

# SVG's Viewpoint on Value



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Transaction databases: Handle with care

The what, when, how and who of blockage discounts

Determining business value  
**Site visits can make all the difference**

Does goodwill equal noncompete?



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# Transaction databases: Handle with care

Transaction databases reveal details of thousands of real-life stock sales, whether public or private, control or minority. This information helps valuers determine the value of comparable business interests. It also provides insight into industry trends when business owners contemplate buying or selling their company.

Courts, too, perceive transaction databases as one of the most straightforward, objective valuation metrics. But, used incorrectly, these databases can mislead — or skew the results. Valuers using transaction databases inevitably encounter subjective elements. Handling these elements effectively requires competence, expertise and experience.

## Theory vs. practice

Transaction databases come into play when valuers apply the merger and acquisition (M&A), or guideline transaction, appraisal method. A subset of the market approach, the M&A method derives value from prices paid for companies engaged in the same, or similar, lines of business.



Pricing multiples relate the price paid in each transaction to the respective company's underlying financial data. For example, a valuator might apply the median price-to-revenues or average price-to-earnings multiples to the subject company's revenues or earnings to estimate value.

Valuators have several transaction databases at their disposal, but not all of them are created equal.

As valuers apply this methodology, they make assumptions and adjustments based on informed professional judgment. In turn, these modifications affect valuers' final conclusions. The outcome of the M&A method is only as reliable as a valuator's professional judgment and understanding of the transaction data.

## Choosing the right database

Valuators have several transaction databases at their disposal, but not all of them are created equal. Some provide more detail than others. And some specialize in large, public deals, while others focus on small Main Street businesses. Among the most popular are:

- BIZCOMPS,
- Done Deals/Mid-Market Comps,
- Mergerstat/BVR Control Premium Study, and
- Pratt's Stats/Public Stats.

Before combining the information contained in multiple databases, valuers ensure they understand the differences in terminology and application. "Price" in one database may not equate with "price" in another

database. And each source includes different assets and liabilities in their pricing multiples.

For example, “price” in BIZCOMPS refers to a private asset sale that includes fixtures, equipment and goodwill, as well as noncompete and consulting agreements. Cash, receivables, inventory, real estate and debt are specifically excluded from the selling prices BIZCOMPS reports.

Conversely, Pratt’s Stats contains both private and public transactions that may be asset or stock sales. For asset sales, the selling price typically includes inventory, fixed assets, leasehold improvements, intangibles, noncompetes and goodwill, but excludes cash, receivables, real estate, earnouts, consulting agreements and debt — though these terms are disclosed when known.

Valuators research each individual transaction closely to understand what’s being transferred and the underlying terms of the deal. The more detail a database provides about the transaction and the company, the more confident an appraiser can be that the guideline company is comparable to the subject company.

### Selecting a pricing multiple

Valuators can compare selling price to many different financial metrics. Examples include revenues, earnings, net cash flow and book value. What’s relevant depends on the comparables’ business structures.

Generally, appraisers have the most confidence in the pricing multiple that shows the lowest standard deviation. This means that, if the transactions are graphed, the preferred pricing multiple is the one in which the data points are most tightly clustered with the fewest outliers.

Rather than selecting only one multiple, a valuator might use several pricing multiples and assign varying weights to each relevant multiple. The pricing multiple decision is another component that has a material impact on value.

Some databases report financial data for the previous 12 months, while others annualize the latest publicly reported financial data. The valuator needs to know how each database reports its financial metrics, so he or she can compute the same financial metric for the subject company. If not, apples-to-oranges comparisons might result.

## Determining the guideline transaction

Appraisers make informed assumptions about what constitutes a “guideline” transaction. Standard Industrial Classification (SIC) or North American Industry Classification System (NAICS) codes are the most obvious selection criterion. But valuers also might set parameters for such factors as size, financial performance, geographic location and time frame.

Selection criteria affect which transactions the valuator analyzes. A minor change in the selection criteria can have a major impact on value.

Timing is essential in today’s uncertain marketplace. Most investors aren’t willing to pay as much as they were during the bull market a decade ago. The recession has stunted M&A activity and pricing multiples in many industries, particularly the retail, automotive and construction sectors. A valuator who includes outdated transactions in a sample risks overvaluation.



### Right person for the job

The M&A method requires appraisers to make a series of choices, based on informed judgment, which affect the value conclusion. Such choices include a decision as to whether a database transaction should be used as a major valuation method or as a reasonableness check.

Attorneys and business owners also face a tough choice: Who’s the right valuator for the job? Although transaction databases contain a wealth of valuable information, they can be misleading in the hands of a layperson or an inexperienced valuator. The best bet is a credentialed expert who’s competent, patient — and diligent enough to go the extra mile. ●

# The what, when, how and who of blockage discounts

Discounts for lack of control and marketability are common in business valuation. But a lesser-known discount for blockage may apply when valuing large blocks of public stock with limited trading volume.

## What's a blockage discount?

Blockage discounts are based on the law of supply and demand. That is, if supply of an asset increases and demand remains the same, the asset's value will decrease.

Valuing public stock usually is straightforward. Simply multiply the number of shares being valued by the current market price. But when someone wants to sell a large block of stock within a limited market, selling it immediately floods the market with excess supply. What's more, there are fewer potential buyers who want to purchase large blocks of stock. As such, the shares are sold over time in smaller chunks and must contend with the time value of money and price volatility. Either way, a discount from the pro rata market capitalization applies.

Larger blocks tend to warrant higher discounts because they have a greater immediate impact on trading volume.

Sometimes blockage discounts also apply to real estate or art collections. To illustrate, courts have permitted blockage discounts for a real estate investment portfolio concentrated in one geographic market and for an artist's estate that contained a large collection of her unsold artwork. Why?



An immediate sale of either of these investments floods the market and lowers liquidation proceeds.

## When do they apply?

In Tax Court, there's no presumption of a blockage discount. Rather, it's a question of fact that taxpayers must prove. Tax courts have recognized blockage discounts in a handful of cases, such as *Estate of Friedberg v. Commissioner*, *Estate of Davis v. Commissioner* and *Estate of Foote v. Commissioner*. These discounts also may be relevant in shareholder disputes and divorce cases.

The general range of blockage discounts is 0% to 15%, according to Reilly and Schweihs' *The Handbook of Advanced Business Valuation*. But higher discounts may apply, depending on case specifics.

## How do valuers quantify them?

Factors an appraiser considers when quantifying blockage discounts for thinly traded public stock include:

**Previous high-volume transactions.** The most objective source of blockage discounts is prior

sales of large blocks of the subject company's stock. Sometimes courts also permit analysis of *subsequent* sales of large blocks.

**Relative size of the block.** The appraiser compares the size of the stock block to the total shares outstanding. Larger blocks tend to warrant higher discounts because they have a greater immediate impact on trading volume — or take longer to dribble out into the market.

**Average daily trading volume.** Blockage discounts generally are reserved for cases in which the block represents several weeks or more of normal trading volume. Lower trading volumes typically equate with higher discounts. Similarly, the stock exchange upon which the stock trades can affect blockage discounts.

**Stock price volatility.** When the price fluctuates, an investor's expected return is less certain. Uncertainty, in turn, increases blockage discounts.

Other factors an appraiser considers include company, industry, market and institutional ownership

trends. Some large blocks also act as a swing vote or have enough critical mass to control major business decisions.

Courts frown upon using blockage discounts applied in earlier court decisions. Instead, as in *Estate of Foote*, courts typically prefer experts to determine each discount independently of legal precedent.

One way valuers support blockage discounts in court is to use comparable high-volume transactions — including sales of large blocks of comparables and similar amounts of the subject company's stock. Valuers also analyze the costs of a secondary offering, restricted stock sales, private placements and synthetic put options when quantifying blockage discounts.

### Whom do you call?

Although reserved for exceptional cases, blockage discounts can have a significant impact on value. Experienced valuers understand the factors involved in analyzing and estimating an appropriate customized blockage discount that fits the facts and circumstances of each case. ●

## Determining business value

### Site visits can make all the difference

A business owner may be surprised — or even irritated — when a valuator asks for a tour of the company's facilities, especially if the valuator represents the opposing side in a lawsuit. Even in an amicable situation, the owner may see a site visit as a waste of time or an intrusion.

But a site visit is an important step that can make all the difference in determining a company's value. The most obvious reason appraisers perform site visits is to gain a better understanding of how the company operates and view the onsite factors that may enhance — or decrease — the company's value.

### Site unseen

A site visit can be especially helpful in adversarial situations, because the valuator may uncover hidden assets or fraud.

For example, suppose an attorney (Tom) is forced to file a court order to hire an appraiser (Sue) to value a minority interest in a steel galvanizing plant and allow her access to the company's facility. While waiting in the company's lobby, Sue gathers information from newspaper articles posted on the walls, which she subsequently reports to Tom. These facts include the grand opening of an affiliated company in a nearby town.

Further investigation reveals unrecorded loans to the affiliated company and a shift of several large customers' income from the old to the new plant. What's more, the old plant is paying exorbitant management fees and above-market outsourcing fees to the new affiliate. These discoveries could potentially increase the value of the steel galvanizing plant significantly — and they would have gone undetected if not for Sue's diligence during the court-ordered site visit.

### Expect the unexpected

If a valuator has never seen your company's facilities, expect him or her to request a site visit soon after being hired. Before showing up, most valutors perform a preliminary review of the company's financial statements and other relevant documents to ensure efficiency and customize interview questions. They also may send a written questionnaire in advance to help management prepare.

## A side benefit of face-to-face interviews is that the valuator will establish a positive working relationship with employees.

Depending on the size of the company and the engagement's confidentiality requirements, the valuation expert will want to talk to several individuals, including the:

- ➔ CEO,
- ➔ Controller,
- ➔ Marketing director,
- ➔ Plant manager, and
- ➔ Human resources director.

A side benefit of these face-to-face interviews is that the valuator will establish a positive working relationship with employees, which facilitates the valuation process.



If, for some reason, a valuator can't conduct a site visit or is denied access to part of a company's facilities, he or she indicates this as a limiting condition of the valuation. This can severely compromise the perceived reliability of a valuator's conclusion.

### Covering the gamut

Interviews typically cover a broad range of subjects, including but not limited to operations history; a description of the company's function and market; management quality and compensation; technology; marketing strategies; and financial performance.

Many valutors end interviews with a broad question, such as, "In your opinion, is there anything else about the business we haven't discussed that could potentially affect its value?" Such a question minimizes the danger that a valuator will overlook a key fact or that management will withhold information.

### Site visit checklist

During a site visit valutors assess many factors, including:

**Location.** How adequate is signage, parking lot size and ingress/egress?

**Asset condition.** Is there any nonoperating, idle, damaged or obsolete equipment or inventory?

**Physical asset controls.** Are inventory and fixed asset items tagged or locked up?

**Overall quality of internal controls.** Is there an apparent risk that fraud could be occurring?

**Facility condition.** Are facilities disorganized or unsafe? The appraiser evaluates workflow order, working conditions and facility cleanliness and asks about dress code policies, OSHA violations, environmental contingencies and workers' compensation claims.

**Capacity issues.** Does sufficient capacity exist to meet short-term financial projections? Facilities near capacity may require additional capital investments and those with significant excess capacity may benefit from downsizing.

### Why not?

It's difficult to assess a business's value without physically inspecting its operations. A site visit is an important part of the valuation process. Instead of asking the valuator why he or she is performing a site visit, a better question would be: Why not? ●

## Does goodwill equal noncompete?

Goodwill is one of the gray areas in divorce. Most states specifically exclude all or part of goodwill when dividing the marital estate. A recent Ohio divorce case eliminates the guesswork by equating a dentist's personal goodwill with the portion of the actual selling price that was allocated to a non-compete agreement.

In *Banchefsky v. Banchefsky*, the husband had practiced cosmetic dentistry for over 20 years. In May 2009, in the midst of divorce proceedings, he sold Eastside Family Dental, including its trade name, telephone and fax numbers, websites and e-mail addresses, for \$580,000.

The parties entered into an asset purchase agreement that allocated \$126,000 to dental and office furniture, \$3,000 to dental supplies, \$20,000 to patient records, \$15,000 to the noncompete agreement, and \$416,000 to goodwill. The noncompete agreement prevented the husband from practicing dentistry within a 10-mile radius for five years. But he could work for Eastside Family Dental as an independent contractor for six months following the sale.

In Ohio and many other states, personal goodwill is a personal asset that is excluded from a marital estate. The Domestic Relations Division of the Franklin County Court of Common Pleas assigned \$15,000 to the husband's personal goodwill, which equals the value assigned to the noncompete agreement.

Mr. Banchefsky argued to the Ohio Tenth District Court of Appeals that his asset purchase allocation had been "arbitrary." His expert valued personal goodwill at \$215,500, applying a Multi-attribute Utility Model (MUM). The lower court ruled that the MUM analysis was inappropriate because the practice was sold in an arm's-length transaction and the terms included a noncompete clause. The appellate court affirmed the decision.

This case demonstrates a judicial preference for real-life transactions over theoretical analyses. When previous stock transactions, sales, purchase offers or comparable deals exist, use them first. If the data is invalid, explain why. In addition, purchase price allocations should approximate fair market value. If not, they may come back to haunt buyers and sellers later.





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