BUSINESS VALUATION REVIEW

CAVEATS IN USING GUIDELINE COMPANY TRANSACTIONAL DATA IN VALUING A BUSINESS

by

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Included in the Market Approach to business valuation are the Guideline Public Company Method and the Merger and Acquisition Method. Both methods involve the development by the business appraiser of valuation ratios[1] derived from transactional pricing information that is related to the appropriate underlying financial data of guideline companies, and then applied by the appraiser to the corresponding data of the subject company to arrive at an indication of value. The analysis involves the comparison of the respective qualitative and quantitative factors relating to the company being valued to those of the guideline companies, including, if appropriate, dissimilarities with respect to minority, control, and marketability. The calculation and use of these valuation ratios, or pricing multiples, are intended to provide meaningful insight as to the value of the business being appraised, considering all relevant factors.

In brief, care is exercised with respect to:

- The selection of the underlying data used to compute the valuation ratios;
- The selection of the time periods and/or the averaging methods used for the underlying data;
- The computation of the valuation ratios;

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(1) Fractions in which values or prices serve as the numerator and financial, operating, or physical data serve as the denominator.

- The timing of the price data used in the valuation ratios; and
- How the valuation ratio(s) was/were selected and applied to the subject's underlying data.[2]

Comparisons are generally made by using comparable definitions[3] of the components of the valuation ratios. However, where appropriate, valuation ratios based on components that are reasonably representative of ongoing results may be used.[4] The valuation analysis must distinguish between invested capital and equity.

ASA's Statement on Business Valuation Standards (SBVS-1), "The Guideline Company Valuation Method", currently provides as follows:[5]

> **"VI. Valuation ratios derived from guideline companies**
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> "A. Price information of the guideline companies must be related to the appropriate underlying financial data of each guideline company in order to compute appropriate valuation ratios.
>
> "B. The valuation ratios for the guideline companies and the comparative analysis of qualitative and quantitative factors should be used together to determine appropriate valuation ratios to be applied to the subject company.
>
> "C. Several valuation ratios may be selected for application to the subject company, and several value indications may be obtained. The appraiser should consider the relative importance accorded to each of the value indications used in arriving at the opinion or conclusion of value.
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> "D. To the extent that adjustments for dissimilarities with respect to minority and control, or marketability, have not been made earlier, appropriate adjustments for these factors must be made, if applicable."

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(2) Business Valuation Standard BVS-V, "Market Approach to Business Valuation", American Society of Appraisers.

(3) For example, comments of Dr. Shannon P. Pratt concerning "discretionary earnings", *infra*., footnote 6, *op. cit.*, page 7.1

(4) *Supra*, footnote 2.

(5) This Statement is being currently reviewed by the BV Standards Subcommittee and is expected to be replaced by two separate Statements: The Guideline Public Company Method and The Merger and Acquisition Method.

In his article, "How to Use Transactional Databases for M&A",[6] Dr. Shannon P. Pratt (who produces the widely-used *Pratt's Stats*™ transactional database[7]) provides excellent insight on the use of these databases[8] for pricing and valuation, including a detailed checklist and several instructive exhibits. A business valuator who uses a transactional database should be thoroughly familiar with the basic fundamentals, which Dr. Pratt explains in his article.

The BV Standards of ASA define "guideline companies" as companies that provide a reasonable basis for comparison to the investment characteristics of the company being valued.[9] Ideal guideline companies are in the same industry as the subject company. However, if there is insufficient transactional evidence available in that industry, the valuator might select companies in other industries having an underlying similarity to the subject company in terms of relevant investment characteristics such as markets, products, growth, cyclical variability, and other salient factors. While guideline-company empirical data can typically be found in transactions involving controlling or minority interests in publicly-traded or closely-held companies, this article focuses on the use and interpretation of data that the business appraiser would glean from a transactional database.

As market transaction values and ratios developed from them are intended to provide meaningful insight in valuing a business interest, there must be sufficient similarity of qualitative and quantitative investment characteristics; even if such similarity does exist, appropriate adjustments may still be required to place the subject's relevant financial data on a basis consistent with those of the transacted business.

Clearly, in the event that there is insufficient information as to the specifics of the selected market transactions, and the rationale behind the consideration paid by the purchaser, the use by the business appraiser of publicly-available transactional data in valuing a business can lead to a virtually meaningless procedure.

In an ideal situation, background transactional details can be obtained from first-hand knowledge of financial and other data specific to the transaction (perhaps, the business valuator happened to have worked on a particular guideline-company transaction and therefore had in-depth knowledge of the background specifics concerning, among other things, (a) the acquiree, (b) the

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(6) S.P. Pratt, "How to Use Transactional Databases for M&A", *The Journal of Corporate Accounting & Finance*, Vol. 13, No. 3, Wiley Periodicals, Inc., March/April 2002, pp. 71-80.

(7) A private transactional database of over 4,000 completed sales under $500 million, with eight valuation multiples computed for each, containing guideline company, guideline transaction, comparable sales, business comparable and/or market data, which reports information compiled on approximately 70 datapoints highlighting the financial and transactional details of the sales of closely-held companies.

(8) Other databases include *BIZCOMPS*®, which also compiles transactional and financial data on sales of closely-held businesses.

(9) *Supra*, footnote 2.

purchaser, (c) the value of the consideration paid, and (d) the other substantive terms of the deal. With respect to (c), there may have existed a detailed quantification of the purchaser-perceived post-acquisition synergies and/or strategic advantages when establishing the price for the target. In most cases, however, the business appraiser will not have benefited from direct, hands-on experience (either as a valuator, analyst, advisor, or negotiator) and therefore would seek pricing, financial, and other relevant data from valuation databases that provide reported guideline company information.

Even though there may be many datapoints provided in a database, unless otherwise evident from the information provided, it would be naïve for the business appraiser to simply rely on such data in developing valuation multiples (such as Price/Revenues, Price/Cash Flow, Price/Earnings, Invested Capital/Sales, Market Capitalization/EBITDA) without first seeking answers to the following types of critical questions (as may be appropriate in the circumstances) *vis-à-vis* each of the guideline company transactions, to the extent such information has not been provided:

- Do the data derived from the guideline companies relate to a transaction involving the *shares* of the businesses or the underlying *operating assets*?
- Do the data relate to total invested capital or to equity?
- Were there redundant or excess assets? If so, were they included in the deal?
- How similar are the respective characteristics of each guideline company and the subject in terms of, for example:
  - Size?
  - Diversification of markets and products/services?
  - Geographic location?
  - Demographics?
  - Political environment?
  - Market share?
  - Customer base?
  - Employee, customer, supplier and bank relationships?
  - Technological development?
  - Intellectual property protection?
  - Growth trends in revenues and profits?

  - Capital structure, leverage and liquidity?
  - Tangible asset backing?
  - Regulatory compliance?
  - Profit margins?
  - Return on tangible on capital employed?
  - Maturity of the business?
  - Off-balance sheet assets and liabilities?
  - Depth and continuity of management?

- To what extent do the Notes to the respective financial statements of the guideline companies affect the interpretation of the balance sheet and income statement?

- Does the business appraiser know the contents and impact of the Notes? Were there contingent assets or liabilities? How were they dealt with? As an integral part of the financials, they can have a material impact on the valuator's analysis.

- How long had each guideline company been in business?

- Were any of the respective acquirees "compelled" to transact? Was there "compulsion" on the part of any of the respective purchasers? Were any of the transactions negotiated under distress conditions?

- Did any of the transactions include payment in respect of a consulting agreement and/or a non-compete agreement with the vendor?

- Were there any earn-out provisions; if so, what were their terms?

- Were any of the acquirees heavily dependent on only a few customers and/or suppliers?

- Were any of the guideline companies operated by a key person on whose services the business was highly dependent?

- What was the timing of the data used for purposes of developing the respective valuation ratios with respect to the selected transactions?

- How long had each acquiree been exposed for sale in the marketplace?

- Were any of the transacted businesses acquired by a "special purchaser", i.e., a purchaser who, for one or more reasons, such as perceived post-acquisition synergies and/or strategic advantages, was willing to pay a higher price for the acquiree than other (ordinary) purchasers? If so, does the business appraiser have insight into what portion of the negotiated purchase price may have represented a premium for anticipated synergies and/or strategic advantages?

- Were there any material customer, supplier, labor and other contracts that may have been under negotiation by a guideline company, which could have impacted the transaction price?

- Were there new products ready to be launched by any of the guideline-company acquirees, which might otherwise render some of the financial data “irrelevant”?

- For high-tech businesses, pharmaceutical firms and other firms owning intellectual property, how much had the respective acquirees been spending, and planning to spend, on research and development?

- Was the guideline company share transaction in respect of 100% of the shares, 66-2/3% of the shares, 50% plus 1 or some other *de jure* control position?

- Was the transaction internally financed or externally financed?

- Was the transaction at arm’s length?

- What portion of the price related to the purchaser’s ability to lever the acquired assets?

- Was the price paid for the acquiree effectively adjusted with respect to the interest rate on the acquiree’s debt?

- Was the price effectively adjusted in respect of the *terms* of the deal?

- Was the guideline company unionized?

- Was any portion of the transaction price not reflected in the publicly-disclosed data?

- Do the published transactional data provided by a database (as opposed to a Form 10-K or a financial statement) indicate whether an acquiree was reporting its inventory for accounting purposes on a First In-First Out (FIFO) or a Last In-First Out (LIFO) costing method? How would the valuation ratio change using one inventory costing method as opposed to the other? What about other accounting policies possibly having a material effect on the comparative financial data?

- Have there been certain patents applied for with respect to which commercial exploitation has not yet begun and therefore their potential is not reflected in the accounts?

- Were any of the guideline-company aquirees receiving government loans, grants or subsidies?

Valuation ratios may definitely provide insight into pricing/valuing the subject business, or may even be used for corroborative purposes, provided that the types of items enumerated above are considered. The business appraiser should use published transactional data from databases or from other sources but simultaneously attempt to seek answers to the foregoing types of questions. Absent truly meaningful comparability, simply taking figures from a well-researched database and calculating a ratio or multiple, without considering many of the foregoing factors, could lead to a flawed conclusion.

The BV Committee's Standards Subcommittee is actively working on "The Guideline Public Company Valuation Method" and "The Merger and Acquisition Method" as Statements on Business Valuation Standards, which are intended to define and describe the requirements for the use of these two Market Approach methods under ASA Standard BVS-V. It is not expected that the types of factors enumerated above would be incorporated; rather, emphasis would be on the need to analyze the relevant data and make necessary adjustments, but only after performing a thorough and objective search for meaningful transactions involving guideline companies.

The foregoing "shopping list" might serve as a checklist not only in the exercise of due diligence, but perhaps may be useful in the cross-examination of an expert who had used guideline-company data in developing a valuation that is filed in court.