BUILDING VALUE

A Business Valuation Newsletter for Business Owners and the Professionals Who Advise Them

The Guideline Company Transaction Method: What Does The Information Really Mean?

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"The question is," said Alice, "whether you can make words mean so many different things."

"The question is," said Humpty Dumpty, "which is to be master – that's all."

- Lewis Carroll: Through the Looking-Glass

INTRODUCTION

The exchange between Alice and Humpty Dumpty regarding the meaning of the words in Lewis Carroll's *Through the Looking Glass* provides a useful lesson to appraisers considering the use of the market approach and more specifically, the guideline company transaction method. Such transaction multiples may be meaningful for purposes of valuing the subject company; however, the appraiser must fully understand what information is or is not reflected in the multiples in order to assess whether or not these multiples are meaningful. The following example illustrates this issue.

ILLUSTRATIVE EXAMPLE

Our firm recently represented a closely held firm in an assignment to determine the value of a departing shareholder's interest and to also review the valuation performed by another firm (an investment banking firm specializing in mergers and acquisitions in the relevant industry) that represented the departing shareholder. After receiving the investment banker's report, we noted that (surprise!) the value was substantially higher than the value we had determined. After a quick perusal of their report, we determined that the investment banker had solely relied upon the guideline company transaction method for his valuation methodology. Upon further review, we made some interesting observations relating to the transactions selected as comparables for purposes of computing the multiple:

- There was no information provided, other than assets, to: 1) indicate whether or not the investment banker assessed the comparability of the business services and other qualitative characteristics or the financial data for the acquired companies to the subject company or, 2) permit another appraiser to perform his own assessment of the comparability.

- The transactions occurred over a period of years, and there was no information provided to indicate whether or not the investment banker assessed the market and economic conditions during the time period in which the transactions occurred to determine if those conditions were comparable to those as of the valuation date.

- There was no information provided to indicate the level of value (e.g., fair market value, investment value, etc.) represented by the transaction prices.

- There was no information provided to indicate the motivations or perspectives of either the buyers or sellers.

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FEATURED CASE

ESTATE OF GALLAGHER V. COMMISSIONER

CITATION

ESTATE OF LOUISE PAXTON GALLAGHER, DECEASED, F. GORDON SPOOR, PERSONAL REPRESENTATIVE, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent Docket No. 16853-08, T.C. Memo 2011-148, Filed June 28, 2011, Judge: James Halpern

OVERVIEW

Once again, the Tax Court was faced with having to decide between tax affecting income and not doing so for a pass-through tax entity. Although the court's analysis resulted in a value much closer to the taxpayer's asserted value than the IRS's conclusion, tax affecting was rejected.

THE FACTS

Louise Paxton Gallagher ("Decedent") died July 5, 2004, owning a 15% member interest in Paxton Media Group, LLC ("PMG" or "Company"), a company that owned daily newspapers and other publications, plus a television station. PMG's members had executed an agreement to maintain its pass-through tax status. Further, there was no expectation that the pass-through status would be discontinued.

Decedent's Form 706 indicated that the fair market value of the subject ownership interest was $34,936,000 based on an appraisal prepared by the Company's CEO.

However, the IRS asserted the value was $49,500,000.

In response, the estate hired an independent appraisal firm which appraised the value at $26,606,940. Prior to trial, the taxpayer hired a second appraiser who valued the Decedent's interest at $28,200,000.

Also prior to trial, the IRS hired an appraiser who concluded the value should be $40,863,000.

The taxpayer's second expert (hereafter, "taxpayer's expert") used Company financial data for the period ending May 30, 2004 (approximately five weeks prior to the date of death), asserting that Company's June 30, 2004 financial statements (dated approximately one week prior to the date of death) would not have been available to an investor on the July 5, 2004, valuation date. For similar reasons, the expert's market approach relied on first quarter (as opposed to second quarter) SEC financial statements of guideline public companies.

In contrast, the IRS expert used Company financial data as of the month ending prior to the valuation date, plus guideline public company data as of the end of the second calendar quarter.

The court accepted the IRS expert's second quarter public company data and the Company's June 30, 2004, financials, thereby rejecting the estate's argument that such information would not have been available to an investor.

Both parties' experts considered the income and market approaches to value the subject ownership interest.

The IRS expert identified 13 potential stocks for his market approach but narrowed the list to four.

In contrast, taxpayer's expert asserted that reliance on the market approach was improper "because no companies sufficiently similar to PMG exist to support the method's application." [quotation from the court's ruling presumably is not a direct quote of the expert's testimony]

The court criticized the IRS expert's choice of guideline public companies because PMG's size, product mix, growth (based on EBITDA and revenue), and leverage differed. Interestingly and with regard to product mix specifically, the court observed that PMG did not have Internet-based distribution channels, while all of the IRS expert's guideline stocks did. Ultimately, the court rejected the IRS expert's guideline public company method.

Turning to the experts' use of the income approach, the IRS expert relied upon EBITDA projections as his measure of economic income, and used June 27, 2004, as period zero of his present value analysis.

However, the estate's expert used "free cash flow" (net cash flow to invested capital) and May 30, 2004, as period zero of his discounted cash flow analysis. Recalling the above discussion, the expert believed the date of the Company's most recent financial information should be the basis for the analysis.

Next, the court considered the reliability of the experts' income projections. Having considered the experts' reasoning, the IRS expert's measure of economic income was accepted, but adjusted by the taxpayer-expert's depreciation expense because the IRS expert's "operating margin" did not include depreciation.

Having determined cash flow, the court turned to the controversial issue of tax affecting the Company's income. Taxpayer's expert tax affected his cash flow, while the IRS expert did not. Citing *Gross v. Commissioner,* T.C. Memo. 1999-254 as well as the taxpayer's failure to discuss and justify tax affecting income, the court rejected the adjustment to income, saying, "we will not impose an unjustified fictitious corporate tax rate burden on PMG's future earnings." In a footnote, the court

further noted that the taxpayer's income tax rates (both personal and corporate) did not match the valuation date statutory marginal rates.

Needing to determine an equity discount rate (one of two components of the weighted average cost of capital, "WACC", discount rate), the court considered the taxpayer-expert's use of the capital asset pricing model ("CAPM") versus the IRS expert's use of the build-up method. The latter method was considered more appropriate, saying, "The special characteristics associated generally with closely held corporate stock make CAPM an inappropriate formula to use in this case." Having considered the facts, an equity discount rate of 18 percent was selected.

Even though the court rejected both experts' analysis with regard to the second component of the WACC discount rate, it accepted the IRS expert's conclusion because it "cannot be objectionable to petitioner, since [IRS expert's] proposed higher cost of debt results in a lower present value of expected cashflow." [insertion substituted for IRS expert's name]

To determine the WACC, appropriate weights must be assigned to the cost of equity and debt capital. Recalling the guideline public companies considered earlier in the market approach, the estate's expert used their capital structures to determine the WACC components' weights.

In contrast, the IRS expert proposed using the Company's book-basis capital structure.

Based upon the estate's objection to the IRS expert's reliance on book values, the court acknowledged the weights should be based upon market (not book) value. Yet, citing the taxpayer's objection to using the earlier cited guideline public companies in the market approach, the court rejected the estate's reliance upon them in the income approach for this specific characteristic. Accordingly, the book-basis weights were used by the court in its analysis.

After discounting the above determined cash flows using the WACC, analysts must reduce the conclusion by the Company's valuation debt long-term debt. Because the experts relied on different financial statements for their analyses (recall that the taxpayer expert's financial statements were dated approximately one month earlier than the IRS expert's statements), the court was forced to choose between debt principal balances that differed by approximately $300,000. For the reasons cited earlier, the June 27, 2004, debt levels were used in the court's analysis.

Having determined a value, the taxpayer's expert reduced it by his estimate of a working capital deficit relative to the working capital levels of the guideline public companies identified in the market approach. Again, the court rejected the expert's analysis, citing the inconsistency associated with rejecting the guideline companies in the market approach but relying upon them in this part of his analysis.

To reflect the Company's pass-through tax status, the estate then argued that the concluded value should be adjusted as follows:

1. Add dividend tax savings (relative to the concluded C corporation value) for all income distributions in excess of the companies income tax distributions,
2. Add a significant sum "to reflect the future value of the company's deductible goodwill, discounted back to the valuation date,"
3. Add an amount "to account for the company's extra marginal debt tax shield."

Importantly, the estate maintained the preceding adjustments were proper under *Gross v. Commissioner*, cited above. Asserting that the taxpayer had misinterpreted *Gross*, the court rejected the estate's position.

Because the IRS expert's cash flows were presented on a control level basis, the court concluded that application of minority interest discount was appropriate. The IRS expert provided an extensive review of contemporaneous control premium studies (which can be used to determine minority interest discounts). While the court considered the expert's information, it disagreed with the proposed 17 percent discount. Relying on the same data, the court selected a minority discount of 23 percent.

In addition to a minority interest discount, a discount for lack of marketability ("DLOM") needed to be identified. Citing seven restricted stock studies having an average discount of 32 percent, the IRS expert selected a 31 percent DLOM.

In contrast, the taxpayer's expert selected a 30 percent discount based on 11 restricted stock studies plus four studies that that impute DLOMs from pre-IPO stock transactions.

Citing *Furman v. Commissioner*, T.C. Memo. 1998-157, the court stated that it has "previously disregarded experts' conclusions as to marketability discounts for stock with holding periods of more than 2 years when based on the above-referenced studies." Yet, because both experts relied on the same studies, the court accepted the IRS expert's 31 percent DLOM.

CONCLUSION

Having considered the facts and performed its own analyses, the court rejected the estate's various appraisal conclusions of $34,936,000, $26,606,940 and $28,200,000, as well as the IRS values of $49,500,000 and $40,863,000. Instead, the court concluded that the estate's interest should be valued at $32,601,640.

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- There was no information provided regarding what was acquired by the purchaser (e.g., assets or stock).

- No information was presented regarding the transaction terms (e.g., cash only, restricted stock, seller financing, employment contracts at below market compensation, earn-out provisions, non-compete agreements, etc.)

- There was no indication that the investment banker made any adjustments to the "raw" transaction multiples to reflect differences between the characteristics of the acquired firms and the subject company.

In other words, with the exception of the transaction multiples, there was virtually no other information presented for the acquisitions.

GUIDANCE PROVIDED BY PROFESSIONAL STANDARDS

The business valuation standards of the professional appraisal organizations provide useful guidance to their members in applying the market approach and the guideline company transaction method.[1] For example, the American Institute of Certified Public Accountants' (AICPA) *Statement on Standards for Valuation Services No. 1* (SSVS) provides the following guidance to CPAs who are members of the AICPA for using the market approach and the guideline company transaction method:

37. In applying the methods listed in paragraph 36 or other methods to determine valuation pricing multiples or metrics, the valuation analyst should consider:

    - Qualitative and quantitative comparisons
    - Arm's length transactions and prices
    - The dates and, consequently, the relevance of the market data

38. The valuation analyst should set forth in the report the rationale and support for the valuation methods used[2] . . .

Similarly, the American Society of Appraisers Business Valuation Standards require that an appraiser who is a member consider the following:

III. Reasonable basis for comparison

A. The business, business ownership interest, security or intangible asset used for comparison must serve as a reasonable basis for comparison to the subject.

B. Factors to be considered in judging whether a reasonable basis for comparison exists include:

1. *A sufficient similarity of qualitative and quantitative investment characteristics.*
2. *The amount and verifiability of data known about the similar investment.*
3. *Whether or not the price of the similar investment was obtained in an arm's length transaction, or a forced or distressed sale.*[3]

APPLICATION IN PRACTICE

In order to determine if the transaction multiples are relevant for purposes of estimating the value of the subject company, sufficient qualitative and quantitative data for the acquired company must be obtained and analyzed by the appraiser for purposes of assessing the comparability of the acquired and subject companies. Moreover, this data should be disclosed in the appraisal report for purposes of permitting the reader to replicate the analysis. Finally, the source of the data should be disclosed to enable the reader to assess the credibility of the information or to obtain additional information, if additional analysis is required. To the extent that these requirements cannot be satisfied, then the appraiser must give careful consideration to the weight, if any, to be given the value derived using this method.

Unfortunately, while these standards apply to those of us who are professional appraisers and members of these organizations, other firms that provide valuation services but are not members (e.g., the investment bankers I encountered in the aforementioned case) are not subject to these same standards. In most instances, it should be readily apparent that a valuation performed by an appraiser who complies with such standards is more credible. Unfortunately, in a situation such as that described here, a valuation that does not comply may result in an inequitable outcome.

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[1] With respect to valuations for tax purposes, Rev. Rul. 59-60 does not specifically address the use of the guideline company transaction method in valuing closely held companies as this data has only become publicly available in recent years. However, the guidelines relating to comparability of the business lines and consideration of other relevant factors presented in Rev. Rul. 59-60 for the application of the guideline public company method are also applicable to the guideline company transaction method.

[2] American Institute of Certified Public Accountants' *Statement on Standards for Valuation Services No. 1* (New York, NY: American Institute of Certified Public Accountants, 2007), 19.

[3] American Society of Appraisers Business Valuation Standards, BVS-V Market Approach to Business Valuation (Washington, D.C.: American Society of Appraisers, 2005) p. 12.

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