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## How Do You Handle It?

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The purpose of this column is to provide for an exchange of ideas between business valuation professionals regarding issues that can be difficult to address in written reports, in discussions with clients, and in testimony in deposition or trial. Opinions expressed in this column may or may not correspond to the views of *BVR*'s Editorial Board. The column is designed to provide an opportunity for the valuation professional who is too busy to write a full article to contribute some of his or her experience for the benefit of all. Readers' questions on which peer comment is sought are encouraged, as are suggestions as to how to handle difficult situations.

### **Guideline Companies, Proper and Improper Use**

We have had two recent inquiries about the use of guideline companies. One is from our esteemed editor, James Schilt, who commented on statements he had seen to the effect that "guideline companies selected should represent alternate investment opportunities and/or should be equally desirable substitutes for the business being appraised." The other inquiry describes a tax deficiency based on the premise that the valuation of a private company should have been based on the median price earnings multiple of other companies in a similar industry.

The first statement, in quotes above, appears to be partially correct. The second situation does not. Only if there are very substantial similarities between a public and private company should the public company's price earnings ratio be used as a basis for estimating an investor required rate of return for a private company. Other, less direct, transfers of guideline company characteristics, however, can be useful even if the public and private companies are not "equally desirable substitutes" from an investment point of view. Some examples of ancillary uses of guideline companies are mentioned below. Others are discussed in valuation texts such as *Valuing a Business*, by Pratt, Reilly and Schweihs. Our readers can no doubt supplement these uses from their own experience.

We are not privy to all of the facts regarding the tax deficiency situation, but simplistically applying the median of similar public companies' P/Es to a private company appears to disregard many of the basic precepts of Revenue Ruling 59-60. This is the type of formula approach to valuation that should be avoided.

Price earnings ratios awarded by the markets to publicly traded companies in a given industry are, for a number of reasons, usually much higher than can be justified for smaller, less mature, privately held companies, even though in the same industry. Many of the private companies that business appraisers are called on to value simply are not ready for prime time and may never be.

Consequently, there usually are no publicly traded guideline companies whose "Price to Anything" can be directly plugged in to create a satisfactory result. In regard to comparing small private companies with larger public ones, Chris Mercer's frequently stated view comes to mind; to paraphrase: "bold adjustments" to public market P/Es must be made when considering applying them to smaller private companies. Most other authorities agree that the size and maturity of publicly traded companies put them in a different league from the private companies we value and that these factors make much higher P/Es appropriate. At pages 211 and 212 of the 3d Edition of *Valuing a Business*, some of the factors to be considered when using guideline company ratios are listed.

For some successful small companies the possibility exists of growing to the point that a public offering, or merger into a public company, can occur. This growth may take several years to accomplish, however, and as we all know, derailments of even the best of business plans can and do occur along the way. Consequently, applying the P/E of a company the likes of which the small private company aspires to be in several years is inappropriate. The risks of investing in early stage companies are substantial, and investors in these companies during their fledgling years have far higher rate of return requirements than are found in more mature publicly traded companies. If one is willing to speculate, however, that a company in the early stage of development might "grow into" a publicly traded one, some of the financial information available from annual reports and 10-Ks of public companies in the same business, during those public companies' early years, can be useful. Gross profit margins for instance, may indicate the "raw opportunity" that is present. Capital expenditures for plant and equipment as a percentage of revenues, particularly in the early years of the public companies, may provide insight into the amount of capital that may be required. Ratios of working capital to revenues can be an indicator of the amount of funding required to finance inventories and receivables in that industry. These funding needs, reflected in cash flow projections done on the company being valued, may be indicative of the amount of capital which must be infused if the private company is to grow rapidly enough to achieve its goals. Raising equity from new investors dilutes the ownership interests of the present owners of the business, and therefore their opportunity for gain. It is obvious that because a small company is "in the same business" as a public company, and may itself someday be able to go public, is not justification for valuing that small company as if it were already public.

IF YOU HAVE COMMENTS ABOUT THE QUESTIONS RAISED IN THIS COLUMN, OR OTHER ISSUES YOU WOULD LIKE TO SEE ADDRESSED, SEND THEM TO BRAD FOWLER, ASSOCIATE EDITOR *BUSINESS VALUATION REVIEW*, 211 EAST 7TH STREET, SUITE 707, AUSTIN, TEXAS 78701.