

The Market Approach to Valuing Businesses **(Second Edition)**

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The Guideline Transaction (Merged and Acquired Company) Method

Differences in Transaction Structure

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- Noncompete and Employment Agreements
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Summary

The basic principles of the transaction method are the same as for the guideline publicly traded company method. The differences in implementation are a result of the differences in data available and, in some cases, the structure of the transactions.

One of the biggest differences is that mergers and acquisitions do not conveniently occur on the effective date of our subject company valuation. Thus, the analyst must decide how far back in time to go in collecting transactions. Also, the analyst may need to adjust observed market multiples for differences in economic and industry conditions between the dates of the observed transactions and the effective date of valuation for the subject company.

Because the companies have been bought out and there is no trading of shares, there is no body of analytical data or forecasts such as there are for public companies. Consequently, there will be no publicly available multiple of price to projected earnings. However, if a company was public before being acquired, it is possible to get current EPS estimates from the forecasting services. Also, for small companies and professional practices, usually only the latest year's data are available. In these cases, there will be no price to some average of past years' data.

Advantages of the guideline merged and acquired company method in some circumstances include:

- If valuing a very small business or practice, merged and acquired company transaction data are available for thousands of comparable businesses and practices far below the size for which guideline public company data are available.
- Hundreds of Standard Industrial Classification (SIC) or North American Industrial Classification System (NAICS) codes (industry or practice groups) are available for merged and acquired company or practice data for which there are no guideline public companies.
- The merged and acquired company data are for controlling interest transactions. Therefore, if valuing a controlling interest, it is not necessary to address the question of a control premium. (Of course, if valuing a minority interest, a minority interest discount may be applicable in many cases, and usually a discount for lack of marketability as well.)

Disadvantages include:

- The M&A company data is for successful or desirable businesses.
- The multiples may not apply to similar businesses if they lack the key financial and non-financial characteristics of the M&A company.
- The multiples may not apply if there are no eager or willing buyers on the scene.

There is clearly a great difference between the data available for a sale of a public company and the sale of a private company. The *Pratt's Stats*TM database has completely separate sections for sales of private companies and sales of public companies. However, the principles are the same, so we are treating the entire spectrum of guideline control transactions in a single chapter.

DIFFERENCES IN TRANSACTION STRUCTURE

In order to derive meaningful guidance for pricing or valuation from completed transactions, it is necessary to examine, and often adjust for, differences

between the guideline and subject transactions related to what was or was not included in the transaction, and in terms of the transaction.

What Assets and Liabilities Are Included?

An important difference among transactions, particularly for sales of private companies, is the need to understand what was included in the transaction. The guideline public companies are virtually all stock transactions, and all of the companies' assets and liabilities are reflected in the stocks' public market trading prices. Many of the acquisitions, however, are asset sales, especially for smaller private companies. For an asset sale, it is important to know what was transacted, so that the multiples applied reflect the same assets. Many small private company sales include no current assets or liabilities, or in some cases do include inventory but not other current assets. One must carefully ascertain if real estate was included in the price.

Noncompete and Employment Agreements

Private company sales very often also include noncompete agreements and/or employment or consulting agreements that may be nonexistent or not of material amounts in public company transactions. It frequently is necessary to adjust for these factors. Dealing with the question of what may or may not be included in an asset sale is illustrated in Chapter 13, which is a sample valuation of a small sandwich shop.

Transaction Terms

If the standard of value is fair market value, then, by definition, that means a cash or cash-equivalent value. The terms for many transactions are not on a cash or cash-equivalent basis. If that is the case, and fair market value is being sought, then the prices of the guideline transactions might have to be adjusted to a cash-equivalent value before multiples are computed.

Restricted Stock. Public companies often issue restricted stock for all or a portion of the purchase price of acquisitions. The value of restricted stock usually is somewhat less than its freely traded counterpart (see Chapter 12). If the consideration is restricted stock, the analyst should consider whether the deal value should be adjusted to reflect that difference.

Below Market Financing. In some transactions, the seller carries back a note at less than an arm's-length market rate of interest. If fair market value is sought, the transaction price should be adjusted to a cash-equivalent value. This is merely a function of discounting the note payments to a cash-equivalent value at what would be a market rate for comparable borrowing.¹

Earnouts. An *earnout* means some sort of contingent payment, often contingent on customer retention or realizing certain revenue or profit goals. There necessarily is some subjectivity in adjusting these values to cash equivalences because it is necessary to adjust each payment to the expected value of the amount to be received. Rather than make such estimates, some analysts simply remove transactions involving earnouts from consideration.

SCOPE OF MARKET

The merger and acquisition method can cover businesses and practices of virtually any size, from a few thousand dollars in market value up to billions. It can also cover virtually any type of industry or practice.

In the public company sector, several hundred mergers, acquisitions, and going private transactions are reported each year.

In the private company sector, the number of transactions is substantial. Private company databases are capturing close to 3,000 transactions per year and working toward increasing that number.

In a paper presented to the American Society of Appraisers, veteran business appraiser Mike Hill² emphasized the size of the “small” business sector in this way:

- 23.32 million nonfarm businesses of which over 99% were small according to the Small Business Administration (SBA).
- 15 million small businesses *not* counting sole proprietorships.
- 18 million full-time businesses that are family dominated.
- Family-run businesses account for 50% of gross national product (GNP), and also over 50% of employment.
- From 1992 to 1996, all net new jobs were created by companies with under 500 employees.
- Almost 43% of the leadership of family-owned businesses will change hands within the next five years, even not counting sole proprietorships. This is over 1.2 million businesses per year.

AVAILABILITY OF MERGED AND ACQUIRED COMPANY TRANSACTION DATA

Several database providers have made major advances in recent years in capturing prices and other useful data on middle-market and small-company transactions so that they can be used as guidelines for pricing other transactions and for valuing businesses for all purposes. Collectively, these databases are adding several thousand transactions per year, and the number of transactions being captured is growing.

Depending on the status of the public or private acquiree and/or acquirer,

varying amounts of detail may be available on each transaction. Although these classifications are not absolute, it is helpful to think of four categories:

1. Public company being acquired or going private
2. Private company acquired by public company, when transaction is significant enough to public company (10% or more of value of public company) to require filing of SEC Form 8-K
3. If a transaction is material, the financial data may be available in the acquirer's next 10-K
4. Private company acquired by public company with no 8-K report required
5. Private company sold to private company or individual

There is no single source of data listing all company sale transactions. Chapter 6 on finding merged and acquired company data addresses available sources.

Public Company Sale

If a public company sells or goes private, it must file a *prospectus* giving details of the sale. In this case, there will be as much information available as for a guideline publicly traded company. The data are a matter of public record and are readily available.

The primary source for such transactions is the *Mergerstat*®/*Shannon Pratt's Control Premium Study*™, details of which are presented in Chapter 6.

Private Company Sale to Public Company Requiring 8-K Filing

If a public company makes an acquisition of a company worth over 10% of the value of the public company, it must file a special events Form 8-K with the SEC. Form 8-K contains significant information, although not as much as a prospectus for a public company selling out. The data are a matter of public record and readily available through the SEC. Also, if the transaction is material, the data may be available in the acquirer's next 10-K.

Primary sources for such transactions are *Pratt's Stats*™, and *Done Deals*, details of which are presented in Chapter 6.

Private Company Sale to Public Company with No 8-K

If a private company sells out to a public company and an 8-K is not required, then data may or may not be available, depending on the disclosure policy of the public company acquirer. The degree of public access and verifiability varies.

The primary source for such transactions is *Pratt's Stats*™, the details of which

are presented in Chapter 6. There are also some industry-specific databases, for example, Kagan's database for cable acquisitions.

Private Company Sale to Private Buyer

If a private company sells to a private party, there is no legal requirement that any information be released. Since it would be helpful to intermediaries, acquirers, and business appraisers to have such data to implement a market approach to valuation, three database providers have worked to compile such data:

1. *IBA Market Data Base* (from the Institute of Business Appraisers)
2. *BIZCOMPS*®
3. *Pratt's Stats*™ (the official database of the International Business Brokers Association [IBBA])

The information is provided primarily by intermediaries, that is, those who broker the transactions. In the case of *Pratt's Stats*™ and the IBA database, some information comes from certified public accountant (CPA) firms. *Pratt's Stats*™ also gathers data from financiers and acquirers.

The financial data are usually limited to the latest year. The *IBA Market Data Base* and *BIZCOMPS*® present only sales and discretionary earnings, while *Pratt's Stats*™ presents summarized income statement and balance sheet information.

In most cases, the names of sellers and buyers are omitted, so the information is not verifiable by the end user. However, the databases are compiled by people and organizations that are well regarded for honesty and competence, with much of the data coming from members of the International Business Brokers Association and some from members of the Institute of Certified Business Counselors. There is no reason to consider the data to be biased, and the databases are well accepted by appraisers and the courts. More detail on these databases is presented in Chapter 6.

HOW FAR BACK IN TIME ARE TRANSACTIONS RELEVANT?

Obviously, we would like transactions as close in time to our effective valuation date as possible. We also would like to have enough transactions to have a meaningful sample. As a generality, the more data we have per transaction (to select those comparable to our subject) and the more reliable the data, the fewer transactions we need to have a meaningful sample.

Ray Miles did a study on the *IBA Market Data Base* and concluded that there were no long-term secular changes over time in the multiples of the industries represented in that database, and, therefore, the whole 20 years of data are relevant. One should be wary, however, that the general stability of average multiples over the long term may mask significant differences in multiples for interim periods within the long term. In general, during periods when interest rates are high and

financing is difficult to obtain, multiples are lower. Also, the stability or volatility of multiples varies considerably from one industry to another, as some industries become “hot targets,” while others fall out of favor. Perhaps due to rapid technological change, an example of what to consider is historic consolidations that push multiples up, but no longer apply. An appraiser would overstate the value if he simply used these historic multiples without considering the industry conditions at the time of the transaction. Much more research on this is necessary.

In the meantime, the analyst should consider relative similarities or differences in economic and industry conditions for some guidance as to how far back to search, as well as the amount and reliability of available data.

THE GUIDELINE MERGER AND ACQUISITION BASIC PROCEDURE

The guideline merger and acquisition basic procedure is essentially the same as for guideline public companies. The valuation analysis can be done on either an invested capital basis or an equity basis or both. Some steps may be omitted because of lack of available data.

One step that may be added is an adjustment to multiples to account for differences in industry and economic conditions from the date of the observed transaction to the date of the subject valuation. Standard & Poor's (S&P) and other services publish statistical series, such as industry average P/E ratios. Multiples may be adjusted by changes in industry average multiples. For example, suppose that the S&P industry average P/E multiple was 15× earnings at the time of the guideline transaction and 18× at the time of the subject company effective valuation date. This would be an increase of 20%, or an index of 1.20. The guideline company multiple could be adjusted by the index multiple. If the guideline company P/E multiple had been 12, it could be adjusted $1.20 \times 12 = 14.4\times$. However, the analyst must be cautious in applying such an adjustment. Private company transaction multiples tend to be less volatile over time than multiples in daily public market trading. Also, some analysts believe that the gap between market and acquired company multiples narrows when the market rises, although we are not aware of any definitive studies on this.

Because the transactions are, by definition, control transactions, the value indicated by the guideline merged and acquired company method is a control value. It is important that the analyst understands whether this control value is the value of all invested capital or only the value of the equity. Of course, in some transactions, especially of smaller companies, there are no senior securities, so the equity value represents the value of all the invested capital. In such a case—in *Pratt's Stats*TM for example—the number shown for deal price and equity price is the same.

PREMIUMS AND DISCOUNTS

Because the indicated value is a control value, it normally would not be appropriate to add a control premium. One or more discounts may be appropriate.

Valuing Controlling Interests

If valuing a controlling interest, a discount for lack of marketability *may* be appropriate in limited circumstances. There could be significant time and costs that would need to be incurred in order to make the subject company salable, which could be the basis for a lack of marketability discount. Also, there may be considerable risk as to whether the estimated value can actually be attained. This is discussed further in Chapter 12.

Valuing Minority Interests

If valuing a minority interest in a privately held company, a discount for lack of control usually would be warranted, and frequently a discount for lack of marketability as well. Most analysts (and most courts) prefer to deal with the marketability and minority discounts separately because, although related, they are two separate concepts and lend themselves to being quantified by different types of market evidence and analysis. It is quite common for a minority interest in a closely held company to be worth less than half its proportionate share of the value of a controlling interest. Sometimes we see the minority and marketability factors lumped as a single discount. Minority discounts are discussed in Chapter 11, and discounts for lack of marketability are discussed in Chapter 12. The analyst should carefully evaluating the lack of control elements and how minority and marketability discounts reflect this lack of control.

SUMMARY

The basic steps in the guideline merged and acquired company method are (not necessarily in the following order):

- Set criteria for collection of guideline merged and acquired transactions, including the time frame (e.g., back three years, back five years).
- Identify the population and source or sources from which the guideline transactions will be selected (see Chapter 6).
- List the companies that meet the criteria. (When using multiple sources, be careful not to list the same transaction twice, which could result in giving double weight to a single transaction.)
- Obtain financial data on the companies selected.
- Analyze and make adjustments to the subject company's financial statements and, to the extent that the guideline companies' historical financial statements are available, analyze and adjust those statements, if appropriate (see Chapter 7).

- Prepare comparative financial analysis between the guideline companies and the subject company to the extent that financial information is available for the companies in the guideline company transactions. (Of the databases on private company transactions, *Pratt's Stats*TM is the only one that provides sufficient information for this step, and even then the comparative data are limited to summaries of the latest year's statements (see Chapter 8).
- Prepare guideline merged and acquired company market valuation tables, on an equity basis and/or an invested capital basis (see Chapter 9). If necessary, adjust face values of transactions to a cash equivalent value before calculating multiples.
- Adjust, if appropriate, observed multiples by an index (i.e., an index of S&P industry P/E ratios) to account for changes in industry and economic conditions between the observed guideline transaction and the subject effective valuation date.
- Gather and analyze relevant economic and industry data, and summarize in terms of their impact on value.
- Visit the subject company facilities and conduct management interviews.
- Choose which multiples to apply to the subject company.
- For each multiple selected to be used, decide on the value of that multiple to be applied to the subject company relative to the range of that multiple observed for the guideline companies.
- Decide on the relative weight accorded to the indication of value from each valuation multiple used (total weights must equal 1.00) (see Chapter 10).
- Prepare a merged and acquired company method valuation summary table.
- Adjust for any assets or liabilities included in the subject company valuation but not included in the guideline transactions.
- Apply discounts, if appropriate, to reach the level of value called for in the assignment.

Notes

1. For a detailed explanation of converting a price on terms to a cash equivalent value, see "Trade-off between Cash and Terms," chap. 27, in Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, *Valuing Small Businesses and Professional Practices*, 3rd ed. (New York: McGraw-Hill, 1998), 487–502.
2. J. Michael Hill, "Small Business Valuation Revisited," American Society of Appraisers International Conference, Kaanapali Beach, Hawaii, 1998. Full text available on www.BVLibrary.com.

