the court directed the appraiser to use as broad a selection of public comparables as possible yet threw out the appraiser’s two selected public companies due to their

lack of comparability to the subject company in question. In *Northern Trust*², appraisers for both the IRS and the taxpayer used a comparable company approach, however, the court disallowed both methods on the grounds that the public companies selected were not truly comparable. Despite similarities in capital structure and financial ratios, the companies selected by both appraisers were rejected due to the fact that they had no relation to the subject company’s line of business.

Judicial Expansion on Comparables. At the other end of the spectrum, some courts have been willing to expand the universe of suitable comparables, particularly when there are few or no ideally comparable companies available. In *Estate of Joyce C. Hall*³, all parties agreed that only one publicly traded company, American Greetings, was ideally comparable to the subject private company, Hallmark Cards. The valuation expert for the IRS limited his selection of public comparables to American Greetings, however, both valuation experts for the taxpayer included other, seemingly less-comparable public companies in their valuations. Reasoning that Hallmark enjoyed a similar financial structure, name recognition and dominant share of its market, the appraisers for the taxpayer employed public comparables such as Coca-Cola, Avon, McDonald’s, IBM, and Anheuser Busch. Despite the radical differences in operations and product mix, the court allowed the broader universe selected by the taxpayer’s experts. The court found it “inconceivable” that a potential investor in Hallmark would consider only one comparable public company.

Similarly, in *Estate of Margaret A. Jann*⁴, the court allowed a broader universe of public comparables due to the fact that the best public comparable was many times larger than the subject company, an automobile coil spring manufacturer. The court held that a sample

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of five public manufacturers of original equipment for the automotive industry was a reasonable group of comparables. The court reasoned that in the absence of more than one comparable company, it was correct to compare corporations engaged in a similar line of business. Thus, as with the *Hall* court, the *Jann* court also took a broader view of the Revenue Ruling 59-60 language concerning the “same or similar” line of business in holding that if “same” public companies are not available, “similar” public companies are acceptable for comparison.

Selection Method. Given this broader reading by some courts, difficulty still arises in drawing the line between those public companies which are “similar” and those which are not. Indeed, in *Cavalier Oil*⁵, the court noted that “the threshold determination of which companies are ‘comparable’ is highly judgmental.” Of critical importance in establishing a reasonable universe of public comparables is the screening and selection process. The Business Valuation Standards of the American Society of Appraisers (ASA) require a thorough and objective search for guideline companies to establish the credibility of the valuation analysis. Efficient use of the standard industrial classification (SIC) codes in conjunction with numerous printed and on-line databases is vital in narrowing the field of publicly-traded companies down to a manageable yet accurate sample.

Ultimate selection of a suitable group of public comparables requires a detailed analysis of corporate factors, including (but not limited to): asset size, line(s) of business, product mix and diversification, nature of competition, revenues, margins, profits, financial performance, growth rates, capital structure, leverage, cyclical variability, geographical diversification, depth of management, investment performance, and degree to which shares are freely traded. A recurring pattern in numerous cases is the court’s rejection of a group of public comparables due to the appraiser’s failure to adequately consider some or all of the above factors. A detailed, well-reasoned analysis of all industry classifications considered, public companies both selected and rejected for use, and the rationale behind those decisions, stands a far better chance of both arriving at a truer indicator of value as well as being more persuasive, whether with the IRS or in a court of law.

Comparative Analysis. Determining the potential universe of suitable public companies is only half the battle, however, as the thorough appraisal will also contain a comparative analysis of the public companies as they relate to the subject private company. The Business Valuation Standards of ASA suggest a comparative analysis of

qualitative and quantitative similarities and differences between guideline companies and the subject company in order to assess the investment attributes of the guideline companies relative to the subject company. Among other comparisons, the Standards recommend consideration of adjustments to the financial data of the subject company and public comparables to minimize differences in accounting treatments when such differences are significant and relating price information and underlying financial data of the public comparables in order to compute appropriate valuation ratios. These appropriate valuation ratios are then used along with the comparative analysis of qualitative and quantitative factors to determine appropriate valuation ratios for application to the subject company.

Suggested Procedure. As a starting point, such comparative analysis invariably includes the review of public company annual and quarterly reports, conversations with management and investor relations personnel, and consideration of security analyst research and independent investment studies. Detailed analysis of this nature is necessary to ensure that comparison between the public companies and the subject company is as close to “apples to apples” as possible. Key to this analysis is the estimation of risk characteristics of the public companies as relates to the subject company. A public company that on its surface appears to be ideally comparable to the subject company may in fact be entirely unsuitable on an unadjusted basis due to significant differences in its accounting treatments. Arguably, the use of such unadjusted figures in a public company comparison could be as useless as comparison with a public company engaged in an entirely different line of business.

Summary. The use of public comparables is a valuable and well-accepted technique in business valuation, however, its application is anything but mechanical. Difficulties in the search and selection of guideline companies, the comparative analysis of qualitative and quantitative factors between the public comparables and the subject company, and variances in recent case law all call for an experienced and knowledgeable procedure and analysis. A thorough, well-documented, and soundly-reasoned report performed by accredited valuation advisors is far more likely to arrive at a reasonable universe of public comparables than an unorganized, haphazard search. ♦

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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.

Endnotes.

¹Central Trust Co. v. U.S., 305 F.2d. 393 (1962).

²Northern Trust Co. v. Commissioner, 87 T.C. 349 (1986).

³Estate of Joyce C. Hall v. Commissioner, 92 T.C. No. 19 (1989).

⁴Estate of Margaret A. Jann v. Commissioner, 60 T.C.M. 23 (1990).

⁵Cavalier Oil Corp. v. Harnett, Del. Ch. Civil Action Nos. 7959, 7960, 7967, 7968 (1988).