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HYDE Valuations, Inc.

**We Value Both Real Estate and Businesses
Including Machinery & Equipment**

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The Market (Sales Comparison) Approach

The market (sales comparison) approach is based on the principle of substitution, i.e. an investor will not pay more for something than they would for an equally desirable substitute. For example, if a farmer desiring to purchase a used tractor has a choice between two very similar tractors one with a price of \$125,000 and the other \$100,000, the farmer will select the tractor with the lower price tag.

In theory the market approach involves the analysis of comparing similar properties that have sold relatively recently in order to determine the likely value of the subject property, whatever that may be. When valuing real estate, machinery & equipment, or livestock, the application of this approach is fairly straightforward, however, it is often difficult due to the lack of similar comparable sales. In the valuation of business entities or intangible assets, this process is generally much more complex and difficult to apply as these types of investments tend to be more unique and it is harder to find truly similar sales.

Some of the characteristics that are evaluated when valuing real property investments include the following:

- Property rights appraised
- The motivations of buyers and sellers
- Financing terms (i.e. developing a cash equivalent)
- Market conditions
- Size
- Location
- Physical features
- Economic characteristics (if the properties produce income)

The differences between each sale comparable and the subject must be identified and adjustments made to make the sale comparable more similar to the subject. An easy way to remember in which direction the adjustment should be made is to use: CBS (comp better subtract) and SBA (subject better add). If a comparable property is superior to the subject in some aspect, a negative adjustment must be applied to that comparable in order to make it more similar to the subject. Conversely, if the subject is superior to the comparable in some way, a positive adjustment must be made to account for the difference. The difficulty in this adjustment process is the quantification of how much of an adjustment should be made for each difference. The adjustments, in theory, should all be made based on market evidence. In practice, obtaining market evidence to support each adjustment is extremely difficult and often impossible. Instead, the magnitude of many adjustments is based on the appraiser's judgment and experience.

Applying the market approach when valuing a business entity typically involves using one or more of the following business appraisal market methods:

- Guideline public company method
- Public Company Transaction Method
- Private Company Transaction Method

Some people consider another method called the Industry Method or often referred to as "rules of thumb" as a third method. I do not consider "rules of thumb" to be an appraisal method. Instead, "rules of thumb" are used,

when available, as a “sanity check” to help verify the reasonableness of the value obtained from the appraisal methods used.

The Guideline Public Company Method is generally used when valuing larger closely held companies (it is not appropriate for use when valuing small companies and most medium-sized companies). It involves using the stock prices for publicly traded companies in the same or similar line of business as described in IRS Revenue Ruling 59-60. This method is very involved and time consuming but it has value if applied properly. Information obtained from the public stock market is considered to be objective by many appraisers but sometimes there is a lack of comparability between publicly traded guideline companies and a closely held subject company.

The Public Company Transaction Method is typically also used when valuing larger closely held companies. The data for this method comes from mergers and acquisitions with public companies doing the acquiring. Companies that are acquired may be public companies, private companies or often divisions or subsidiaries of public companies. Data is obtained from a variety of sources. Most commonly from a variety of commercial services that monitor and check public company disclosure statements filed with the Securities and Exchange Commission (SEC). The data is used to determine valuation multiples that can be applied to the subject company in order to reach a value indication.

The Private Company Transaction Method is also based on IRS Revenue Ruling 59-60, but it involves using data from the sales of entire private companies, usually obtained from a number of databases maintained around the country. The most common source of data for these transactions is the database maintained by the Institute of Business Appraisers, Inc. and the database called Pratt’s Stats. The information in both of these databases typically comes from business brokers and business appraisers around the country. Very little information is usually known about each of the companies listed in the database. Instead, information for a number of sales is used and analyzed to help determine value. The Private Company Transaction Method is usually more appropriate when valuing a smaller closely held company, but is often useful when valuing medium-sized businesses as well.

Valuations play a part in all strategic transactions, tax, and many litigation matters. For additional information or advice on a current situation, please do not hesitate to call. **We value real estate, businesses, and personal property including machinery & equipment.**

Sincerely,



Paul R. Hyde, EA, MCBA, ASA, MAI
Enrolled Agent – Enrolled to Practice Before the IRS
Master Certified Business Appraiser
Accredited Senior Appraiser – Business Valuations
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