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Tales From the Trenches

Buildup Approach: The Data May Be Correct, But Is the Conclusion Appropriate?

By Robert E. Kleeman Jr., CPA/ABV, ASA, CVA

Editor's note: This is an article in a series of valuable lessons to be learned based on the experiences of seasoned valuation experts. While you may be able to find some of this advice in books, only real-life experiences can highlight the nuances that can only be found in the minds of the experts who have lived through many engagements. Do you have a lesson to share? Contact the editor at andyd@bvresources.com.

Back in 2010, I gave a speech to a group of lawyers focusing on business valuation differences between the public markets and closely held smaller family businesses. During that speech, I raised the issue that public pricing information might not be a realistic proxy for what was really happening in the closely held marketplace. My premise was that, on some occasions, the public-market data do not reflect what is really happening in the private market. Another major premise to my presentation was that the privately held entity is a different "beast" than a publicly traded company.

Just a few months ago, an attorney asked me to review a business valuation report that was prepared for nonlitigation, family planning purposes. The attorney, who is a fairly sophisticated professional and represents many closely held business owners, was concerned that the valuation conclusion seemed exceptionally high. In fact, his client indicated that there was no way anybody would buy the company at the price the valuation professional set.

I was asked to meet with the attorney, the client, and the person that prepared the valuation to discuss the process involved with the valuation and to offer my suggestions as to whether the valuation was accurate or overstated the value of the underlying entity. I had the full cooperation of the valuation professional and had access to the workpapers prepared to support the valuation conclusion. There was no doubt that he had made all the appropriate adjustments to earnings and that the financial analysis of the company was properly done.

By the book. My initial review seemed to indicate that the valuation professional had done everything by the book, but, as I looked at the underlying financial information for the company, I also came to the conclusion that the valuation conclusion was significantly overstated. I have always believed that, as a valuation professional, the last question you must ask before issuing the report is: "Would I put my money into this deal at this price?" The more I looked at the prospects of the company, and the expected returns, my answer became more clear: "No, I would not put my money in this deal at this price." So why did I think the process was right, but the conclusion was wrong? It turns out that I believe that much of the current public-market data are not directly applicable to the valuation of a private closely held entity.

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Think about the market information that we currently have:

- The risk-free rate is below 2%. Depending on whether you use the 20-year maturity of a 30-year bond, or a 20-year bond, the rates are around 1.8% at this writing.
- Stock analysts are indicating that they believe the equity risk premium (ERP) is somewhere close to 3.5%.
- The combination of those two factors gives us a base rate of approximately 5.3%.

The valuation professional used the above information and added a small stock premium of 4%, and no premium for specific company risk, saying that the business was well established, had some proprietary product, a diverse customer base, and good management. The company also had no long-term debt and was paying a modest dividend to the family members. With those factors involved, the valuation professional concluded that the total capitalization rate was under 10%, basically setting a cap rate at more than 10 times earnings. (*Note: The valuation professional did not do a market approach due to the uniqueness of the subject company, so there were no comparables.*)

Current market as proxy. So, with that in mind, why did the attorney, the client, and I think that the company's value was overstated? Simply, the current market is not a proxy for the types of rates that are available to a purchaser of the vast majority of closely held entities. A prospective purchaser of this company would not enjoy the possibility of debt capital costs of less than 6%. The market's ERP is factoring in long-term overall appreciation of the public market as a whole, which may or may not have any applicability to a closely held company. Certainly, there is a much higher risk associated with the closely held company than with the S&P 500 taken as a whole.

Overall, it was clear that the valuation professional had not made any material error in the data

that were selected to develop the capitalization rate, but the question that must be asked is: "Are those data really applicable to the entity being valued?" Another material question that must be addressed is: "Is the hypothetical purchaser willing to accept a total return of approximately 10% on this type of investment?"

I believe that there are times when the public market really doesn't reflect reality when those same metrics are applied to the typical privately held company. This seems to be one of those times. U.S. bond rates are exceptionally low and probably don't reflect the long-term market. In the end, the valuation was redone using more appropriate inputs.

Lesson learned. So what is the lesson to be learned from this tale? The valuation professional has to always keep in mind that part of the valuation process is "common sense, informed judgment and reasonableness."[1] It is incumbent on the valuation professional to take the data available and apply those elements of common sense, informed judgment, and reasonableness when applying the data to determine the conclusion. Did the valuation professional do anything mechanically wrong in the determining the value of the entity? I don't believe so. What the valuation professional should have done is analyze the underlying data and determine whether that data really are applicable to the engagement being undertaken. ◆

1 Rev Rul 59-60, Sec 3.01, 1959-1 CB 237.

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