

Business Valuation Notes

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How Much Risk is there?...

UNIQUE RISK IN DISCOUNT

Specific Risk can be Very High...

A recent case was decided wherein the issue of specific risk premium for a security was debated regarding the appraisal of a hospital with the court determining that the valuation experts must consider many factors in deciding the unique risk and that the appraiser must not assume that certain factors have been sufficiently discounted by the industry.

A specific or unique company risk premium is used by appraisers when ascertaining how much risk a hypothetical willing buyer will discount projected cash flows to derive net present value of an investment. Valuation analysts typically use a build up method, ascertaining first the amount of the risk free interest or cost of capital at a given time. To this is added a risk premium for owning common stock instead of putting the money into a savings account. To this total the appraiser then generally adds an industry risk premium, as each industry typically carries more or less risk

than the market generally.

To this total the analyst will then assess if the subject company warrants a further risk premium due to its size: typically small companies bear more risk than large companies. Finally, the analyst must determine if there is additional risk in the subject company due to factors which are unique to that company and which have not been reflected in the other risk premiums which have already been added. (In the subject case the analysts used a CAPM model, but the general theory is the same.)

The discount rate is applied to discount future earnings and obtain the net present value. Alternatively, the inverse of the discount rate, adjusted for growth, is used to obtain a capitalization rate. The capitalization can be used to multiply earnings and thus obtain a net present value rather than projecting the earnings and then discounting them back. This is similar to using a price to earnings multiple, a com-

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DISCOUNT FOR LACK OF MARKETABILITY

Discounts for lack of marketability (DLOM) have never been a problem. Determining a reasonable percentage or value for them has. DLOMs, simply, make sense and accountants, attorneys, appraisers and judges strived to find a logical method to determine them.

This summary, provided by MBVG Principal Dr. Stan Pollock, MD, PHD, MCBA, recently reminded us of this struggle which has been ongoing for several years and encourages us to remember where valuation theory has been in the past and how it has evolved and continues to change.



Pollock

Business Valuation Notes readers have previously been introduced to Dr. Ashok Abbott, an MBVG Principal and developer of the Abbott Index, a model for empirically determining discounts for lack of liquidity on top of any discounts for lack of marketability, which he has defined as companies which are not registered for public trading.

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DLOM

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Recently MBVG distributed a note alerting readers to a telephone

conference featuring Dr. Abbott through Business Valuation Resources (now owned by David Foster).

Whereas Abbott, who is a professor at the University of West Virginia, has developed a model for assessing issues with liquidity using the trading of blocks of common stock of publicly traded companies, Pollock has been well seasoned in seeing how such discounts have worked in the 'real world'. Pollock has been the most significant contributor and coordinator of the Direct Market Database of the Institute of Business Appraisers (IBA) which contains more than 2,000 entries of dental practices (including specialties) which have been sold. He is a doctor who understands the business as well as a certified business appraiser. He has valued businesses for divorce, shareholder disputes, and other purposes and has also been the intermediary in business purchases and sales. These are not businesses which are now public nor are they likely to ever go public.

In discussing the DLOM, Pollock notes that the Benchmark Method was popular in the seventies. Around a decade later, he states, appraisers were

applying the Pre-Initial Offering Method (Pre-IPO) and then switched to the Quantitative Marketability Discount Method (QMDM) in the nineties.

“Despite this confounding situation,” according to Pollock, “appraisers still dazzle appraisal reports and use these methods, their home-made methods and ‘guesstimates’ to determine the DLOM.

“Appraisers sometimes apply the discount to the final estimate of value while others apply the discount to certain selected methods only, some times to put the chosen method into line with others. Inconsistency abounds. Others who were uncomfortable with any of the methods struggled because each method had defaults, particularly, in their accumulation and analysis of data and had the fear of challenge. Discounts for lack of marketability became a dilemma to the professionals who genuinely felt they were applicable,” Pollock said.

In the past few years, court decisions for McCord, Temple, Weinberg and Gimbel et al, each a major court tax case, have held that DLOMs are appropriate and required. In these cases, the courts found the methodology used was relevant to the cases and was reasonably accurate. The method used was the Restricted Stock Comparative Analysis Method (RSCA)¹. In specifically rejecting the long-standing Benchmark, Pre-IPO and Quantitative Marketability Discount and other Methods,

Pollock asserts that the courts have accepted the Stock Comparative Analysis.

In the significant Temple case, the court found a) the IRS's expert methodology to be correct, and b) reliable in the fact the expert endeavored to understand and incorporate the market dynamics of restricted stock sales. The court, further, found “the better method is to analyze the data from the restricted stock studies and relate it to gifted interests in some manner.”

The Restricted Stock Comparative Analysis Method is a trade-marked product of FMV Opinions Inc., a broad based financial and valuation service company located in New York City. This method applies a comparative analysis between relevant characteristics of companies which comprise the database of FMV Opinions and the company being valued. The Restricted Stock Comparative Analysis Method contains more than 470 restricted stock transactions from over 40 company/transaction-specific characteristics; not a great deal of data but enough relevant data to impress the court. A significant company finding which the court recognized was that smaller companies had larger discounts, something which both general intuition and appraisers find is no surprise. Other significant findings of the FMV Opinions Inc. Restricted Stock Comparative Analysis Method are:

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mon tool used by traders in publicly held common stock.

Minnesota Business Valuation Group President Randall Schostag said that the case is important because it should remind appraisers of the importance of the unique company characteristics when conducting a valuation. “The amount of discount is very significant; the higher the discount rate, the lower the value,” Schostag said. “Analysts may devote considerable time to ascertaining projected income statements and balance sheets and then go through building up the discount rate by simply mechanically applying most of the steps in the procedure, but paying scant attention to the unique characteristics of the company. Often times this can result in a discount rate which is much smaller or at least different from what another appraiser of equal skill may determine and thus can dramatically affect the finding of value.”



Schostag

Schostag also noted that while all of the steps of the build method for determining a discount rate are obtained from empirical information and thus should be consistent from one appraiser to another, the amount of additional premium added for unique characteristics of a company are highly subjective and can vary widely, depending on

the appraiser. “There is no easy way to determine to substantiate the amount of this premium,” Schostag said.

In the subject case, one appraiser had assigned a unique risk premium of five percent while the opposing appraiser had applied a 10 percent specific risk premium. The court decided that even a 10 percent premium was too low in this instance.

This issue arose in a Chapter 11 Bankruptcy filing regarding Doctors Hospital of Hyde Park, Inc. (debtor), Doctors Hospital of Hyde Park, Inc. (plaintiff) versus Dr James H. Desnick, et. al, (defendants), United States Bankruptcy Court for the Northern District of Illinois, Eastern Division. (No. 00B-11520, Adversary No. 02 A 00363). The case was decided March 2, 2007.

This was a complex case: the adversary filed 28 claims following the trustees filing for Chapter 11. There were many loans and guarantees to consider along with a chain of events over a period of time when obligations changed and leading up to the actual claims. The matter was bifurcated with regard to some issues. MBVG’s interest in the case stems from the court’s decision to establish a value which exceeded the market value of the rent paid, and more narrowly the assessment by the court of the amount of excess premium which the court determined to use as well as why it did not use other measures.

In this case, the experts MBVG has considered were Scott Peltz, plaintiff’s expert, American Express Tax and Business Services, and Thomas Blake, an expert from Charles River Associates, representing the trust. There were many other experts involved in the case, but MBVG has elected to focus on these two as the dominant experts cited by the court for the valuation aspect of its opinion. In addition to valuation, experts provided opinions on solvency of the hospital over time.

Regarding the valuation of the hospital, the court detailed issues, such as tax affecting an S-corporation, and the company specific risk premium. Regarding tax affecting the hospital which was an S-corporation, the court allowed the adjustment because the analyst was valuing a controlling interest, based on the expert’s excerpt from a valuation text which stated that when valuing a controlling interest in an S-corporation it is appropriate to make an adjustment for federal tax. The court also considered how the analysts ‘normalized’ the cash flows from the hospital. Normalizing adjustments are made by analysts who may remove or add certain income and expense items or remove certain balance sheet items so that the financial statements accurately represent what is likely to occur in a business in the future, without those

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extraordinary or non operating aspects which are reported in historical financial statements. For this article, MBVG has not considered those discussions.

Regarding the capitalization rate, both experts used an after-tax weighted average cost of capital (WACC). Obtaining WACC requires that the analyst determine the discount rate for equity, as noted above, but incorporate this cost of capital along with an assessment of the cost of debt. The required rate of return for both debt and equity is then combined, using the amount of debt to equity, to ascertain a company's total cost of capital for debt and equity together.

In the court opinion there seemed to be no dispute about the manner of obtaining a cost of debt or the amount of debt employed. Similarly, there was not a dispute about the general methods obtained to derive the cost of equity except for the additional premium paid for the final step, viz., the amount of risk premium which should be added for unique or specific risk. As noted previously, there was a big difference in their specific company risk premiums with Blake using a five percent specific risk premium and Peltz using a 10 percent specific risk premium.

Blake's percentage was based on the nature of the related party

transactions with a member of management and his associated entities. According to the opinion, Blake ignored all other risks associated with Doctors Hospital, i.e., management problems (including the reputation of management), Medicare/Medicaid fraud, and the hospital's unreliable internal financial statements.

The court concluded that Blake's basis for excluding all of the other risks was that "adjustments have been made to normalize historical financial performance, industry factors are already 'baked into' the beta factor affecting the equity risk premium, and a size adjustment has already been incorporated."

Peltz disagreed. He cited risks that were not otherwise accounted for in the calculation of the equity portion of WACC, testifying that he looked at "specific issues relating to the hospital," including depth of management, fraud occurring at the hospital, management's reputation, and the unreliability of financial statements. He also alleged that the Doctors Hospital has more risk because it suffers from a greater effect stemming from the Balanced Budget Act of 1997 ("BBA"). The effect would be greater, he said, because Doctors Hospital has a high percentage of Medicare/Medicaid patients.

A colleague of Peltz disagreed with Blake's assumption that there were widespread fraud investigations in the entire

industry in 1997 and 1998. He testified that the investigations focused on "selected targets," that Doctors Hospital was one of them, and so the risk associated with the investigations was not "baked into the industry." Out of 5000 hospitals in the United States, only 110 were being investigated at the time of the subject Loan.

The Peltz colleague opinion was supported by them using public reporting of "guideline companies" which the Peltz team used to calculate an "unlevered beta," a measure of industry risk. These analysts reviewed the relevant forms 10-K and 10-Q of HCA, Universal Health Services, Health Management Associates, and Tenet Health Care. They found that before 2000 only HCA reported being the target of a fraud investigation, and that the stock price of HCA went down in 1997, while the stock price of the others went up. They asserted that this empirical information demonstrated that the market had not accounted for industry-wide "baked in" risks.

In other issues, the court examined how the analysts had used the market approach, how they had searched for and applied – if at all – the public market guideline company method. For the most part, MBVG believes that the arguments posed are similar to the findings in other cases and were not unique.

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Importantly, the court commented that the hospital's revenues consisted of 85 percent to 89 percent from Medicare / Medicaid compared to 50 percent for the average Chicago hospital. Reimbursement for Medicare / Medicaid is much lower than for commercial insurance, partly because the diagnosis is determined at discharge rather than on admission, regardless of the cost of stay. The length of stay for these patients was also about 25 percent longer than the average Chicago hospital. This resulted in a higher cost per patient and thus a lower reimbursement. These together influenced the court to accept a higher discount for equity and thus resulted in a higher WACC.

The court also considered other hospital competition, obsolescence of facilities, competition for doctors, and the reputation of the hospital. The court heard testimony about the Balanced Budget Act of 1997 and the belief that requirements would drive a number of hospitals out of business. The new requirements would serve to reduce reimbursement to hospitals like Doctors.

The court concluded lease payments far exceeded the reasonably equivalent fair rental value based on its valuation findings. The court used a higher WACC and with other adjustments determined a much lower value.

DLOM

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1. Exchange-traded companies tend to trade at lower discounts than over-the-counter traded companies,

2. Larger blocks tend to trade at greater discounts than smaller blocks because,

3. larger blocks tend to be more illiquid due to the provisions of Rule 144. Smaller entities, in terms of market values, total assets or book value, tend to have significantly higher discounts,

4. High profitable firms tend to have lower discounts. The top decile of the sample arranged by profitability, has a median discount of 11%,

5. Dividend-paying firms tend to have significantly lower discounts.

6. The amount of private placement shows strong negative correlation with the discount,

7. Firms with low shareholders' equity, have an average discount of almost thirty percent (30%),

8. Stocks that are more liquid (higher trading volume) tend to have lower discounts,

9. Private placements that are very large compared with the monthly trading volume for the stock sell at higher dis-

counts

To most appraisers, the findings are not new. For whatever reasons, the Restricted Stock Comparative Analysis Method, apparently, substantiates the findings and has impressed the court so that it now has been the standard to determine discounts for lack of marketability, Pollock says.

"Astute appraisers, accountants, attorneys and judges will have to become aware of the latest, court-accepted method to determine marketability discounts, grasp the myriad implications and properly apply the new method," Pollock said. "The Courts seem to have solved the DLOM dilemma, at least for a while or until some case comes along to replace the RSCA method."

MBVG President Randall Schostag agreed that Pollock's observations point to a very important tool which appraisers must consider when examining how much of a discount to apply for the discount for lack of marketability.

"MBVG believes strongly in using the Abbott Index whenever possible," Schostag said. "However, there is a high cost to obtain findings using that index which can't be justified for smaller private firms.

"In the absence of using this tool, Pollock's use of the RSCA method offers a more defensible opinion."

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BUSINESS VALUATION

Goodwill Impairment Analysis (141/142)

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