

FAIR VALUE™

Reprinted from the April 1995 Issue

PUBLIC AND PRIVATE COMPANY DIFFERENCES CAN HAVE MAJOR VALUATION IMPLICATIONS

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Introduction. Another article in this issue of *Fair Value* talks about how changes in the stock market, inflation, investor emotions, and other factors can directly impact the value of a closely-held business and how some of these factors lead to important differences



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between public and private counterparts that are critical in the valuation process. However, there are a number of other important differences between public and private companies which can cause multiples for the latter to differ from those paid for public counterparts and, in some cases, diverge in opposite directions.

Readers of a valuation may not be aware of these differences and must look to the business appraiser to articulate the rationale for why the private company value was impacted. Otherwise the reader might assume that because Wal Mart is a retailer it is therefore reasonable to apply its price-earnings multiple to your client's small, ten store retail chain company. Obviously this is an extreme example but similar stories occur often. As the humorist Dave Barry would say, "I'm not making this up." This article will touch upon some of those differences and why the business appraiser must account for these factors in valuing the private business.

Size. Size alone can be a major factor in comparing risks for companies of differing size, whether public or private. In deciding what public company earnings or other multiple to use in valuing the private business, adjustments may be needed for the additional risk associated with smaller size. Factors such as lack of market clout, more limited access to debt and equity

capital, less public awareness, key person issues, and a host of other factors contribute to a generally greater perception of the risk associated with smaller companies by investors. This greater risk is reflected in a lower multiple afforded to earnings or cash flows.

Return Impacts of Size. Just how big a difference can this make in valuing the private business? Ibbotson Associates publishes a detailed annual study of the returns (dividends and capital appreciation) of public company stocks for varying time periods ranging from the 1926 to today. Used by business appraisers as one factor in developing capitalization rates for private companies, the Ibbotson study further segregates average returns by size of company. The results concerning the risks investors typically perceive in smaller companies is eye opening.

Ibbotson data covering the period from 1926 to 1994 indicates that the average large company public stock returned an average of about 7.6% annually above the risk free income returns on intermediate term treasuries, while the average "small" stock returned an additional 5.2% above that of the average large company. And what is meant by small? This is defined as the smallest fifth of the companies traded on the New York Stock Exchange, companies still far larger than the typical private company! Ibbotson has recently begun providing a greater segmentation of returns by specific size ranges. The truly small companies result in returns that can be far higher than those companies in the previous "small" definition.

Just How Big Are the Differences in Return?

Let's take a look at how much rates of return differ when size is broken down further. **Table 1**, derived from Ibbotson data, shows the average total annual rates of return by decile size of company and the average market

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value of the companies in each decile. For example, over the 1926-1994 period, the largest companies (those in decile 1, having an average market value of \$14 billion) returned an average total annual return of 11.01%, or 6.31% above the average risk free return on intermediate term U.S. Treasury notes over the same time frame. As company size decreases, total returns increase, culminating in the highest returns for the smallest companies in decile 10, the companies have an average annual return of 21.98%, (17.28% above the risk free rate) a premium that is 174% higher than the largest companies. And while we are now looking at the “smallest of the small” in the Ibbotson study, the average company in this tenth decile has a market value of \$41.5 million, larger than many private companies.

average cost of capital, taking into account debt and equity in the capital structure. Additionally, this study is of average market conditions over a very long time frame. Current equity markets may differ and warrant consideration of other market measures or adjustments. Finally, these rates represent only the discount rate portion of the capitalization rate equation, and compensate only for risk. To arrive at the capitalization rate to be applied to the private company’s earnings, an annual growth factor must then be subtracted. Growth itself is a complex topic that is outside the scope of this article.

Key Person and Depth of Management Issues.

Another glaring difference between many private and public companies relates to key person risk. The small or mid-sized private company is often dependent upon one or several key leaders on which much of the business’s fortunes rise or fall. The leader is often the original founder- an entrepreneur who seized a good idea, scrounged for capital and the customers to make it happen, and often worked 70 or 80 hours per week at great personal sacrifice. The leader has long personal relationships with key customers that made the company a success and on whom the business is still heavily dependent. That same individual has strong ties with key suppliers and oversees manufacturing, personnel, and many of the essential aspects of the business. And don’t forget the banks. They took a risk lending the company money on the strength of the owner’s vision and integrity, and almost always received the personal guarantee of the owner and his or her entire personal wealth in the event things went south.

Has the Organization Evolved Beyond the Key Person’s Ability to Manage? As time moves on the business becomes heavily dependent on this one individual even though the business has reached the limits of the ability of a sole person to effectively manage it. Although the business is now years away from its risky days as a startup, substantial key person risks remain. Imagine what would happen if this person were to die or become disabled. Would the customers and suppliers who dealt with the company largely on the basis on personal relationships have less reason to continue with the company in the future? Would the bank continue to see the business as a sound credit risk? Simply put, would the business survive? Its surprising how many do not or have a difficult time managing the transition. Contrast all of this with the typical public company where there is a strong management team with greater size, depth, and the ability to better survive the loss of a leader. In addition, the typical public company often has a stronger equity capital base to weather any transition.

TABLE 1
Smaller Public Companies Have Historically Resulted In Higher Annual Returns To Investors¹

| Size Decile | Average Company Market Value (Millions) | Average Annual Total Returns, 1926-1994 | Average Annual Equity Risk Premium Above Risk Free Treasury Rates, 1926-1994 |
|-------------|---|---|--|
| 1 | \$14,193 | 11.01% | 6.31% |
| 2 | \$3,509 | 13.09% | 8.39% |
| 3 | \$1,826 | 13.83% | 9.13% |
| 4 | \$1,114 | 14.44% | 9.74% |
| 5 | \$730 | 15.50% | 10.80% |
| 6 | \$484 | 15.45% | 10.75% |
| 7 | \$292 | 15.92% | 11.22% |
| 8 | \$194 | 16.84% | 12.14% |
| 9 | \$104 | 17.83% | 13.13% |
| 10 | \$41 | 21.98% | 17.28% |

¹Source- Derived from data contained in *Stocks, Bonds, Bills & Inflation, 1995 Yearbook™*, Ibbotson Associates, Chicago (annually updates work by Roger G. Ibbotson & Rex A. Sinquefeld). Used with permission. All rights reserved.

An astute business appraiser will therefore consult studies to make adjustments for size differences where appropriate in arriving at the final capitalization rates and multiples applicable to the small and mid-sized private company.

Thorough Analysis Required to Ascertain Size Impact. Having pointed out the potential importance of size, this does not mean that a small company will necessarily be more risky and always require a higher return. Analysis of all factors impacting the specific business may lead to the opposite conclusion in some circumstances.

The business appraiser must prepare an in-depth analysis to make a realistic interpretation of risk, both for the private company being valued and the public companies being used as comparables. Further, the rates previously cited are “all equity” returns and may warrant significant further adjustment to arrive at a weighted

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There's More to the Key Person Risk Factor.

At some point in a company's life cycle the key person actually can become the problem. Because the company is her or baby, the individual is often reluctant to delegate responsibility even though the business may be too big for one person to effectively manage. While competitors are innovating and the needs of suppliers and customers are evolving, the leader may become bogged down in handling day-to-day details and may miss sight of opportunities or threats to the business. While public company leaders can make the same mistakes, it is the privately-held owner's emotional tie to the business that can prevent sight of the chance to take appropriate action.

Family Succession Clouds the Picture. Finally, there's the family factor and its influence on the management team and the ability to lead as the business transitions to another generation. Some founders have the good fortune or the skill to have capable, driven offspring who have the ability (or potential) to successfully lead the business into another generation. It is hard not to want to see one's children carry on a family tradition with the business, but family relationships can make it difficult to admit that one's son or daughter may not have what it takes to be a leader. An even more difficult issue arises if the owner does not demand of offspring the same competence that would be demanded from a professional that is not a family member. The opposite problem can also arise with unreasonably high expectations demanded of an offspring, leading to family conflict.

Appraisal of Management Important. The business appraiser, particularly in valuing a second generation business, often must make the delicate yet essential determination of management's ability and its impact on the risk of owning the company's stock. It is astounding how many private companies do not survive past the second or third generation. Poor intra-family management transition is often the reason. Public companies, meanwhile, have a harder time perpetuating incompetent management under the glare of securities analysts and investors who constantly compare companies looking for those businesses with the brightest futures. If management is the problem, these investors vote their displeasure by selling their shares, driving down the stock price, and placing greater pressure on the company to act.

Management Factor Doesn't Always Increase Risk. Please do not interpret this as a blanket condemnation of private company management. Many private companies are well managed and do a superb job of acting creatively and strategically to a changing business environment. Since management can play a key ele-

ment in overall risk, the business appraiser must be attuned to factors in closely-held companies which can sometimes give rise to enhanced risk. If this risk is present, an unadjusted use of the public company multiple alone may not result in an accurate valuation of the company.

Access to Financing. Access to capital is often a key difference between private and public companies and gives rise to risk variations. Public companies, carefully followed by armies of securities analysts, on-line reporting services, and millions of individual and institutional investors, generally have a much easier time attracting debt and equity capital than does a private company. To attract debt, a private company often must look to banks who may demand higher interest rates, more restrictive loan covenants, and faster amortization periods. This can place greater pressure on company cash flows, increase the risk that unexpected events could lead to a deviation from loan covenants, and possibly culminate in an acceleration of outstanding loans.

Debt Terms and Pricing Are Often Less Advantageous. What about the rapidly growing private company where every ounce of cash flow is going to support an ever growing investment in receivables and inventory? Financing often is in the form of "asset based" credit facilities with loan advance eligibility tied to a percentage of eligible accounts receivable and inventory. These loans often are at interest rates ranging from 1.75% to as much as 6% above the prime rate. Lacking access to equity capital, the company's leverage (i.e., the degree of reliance on debt versus equity) sky-rockets, dramatically magnifying the firm's vulnerability to increases in interest rates and unforeseen business problems. These problems may cause the private company to go into bankruptcy more quickly than public companies who have greater use of equity capital.

Equity Capital Alternatives Often Limited. Equity capital for private companies often comes from venture capitalists who are highly discriminating in seeking the appropriate investment. Venture capitalists are astute investors who realize the risks and therefore expect a high rate of return, often demanding a significant ownership position. What about going public? It is only the exceptional private company that has the earnings story, rapid growth rate, or "sex appeal" that makes them a candidate to go public. For most closely-held businesses, the risks, key person issues, volatility of year-to-year earnings, and a host of other factors rule this option out as a legitimate source of capital.

The Portfolio Effect Assumption. Dad told me when I first started buying stocks as a child not to put all

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of my paper route earnings eggs in one basket when it comes to the stock market. By owning a portfolio of stocks, I would lessen the effect of any one of my picks doing poorly or going bankrupt by having my other picks do well. The assumption that investors are risk averse and typically hold a market basket of securities is a central tenet underlying the Capital Asset Pricing Model (CAPM). CAPM, which is used by business appraisers to estimate capitalization rates for private companies, assumes that by owning a portfolio of stocks, investors can diversify away specific company risk factors and are left only with “market risk.”

All or Nothing. While most investors in public shares hold diversified portfolios, this assumption is much more questionable when it comes to private company shares, particularly those of smaller companies. The typical buyer of a private company often ties up much or all of his or her net worth in the business and also guarantees substantial bank debt. Therefore, not only is the individual exposed to market risk, he or she is also unable to diversify away specific company risk with a portfolio of one company. Guess wrong about the company purchased and personal net worth can evaporate. This specific company risk factor becomes an important added element to CAPM in estimating the capitalization rate for the private business. The higher the risk, the higher the return. The higher the required return, the lower the value of the capitalized earnings stream of the business.

Assumptions of Efficient Market and Widely Available Information. Further, CAPM assumes that the market is “efficient” and that the flow of information, widespread analysis, and other factors eliminate the ability to find inefficiently priced securities. That is, the market equalizes the playing field and makes it difficult or impossible to find stocks with an intrinsic value above the market price, a scenario which could create a profit opportunity.

Informational Limitations for Private Companies. And what about this notion of market efficiency? Private companies do not have hoards of stock analysts producing detailed reports on the company, its industry, and various factors that impact the outlook for the shares in the future. Often the private company operates in a small industry niche not directly served by larger companies. As there may be little or no published research about this industry niche, the buyer (or the business appraiser) must make an assessment based on limited data.

And what about financial statements? The public company files audited financials, 10-Ks, 10-Qs, and all

sorts of disclosures with the Securities & Exchange Commission, often with the imprimatur of a big-6 CPA firm. The private company often has unaudited financials with poor reliability of data and may lack many of the internal reporting and control mechanisms to provide detailed management information to manage and assess the business. Thus the idea of stock market efficiency may be irrelevant in valuing the closely-held business and place great importance on the skills and abilities of the business appraiser to know the right questions to ask and to accurately judge the business and its risks.

Conclusion. Valuation of the private business requires a business appraiser who is astute at recognizing and accurately quantifying risk from sources that may not be present in similar public companies, even companies of the same size. While public companies can and should be used where appropriate as comparables, important risk differentials need to be reflected in the multiples and capitalization rates that are ultimately used to value the private company.

The astute business appraiser must be able to both see the big picture as well as identify the many risks and opportunities facing a private company. The charts, graphs, and detailed management discussions found in the public company annual report are simply not present when valuing the private business. This places a supreme importance on the skills, abilities and resourcefulness of the business appraiser to know how and what to ask. Finally, the final valuation report must clearly and effectively articulate these factors in a sound, unbiased, and convincing manner for the Internal Revenue Service and others who will critique it. ♦

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