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FAIR VALUE™

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Proposed IRS Valuation Guidelines: 1 + 1 = 3 (Which May Be Right)

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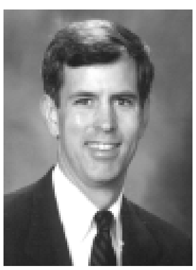
Introduction. In an effort to ensure a minimum level of quality in business valuations, on May 1, 2001 the IRS published new proposed valuation standards entitled *Business Valuation Guidelines.* The new proposed IRS Valuation Standards can be found at Banister's web site at: www.businessvalue.com. While still only in proposed form, the *Guidelines* suggest that appraisals submitted for gift, estate or other tax purposes should comply with these standards to reduce the risk of challenge. The *Guidelines* are largely bare bones in nature and are in many ways too weak to guarantee that a client receives a quality valuation product. The *Uniform Standards of Professional Appraisal Practice (USPAP)* and the *American Society of Appraisers Business Valuation Standards*, both followed by Banister Financial, Inc., are much more rigorous. Both USPAP and the ASA Standards incorporate many of the same issues found in the proposed *Guidelines*, however, *USPAP* and the *ASA Standards* go much further.



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Important New Wrinkles with Major Implications. Nonetheless, the IRS *Guidelines* include some new wrinkles, which, although subtle, could have enormous potential valuation implications. This article will deal with the most important one, the concept of synergistic or strategic value. An understanding of synergistic or strategic value is critical to understanding whether the fair market value in a company appraisal arrives at the right value, or if it is substantially under or over-valued. It is dangerous to assume that the business appraiser has accurately dealt with this issue.

Strategic or Synergistic Value (or 1 + 1 = 3). In our opinion, the issue with the most significant implications to all tax-related valuations is the proposed IRS guideline dealing with strategic or synergistic elements of value. Tax practitioners need to pay close attention to and fully understand this guideline. Section 2.3.6.3 of the *Guidelines* state that the report should consider:

> "[o]ther levels of value considerations, such as the impact of strategic or synergistic contributions to value."

Fair market value is the standard of value that applies for tax purposes and represents what a hypothetical "willing buyer would pay a willing seller, neither operating under compulsion and with all knowledge of the relevant facts." Fair market value does not **normally** represent what a specific buyer would pay, a value that is referred to as "investment value." A specific buyer might pay more or less than the typical buyer (fair market value) buyer for any number of reasons. For example, a specific buyer might be another company in the same industry, who, by acquiring the subject company, can eliminate a competitor, reduce costs, gain market share, create greater economies of scale, and so on. Therefore, the value to that buyer might be substantially greater than to a buyer who would not realize such benefits from an acquisition. Thus, the synergistic or strategic value might be far higher than fair market value.

Is the IRS Right or Wrong? So is the IRS right here or is it simply trying to find a way to argue for higher values for estate or gift taxes? Banister Financial, Inc. cannot answer the second half of the question, but we can address the first. In truth, the IRS may be right, so tax practitioners beware. If an industry is consolidating, the predominant buyers are often purchasing companies for strategic or synergistic reasons, and there is active competition among the buyers to acquire the acquisition targets available. This buying activity may cause fair market value to rise to a level that is at or near strategic or synergistic value.

An Example of Why Fair Market Value May Equal Synergistic Value. Think about it this way. Suppose you own a company that is in a quiet industry where no consolidation is occurring. The most likely buyer will probably not purchase your company based on future synergies, but will buy solely based on the company as it is, with its existing income stream (another term for this kind of buyer is a "financial buyer"). Suppose your company's value under that scenario is $10 million. Now suppose industry consolidation begins to occur in earnest, with a number of larger companies buying smaller ones to become more dominant, eliminate costs, and so on. With acquirors vying to buy the available companies in the industry, this drives the price they are willing to pay for your company to $15 million, close or equal to the true investment value of your company to strategic buyers.

Under the standard of fair market value is the company still worth $10 million, assuming a hypothetical buyer? The answer is most likely no, because buyer activity has forced the fair market value to rise to close or to equal a synergistic or investment value ($15 million). Said another way, why would a willing seller sell for a financial buyer price ($10 million) when the predominant buyers (synergistic buyers) are paying $15 million? A more complicated question, however, is the valuation of a minority interest and whether or not the impact of synergistic buyers on the fair market value of a 100% controlling interest (the sale of the entire company) will trickle down and impact the value of the minority shares when those shares cannot force the sale of the company to realize a 100% control value. This issue will be dealt with later in this article.

The Existence of Synergistic Pressures on Fair Market Value. To address when or if synergistic or strategic value might come into play as an element of fair market value, one must look at the facts of each company valuation on a case by case basis. This involves an analysis of the most likely buyer and the dynamics of how buyer activity is influencing the prices paid for companies in the industry. Therefore, one must first understand more fully the concept of strategic and synergistic buyers, why they might pay more for a company, and how to identify when such buyers are a driving force in the prices paid.

Strategic/Synergistic Buyers Explained. Whether it is a competitor in the same industry, a related industry, or an unrelated industry, strategic buyers are typically corporate buyers who are interested in buying a company in a specific industry or a specific company itself for variety of possible reasons. Such reasons may include:

- Entrance into an industry where the acquiror has no presence but feels it must have one as part of its long-term strategy, or where the acquiror feels it is weak or disadvantaged compared to the competition.
- To round out an array of products or services for an existing customer base.
- To increase market share within an existing industry, whether by growing its product line, extending geographical coverage, or eliminating a competitor.
- To diversify into other more promising industries when increased competition in an existing industry has led to pressure on profits.
- To gain access to proprietary technology, intellectual capital, specialized expertise, etc., that is otherwise difficult or impossible to obtain, and which will enable the acquiror to leverage those assets within its existing business.
- The ability to realize "synergy" from the purchase. Probably the most often-used word when talking about mergers and acquisitions is *synergy*. The concept of synergy is simply that the sum of Company A's value and Company B's equals C, which is greater than the individual values of A and B. That is, 1+1 = 3. The two companies combined are worth more together than the two are separately. The term synergy is most often used when describing fragmented and inefficient industries, where the potential exists to consolidate the industry into a few larger players who are able to eliminate duplicate costs (overlapping salesforce and distribution infrastructures, etc.), realize savings

in negotiating volume purchases from suppliers, and other benefits. Fragmented industries, those with numerous publicly held companies and thousands of smaller, privately held competitors, are believed by some to operate less efficiently than concentrated industries.

Determining if the company being valued fits the characteristics sought by synergistic or strategically-motivated buyers is essential, since this type of buyer will often pay a premium price far above that paid by a financial buyer. Financial buyers are typically individuals, investor groups, venture capital funds and other companies who are making acquisitions principally for the earnings or cash flow they will receive as a source of return on their investment from the acquired company. Therefore, the strategic buyer is the usually the ideal purchase candidate.

Valuator Must Determine the Importance of Synergistic Buyers. Determining if the conditions exist for the presence of strategic buyers and the identification of such buyers is typically uncovered as a part of the valuation process, since a properly prepared professional valuation examines internal and external aspects of the company and the acquisition environment. However, not every business appraiser is up to this challenge. Regretfully, some valuators churn out valuations as if all companies were alike, failing to delve into the company and industry in detail, and foregoing a detailed acquisition search of comparable sales. Instead, these "appraisals" usually rely on often-erroneous formulaic valuation approaches with only a superficial study of the company and those factors that make the company unique. Furthermore, many valuators have no acquisition or transaction experience whatsoever, and rely solely on textbook theory and accounting training.

"Consolidators" and Their Impact on the Company Sale. Many industries in the United States are highly fragmented, being made up of hundreds or thousands of small and mid-sized companies, each generally operating on a local or regional basis, with no one dominant company. While many industries are subject to consolidation through acquisitions, in recent years the highly fragmented industry has been the focus of a new breed of acquiror, the publicly traded industry consolidator. These consolidators emerged in the mid and late 1990s as a major force in driving the prices paid for small and mid-sized private companies to new heights. Many of these prices were out of context with all historical norms and were fueled in large part by a favorable stock market that was receptive to the consolidator's "story." While the current stock market downturn makes this type of buyer presently less active, valuators must still be attuned to those situations where consolidators are still active.

Consolidators Explained. Consolidators seek to purchase competitors in fragmented industries for a variety of reasons, including: cost reduction by removing owner perquisites (e.g., owner compensation and benefits at levels higher than a professional management team), elimination of duplicate distribution channels and sales forces, the increase of profit margins by using increased volume to squeeze concessions out of suppliers, and the purchase of access to new markets and new products. Also, consolidators believe they bring professional management skill to the table that is not possessed by the typical small, closely held business owner. Finally, consolidators may believe an industry needs an entirely new business model that stands to transform and reshape the landscape of how business is done.

Typically, an industry consolidator is a young publicly traded company or a company who is seeking to gain enough critical mass through acquisitions to go public. Using its story of efficiencies and increased earnings through market share, the consolidator aims to gain funds from an initial public offering of its common stock to fuel rapid growth through continued acquisitions. Once this kind of acquiror has gone public, it is under great pressure to maintain a rapid rate of growth. Otherwise, the consolidator runs the risk that its stock price will collapse. Therefore, the consolidator is usually a highly motivated buyer and is often willing to pay a premium price for privately held companies in the industry it is consolidating.

Consolidator Implications for Value. Because many consolidators can often only sustain their acquisition binge through a high share price, their shelf life as prospective acquirors is typically short (perhaps only two to three years). This has important implications to the valuation to determine if the company being valued is in this type of consolidating industry. First, it is important to identify if consolidators are present or are emerging in the industry of the company being valued. Second, the consolidator's lifespan is often short and the consolidator's ability to sustain its acquisition binge often runs its course as its source of funding dries up. Once this has occurred, the prospects for this type of buyer vanish and the multiples paid in the highly fragmented industry may revert to historical norms. In an industry dominated by local or regional companies, this often means going back to financial buyers, individuals, investor groups, or competitors as the primary sources of liquidity for the closely held business owner. Also, since comparable sales data is always based on historical transactions seen in the "rear view mirror," be sure your business appraiser isn't applying comparable sales multiples that reflect consolidator activity when it is no longer present as this may lead to an overvaluation. Also, if historic multiples are no longer applicable it is important that the valuation carefully explain why this is the case to avoid claims by the Service that the valuation purposefully ignored comparable sales data to arrive at a lower value. Making such an argument after an IRS challenge, even though it may be completely valid and unbiased, will be met with great suspicion.

Examples of Industries Where Consolidators Have Recently Been Active. The list of industries where consolidators have been active is enormous, so it is not possible to list every one. **Table A** shows a representative list of a few of the many diverse industries that we have seen at Banister Financial, Inc. as being reshaped by mergers and acquisitions and the impact of consolidators.

Valuation Impact on Minority Interests.

Table A
A Few (of Many) Examples of Consolidating Industries in the Late 1990s and Early 2000s

Convenience store chains	Heating / AC Contractors	Commercial printers
Printing supply wholesalers	Industrial supply wholesalers	Floral supply distributors
Fuel oil distributors	Automobile dealerships	Scrap metal dealers
Chemical wholesalers	Local telephone companies	Cellular phone operations
Banking	IT consulting firms	General / specialty contractors
Equipment rentals	Video retailing	Public accounting
Primary care medical practices	Beer distributors	Soft drink bottling companies
Food manufacturing	Temporary staffing firms	Trucking
Seafood wholesalers	Food wholesalers	Textile yarn producers
Freight forwarders	Water utilities	Propane gas dealers
Home insulation contractors	Electrical wholesalers	Funeral homes

Going back to our earlier example, the strategic value and the fair market value of the entire company (a 100% controlling interest) in a consolidating industry became the same value, $15 million, versus a $10 million fair market value when such strategic elements were not present. Will either of these values fully or partly impact the value of a small minority interest in the company, particularly when that interest cannot unilaterally force the company to be sold to realize upon either value? The answer will usually depend in significant part on the specific facts present. For example, the following factors may help answer this question:

- **Plans of the Majority-** Are the majority of the shareholders interested in placing the company on the market for sale? If so, this increases the probability that a sale of the company might occur. This can cause the minority value, even if discounted for minority interest status and lack of marketability, to take the potential acquisition value somewhat into account. It is unreasonable to assume that a minority interest holder would sell his or her shares at a price which totally ignores the prospects of a potentially imminent synergistic sale of the company. Such a seller would have the option of holding on to the shares to possibly realize the control level price windfall. However, because a sale is not assured and may not occur, it is also reasonable to expect that the minority value will only rise part of the way towards its pro rata share of that control value.
- **History of the Company-** The history of a company might affect the way a prospective buyer of a minority interest (and a seller of that same interest) might view the potential for realizing a near or intermediate term pro rata share of that control value. Suppose a company has been in one family's hands for 100 years, and a third generation of management is now coming into the business to manage it and carry on the family tradition. This might suggest that a buyer of a minority interest might not reasonably consider much, if any, impact on value of a future control or synergistic sale since the odds of such a sale appear to be very long.

Obviously, the above issues are not always easily answered. Furthermore, these issues may interact with the rights of the interest being valued, the distribution of ownership, and consolidation conditions in an industry, to name a few factors. On the latter issue, the majority may steadfastly maintain that a company is not for sale. However, if a large number of a company's competitors have been acquired, control or synergistic value might still impact how buyers and sellers of a minority interest view value, although this will be an element among many that needs to be considered.

Example of Minority Value Impact- A Coca Cola Bottler. As an example, in the second half of the 1980s, Banister Financial valued a minority interest in a Coca Cola bottler for the Government in an estate tax valuation case. As a part of Banister's research, we found that during the first half of the 1980s alone, more than 50% of the independent bottlers in the nation had been acquired. Most acquisitions were at very substantial, strategically motivated prices paid by several large, dominant bottlers. These prices were far above those prices that would normally be offered by financial buyers. Additionally, it was clear from the research that this trend of consolidation was reasonably expected to continue. In this instance, and in light of other facts, Banister concluded that a buyer and seller of a minority interest would reasonably factor this prospect into the value, even if not fully to a control level. The difference in the value in this instance for the minority interest was several times higher than what might normally be implied in the absence of these conditions. Thus, the impact can be enormous.

An Example of How Control Value Might Not Impact Minority Value- The *Barnes* Case. These were precisely the same issues in a gift tax case in U.S. Tax Court (*Louise B. Barnes, Donor, et al, v. Commissioner, TC Memo. 1998-413*) in which Banister Financial appeared on behalf of the petitioners to testify as to the value of minority interests in two privately owned local telephone companies. Banister Financial was hired after a challenge by the Government of an earlier gift return based on a valuation prepared at that time by another valuation firm.

In valuing the two private companies, ten local or regional publicly traded companies in the same industry were compared to the two private companies. From those public companies, multiples for price to latest year earnings, price to 3-year average earnings, price to latest year gross cash-flow, price to 3-year average gross cash-flow, dividend yield or capitalization of latest year's dividends, and dividend yield on capitalization for 3-year average dividends were derived. Dividends paid by the private companies were compared to those paid by the guideline companies, excluding special nonrecurring dividends.

In reaching a conclusion of value, the most weight was given to actual dividends rather than to price to earnings and price to gross cash-flow ratios because the private companies had significantly lower dividend payout ratios than the guideline companies. The dividend payout rates (dividends as a percentage of annual earnings) of the two private companies ranged from 13% to 25%, which were considerably less than that of other guideline companies, whose dividend payout rates ranged from 28% to 85%. Six of the ten guideline companies paid dividends totaling more than 50% of their net income. Banister Financial testified that a public company that has a much greater dividend payout than the private companies at issue will also have a higher stock price. In other words, an investor looking to buy a stock of a company in the industry has two choices. He can buy the private company's shares which pay out 12% to 25% of annual earnings in dividends. Alternatively, he could buy an essentially identical public company stock which pays out 50% of annual earnings in dividends. Would the investor be willing to pay the same price per share for the private company, yet realize less than one-fourth the level of dividends? Probably not, unless there were other compelling reasons, such as the imminent sale of the private companies (there were not, see discussion below). As a result, Banister Financial placed virtually all of the weight on the findings of the dividend yield approach, which resulted in a far lower value per share than would have been found based on the use of the price to earnings and price to cash flow measures.

The Tax Court Found This Was Proper Methodology. The Court agreed with Banister Financial's methodology, finding in its opinion:

> "A prospective minority shareholder … would almost exclusively consider dividend yield rather than discounted cash-flow or income capitalization to estimate the value of stock in either of these companies because of the likelihood that he or she could only recoup his or her investment through dividends. [Banister Financial] properly considered dividends to be the most significant factor because they are the principal means by which a prospective shareholder could obtain a return on his or her investment."

A 45% Discount for Lack of Marketability. In deciding the appropriate discount for lack of marketability, Banister Financial considered the crucial impacts of the limited avenues available to the minority shareholder to exit the investment in the private company shares. Banister Financial concluded, and the Tax Court agreed, that an above-average 45% discount for lack of marketability was appropriate because:

(a) the companies had been controlled by the same family for almost a century;
(b) the family intended to keep control of the companies in the future;
(c) the families had taken steps such as

implementing a voting trust, bringing the younger generations into the business, and buying insurance to avoid having to sell shares to pay death taxes;

(d) both private companies paid much lower dividends than the guideline companies;

(e) there have been no sales of one of the private company's shares and only limited family and insider sales of the other company's shares;

(f) the shares of both companies were not registered or traded on any exchange or over the counter; and,

(g) the shares being valued represented very small minority interests that had no ability to direct the affairs of either company or cause the sale of its assets.

In this instance, the specific facts (and particularly the company history) suggested that the minority shares were worth little more than the capitalized value of any dividends received. This was true despite much higher public company multiples, acquisitions occurring in the industry, and so on. Additionally, these same facts had an impact on the level of the discount for lack of marketability applicable.

Conclusion. The proposed IRS *Guidelines* should be fully read and understood by tax practitioners to be sure that business valuations prepared for clients meet IRS expectations. The estate or gift planning attorney cannot simply assume or rely on the business appraiser to determine if this is the case. Business valuation is an easy entry field, full of many inexperienced practitioners who know little about business valuation in general and even less about meeting current minimum standards. Additionally, the *Guidelines* suggest a new wrinkle concerning strategic or synergistic value that may, in some circumstances, have a substantial impact on value. The IRS is correct that in some instances this factor may influence fair market value and perhaps even the value of minority interests. Attorneys who deal with valuation issues (including those not only in tax specialties, but also family law, business law and employee benefits) and their clients should be carefully attuned to when and how strategic and synergistic value considerations might impact fair market value. Even if these factors do not have an upward impact on fair market value, it is important for the business valuation to combat potential challenges by detailing why such synergistic attributes do not apply to the case at hand. ♦

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