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Editor's Column

When To Use The Guideline Public Company Method

Paul R. Hyde, EA, MCBA, ASA, BVAL

The purpose of this article is to propose some guidelines that will assist business appraisers to determine when it is appropriate to use the guideline public company method and when it is appropriate to reject this method. In my opinion, the guideline public company method is used by some business appraisers in many instances when it should not have been used or when at least some of the guideline companies selected should have been excluded as not being comparable.

Revenue Ruling 59-60

Revenue Ruling 59-60, the business appraiser's "Bible," supports the use of the guideline public company method. According to number eight of the factors to consider, "The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter" should be considered.¹ The revenue ruling goes on to expand on this topic as follows:

Section 2031(b) of the Code states, in effect, that in valuing unlisted securities the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange should be taken into consideration along with all other factors. An important consideration is that the corporations to be used for comparisons have capital stocks which are **actively traded by the public**. In accordance with section 2031(b) of the Code, stocks listed on an exchange are to be considered first. However, if sufficient comparable companies whose stocks are listed on an exchange cannot be found, other comparable companies which have stocks actively traded on the over-the-counter market also may be used. The essential factor is that whether the stocks are sold on an exchange or over-the-counter there is **evidence of an active, free public market for the stock** as of the valuation date. In selecting corporations for comparative purposes, care should be taken to **use only comparable companies**. Although the only restrictive requirement as to comparable corporations specified in the statute is that their **lines of business be the same or similar**, yet it is obvious that **consideration must be given to other relevant factors** in order that the most valid comparison possible will be obtained. For illustration, *a corporation having one or more issues of preferred stock, bonds, or debentures in addition to its common stock should not be considered to be directly comparable to one having only common stock outstanding*. In like manner, *a company with a declining business and decreasing markets is not comparable to one with a record of current progress and market expansion*.² (Items highlighted and italicized by author).

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An Example

An example of what in my opinion was an inappropriate use of the guideline public company method is summarized below:

Company Being Appraised:

Software Development Company (for Health Care Industry)

SIC Code # 7371

Company Total Assets: \$ 6,047,302

Company Annual Revenue: \$ 390,000

Company Net Income: \$(3,483,000)

Guideline Companies Selected by Appraiser:

Creative Computer Applications, Inc. (CAP)

HBO & Co. (HBOC)

Healthdesk Corp. (HDSK)

Shared Medical Systems Corp. (SMS)

Systems Communications, Inc. (SCMI)

The following table summarizes the characteristics of the five guideline companies selected by the appraiser:

	CAP	HBOC	HDSK	SMS	SCMI
Revenue	6.4 Million	1.4 Billion	\$75,000	1.1 Billion	164,400
Assets	6.6 Million	1.5 Billion	1.6 Million	762 Million	381,206
Net Income	Profitable	299 Million	(2.8 Million)	69 Million	(694,316)
Brief Description	Similar business, over 500 client sites.	Huge company, provides integrated software to healthcare industry.	Developing company in reorganization. Entered into an agreement to sell all of its assets. Not actively traded.	Huge company, sells both hardware and software to the healthcare industry.	In a different industry. Very poor financial health. Not actively traded.
Comparable?	No	No	No	No	No

It was obvious that the appraiser did not investigate any of the guideline companies. Instead, apparently he took some numbers from a secondary source and used them to force a value for the subject company.

Some Proposed Guidelines

In the initial review to determine whether or not the guideline public company method should be pursued, I believe business appraisers could save a lot of time and energy if the following guidelines were adopted:

Finding Potential Guideline Companies:

Prior to a discussion of the application of various market methods, the relationship between the size of the subject company and the size of companies in the various market comparison data needs to be explored.

Size of the Company:

The size of the company matters in business valuation issues. According to Shannon Pratt, "smaller companies in most industries tend to sell at lower multiples of most financial variables than larger companies in the same industry. This conclusion, reached from analysis of market data, is consistent with income approach (cost of capital) research, which shows that smaller companies have higher costs of capital (higher discount rates) than larger companies. Higher discount rates in the income approach should mean lower multiples in the market approach, and this relationship does, indeed, hold true."³

Pratt goes on to give some examples to support his position: Middle Market companies with \$2 to \$3 million of earnings before interest, taxes, depreciation and amortization (EBITDA) are easier to sell and command higher pricing multiples on average than companies with \$1 to 1.5 million in EBITDA.⁴

The following table illustrates data from a study of private company sales showing the relationship between some common sales multiples and size of the company⁵:

Size of Company	Sales Price/Ask Price	Sales Price/Company Sales	Sales Price / Seller's Discretionary Cash Flow
Businesses sold for under \$100,000	76.6%	0.34	1.5
Businesses sold for over \$500,000	91.8%	0.53	2.6

This relationship between multiples and size of the company also holds true for public companies. Companies under \$50 million typically sell for considerably lower price to earnings multiples than companies from \$50 to \$500 million, and companies over \$500 million typically sell for higher multiples than those from \$50 to \$500 million⁶.

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According to Pratt, "Larger companies are less risky, and therefore, are priced in the market reflecting lower discount rates and higher market multiples."⁷ Pratt continues to state, "Size does matter. The smaller the company, the higher the average cost of capital and the lower the average market valuation multiple."⁸

Since size matters, using market data for much larger or much smaller companies than the subject company can result in erroneous conclusions.

Size:

According to Gary Trugman in his second edition of *Understanding Business Valuation*, a size restriction of 10 to 25 times the sales volume of the appraisal subject is appropriate. He also mentions that Shannon Pratt in an earlier edition of *Valuing a Business*, had indicated that 10 times revenue is a good upper limit. According to Trugman, "...common sense must be applied. If the guideline companies are too big, they lose relevance to the appraisal subject."⁹

I feel that revenue multiples should be low for small companies and larger for bigger privately held companies. The following is my suggestion as a guideline to be used for this method (obviously some exceptions will occur):

Private Companies:

Revenue -- Under \$5 Million (Method Not Applicable)

Revenue -- \$5 million to \$20 million (comparables limited to 5 times revenue)

Revenue -- \$20 million to \$50 million (comparables limited to 10 times revenue)

Revenue -- over \$50 million (comparables limited to 25 times revenue)

Active Trading and Penny Stocks

Gary Trugman also mentions that guideline companies must be actively traded and not be penny stocks. He defines actively traded as at least 5 percent of the company's outstanding stock trades over the six-month period prior to the valuation date. He refers to penny stocks as stocks with a selling price of \$5 or less (but indicates sometimes a \$3 and less price is used by his firm -- rarely less than \$3 per share). The restriction on the price limit is designed to get rid of speculators that often trade in penny stocks.¹⁰

Summary

Caution and common sense must be employed when using the Guideline Public Company Method. As Trugman often states, "Using Home Depot to value the local hardware store" just does not work. The relevance is missing. Also, using penny stocks or inactively traded stocks is simply inappropriate.

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The Guideline Public Company Method is very useful and a valid method when used both appropriately and properly.

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Please submit articles for *Business Appraisal Practice* by email to: prh@hydebvp.com.

¹ Internal Revenue Service, Revenue Ruling 59-60, Sec. 4. Factors to Consider, .01, h.

² Internal Revenue Service, Revenue Ruling 59-60, Sec. 4. Factors to Consider, .02, h.

³ Shannon P. Pratt, *The Market Approach to Valuing Businesses*. (New York: John Wiley & Sons, Inc., 2000), p. 242.

⁴ Shannon P. Pratt, *The Market Approach to Valuing Businesses*. (New York: John Wiley & Sons, Inc., 2000), p. 242.

⁵ Shannon P. Pratt, *The Market Approach to Valuing Businesses*. (New York: John Wiley & Sons, Inc., 2000), p. 243.

⁶ Shannon P. Pratt, *The Market Approach to Valuing Businesses*. (New York: John Wiley & Sons, Inc., 2000), p. 243.

⁷ Shannon P. Pratt, *The Market Approach to Valuing Businesses*. (New York: John Wiley & Sons, Inc., 2000), p. 243.

⁸ Shannon P. Pratt, *The Market Approach to Valuing Businesses*. (New York: John Wiley & Sons, Inc., 2000), p. 251.

⁹ Gary R. Trugman, *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium-Sized Businesses*. Second Edition. (New York: American Institute of Certified Public Accountants, Inc., 2002), p. 173.

¹⁰ Gary R. Trugman, *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium-Sized Businesses*. Second Edition. (New York: American Institute of Certified Public Accountants, Inc., 2002), p. 173.