

Market Approach


Business Valuation Workshop
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Louisiana Society of Certified Public Accountants

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Theory and Use


- ◆ Theory of substitution
- ◆ Revenue Ruling 59-60-"...prices at which the stocks of companies engaged in the same or a similar line of business are selling in a free and open market."



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The Market Approach to Valuing Businesses, *Shannon Pratt*


"Courts are becoming more sophisticated and increasingly able to evaluate market approach testimony. Many case decisions ultimately depend on the relative quality of respective experts' market approach presentations. While the market approach can provide an excellent indication of value, it can be one of the easiest approaches to poke holes in during cross examination.."



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Multiples

- ◆ TIC/TEV-total invested capital or total enterprise value (cash or no cash/LT debt or all interest bearing debt)
- ◆ Common equity price
- ◆ PE P/CFAT P/book value or NAV
- ◆ MVIC/EBITDA MVIC/Revenue



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Market Approach

- ◆ Publicly Traded Companies
- ◆ Transaction Method
- ◆ Rules of Thumb



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Publicly Traded Companies

Data sources:


- ◆ Screening-S&P Compustat or Dialog on Disc
- ◆ Financial data-Edgar
- ◆ Analysis and Outlook:
 - Company website-investor relations
 - Investor publications (Value Line)
 - Analyst reports
 - Consensus earnings forecasts



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Publicly Traded Companies

- ◆ Is this a minority or a control value?



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Size Matters!

- ◆ Smaller companies tend to sell at lower multiples than larger companies in the same industry
- ◆ Evidence:
 - Mergerstat
 - Bizcomps/Pratt's Stats
 - Ibbotson Associates
 - PWC studies




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Transaction Method

Data Sources:

- ◆ Mergerstat-Edgar-Securities Data Corporation
- ◆ Done Deals
- ◆ Pratt's Stats
- ◆ IBA Market Data Base
- ◆ Biz Comps
- ◆ Industry specific



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Transaction method- Databases

	Mergerstat	Done Deals	Pratt's Stats	IBA	Bizcomps
Since	1999		1991		
# Transactions	38,000	5,727	5,100	23,000	6,329
Data Points		25	80	8	20
Size	\$1 MM min transaction	\$14MM avg transaction	1MM-1BB revenue	<\$500,000 revenue	<\$500,000 revenue
Buyer/Seller	public	priv/public mid mkt	private	private	private



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Mixing Transaction Databases

Done Deals

Sic: 3569
 Revenue: \$8.2MM(3 Mos
 annualized)
 Price (Equity): \$13.5MM
 ♦ \$7.2 MM cash
 ♦ \$425,000 stock
 ♦ \$5.9MM earnout based
 on 3 yr. Avg EBITDA x
 60%
 P/Revenue = 1.66

Mergerstat

Sic: 3566
 Revenue: \$8.0MM(TTM)
 Price(TIC): \$16.0MM
 ♦ \$7.2 MM cash
 ♦ \$1 MM stock
 ♦ \$5.9MM earnout
 ♦ \$300K CNTC
 ♦ \$1.6MM debt
 TIC/Revenue = 2.00



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Mixing Transaction Databases

Done Deals

♦ P/Revenue = 1.66
 ♦ Subject revenue =
 \$10MM
 ♦ Subject debt = \$8
 MM
 ♦ Equity price =
 \$10MM x 1.66 =
 \$16.60MM

Mergerstat

♦ TIC/Revenue = 2.00
 ♦ Subject revenue =
 \$10MM
 ♦ Subject debt = \$8 MM
 ♦ Equity price = \$10MM x
 2.00 = \$20.00MM -
 \$8MM = \$12MM



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Mixing Transaction Databases

BizComps

Price=FF&E and goodwill = \$10MM
Revenue: \$5.0MM(Last fiscal year)
P/Revenue = 2.00
Subject company:
Revenue = \$3MM
Current assets=\$3MM
Liabilities =\$1MM
Equity Price =2.00 x \$3MM +\$2MM = \$8MM

Pratt's Stats

Price=All assets =\$14MM
Revenue: \$4.5MM(TTM)
P/Revenue = 3.11
Subject company:
Revenue = \$3MM
Current assets=\$3MM
Liabilities =\$1MM
Equity Price =3.11 x \$3MM = \$9.33MM



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Rules of Thumb

Sources:

- ◆ Handbook of Small Business Valuation Formulas and Rules of Thumb-Glenn Desmond
- ◆ Business Reference Guide-Tom West
- ◆ Trade periodicals/Industry publications



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Rules of Thumb

- ◆ If an industry has a widely used rule of thumb, consider it; HOWEVER, it should not be relied on as the only method.
- ◆ Use as a "sanity check."
- ◆ ASA BV Standard "Rules of thumb may provide insight on the value of a business, business ownership interest, or security. However, value indications derived from the use of rules of thumb should not be given substantial weight unless supported by other valuation methods and it can be established that knowledgeable buyers and sellers place substantial reliance on them."




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Rules of Thumb

Most common:


- ◆ % of sales
- ◆ multiple of discretionary earnings
(*sdcf* or *ocf*)
- ◆ multiple of physical measure



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Rules of Thumb


<ul style="list-style-type: none"> ◆ Beer distributor- cases sold ◆ Cellular company-# subscribers ◆ Hospital-# beds 	<ul style="list-style-type: none"> ◆ Newspapers-# subscribers ◆ Engineering firms-# professional employees
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Problems with rules of thumb

- ◆ What assets are included?
- ◆ What are the terms of the transaction
- ◆ Profitability (*example follows*)
- ◆ Changes in industry condition and
outlook



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Example-Newspapers \$1,200/subscriber

<p>Times Journal</p> <ul style="list-style-type: none"> ◆ Revenue \$50MM ◆ EBITDA \$10MM ◆ #subscribers 60K ◆ Price=\$1,200 x 60K = \$72MM ◆ P/Revenue =1.44 ◆ P/EBITDA =7.2 	<p>Daily Post</p> <ul style="list-style-type: none"> ◆ Revenue \$40MM ◆ EBITDA \$15MM ◆ #subscribers 75K ◆ Price=\$1,200 x 55K = \$66MM ◆ P/Revenue =1.65 ◆ P/EBITDA =4.4
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Example-Newspapers

	EBITDA/Revenue	Price/EBITDA
◆ Industry	30.0%	5.0
◆ Times Journal	20.0%	7.2
◆ Daily Post	38.0%	4.4

Times Journal 5 x \$10.0MM = \$50MM
 Daily Post 5 x \$15.0MM = \$75MM

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Market Approach-Common Errors

- ◆ Selection
- ◆ Use of averages and medians
- ◆ Financial statement adjustments
- ◆ Data definitions
- ◆ Matching time periods
- ◆ Non operating assets
- ◆ Deal terms/structure

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Selection

- ◆ There are over 15,000 publicly traded companies. Value Line covers only a small subset. Compustat covers most.
- ◆ No comprehensive list of Transaction data
- ◆ Nature of the company and financial characteristics



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Use of averages and medians

Financial analysis may lead to choice of:

- ◆ Subset
- ◆ % of multiple
- ◆ One point/company
- ◆ Quartile/quintile
- ◆ Outside range



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Financial statement adjustments


- ◆ Nonrecurring items
- ◆ Gains/losses on the sale of assets
- ◆ Restructuring charges
- ◆ Effect of lawsuits/strikes
- ◆ Discontinued operations
- ◆ FIFO/LIFO inventory



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
Data definitions

- ◆ Assets plus...
- ◆ Price = ??
- ◆ Cash
- ◆ Debt

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Matching time periods

- ◆ Historical
- ◆ Average/Single time period
- ◆ Historical/forecasted

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Non operating assets

- ◆ Excess/deficient cash
- ◆ Noncompete/employment agreements

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
Deal terms/structure

- ◆ Seller's note
- ◆ Contingencies
- ◆ Restricted stock
- ◆ Noncompetes

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Synergies or why buyers overpay

- ◆ Overestimate values of synergy
- ◆ Overestimate earning capacity

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Court decisions

- ◆ Tax Court
 - n Estate of Gallo
 - n Estate of Hall
- ◆ Marital Dissolutions
 - n Lotz v Lotz
 - n Hewitson v. Hewitson

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Sources

◆ The Market Approach to Valuing Businesses - *Shannon P. Pratt*



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