
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 in regard to issues that can be difficult to address in written reports, in discussions with clients, and in testimony in deposition or trial. Any opinions expressed in this column are those of the contributing reader of **BVR** and may or may not correspond to the views of **BVR**'s Editorial Board.

The column is designed to be complementary to Letters to the Editor and to provide the valuation professional who is too busy to write a full article a chance to contribute some of his or her experience to the profession. **Reaccreditation credit will be given to those who participate.**

Questions on which peer comment is sought are encouraged. One or perhaps more of these questions will be presented in each column and the best reader response or responses will be shared in a subsequent column.

An excellent response to the December 1994 column which suggested a method to consider when a very similar publicly traded company with a high P/E cast doubt on the defensibility of an otherwise soundly based cap rate has been received from Ray Miles, ASA, CBA, Executive Director of The Institute of Business Appraisers as set out below:

Letter from Ray Miles

"The (December 1994) column suggested a solution based on dividing the public company into separate parts consisting of (a) value based on current earnings and (b) value reflecting expected future growth of the public company.

I have a very different viewpoint, as follows.

The proper function of guideline companies is to serve as surrogates for the "equally desirable substitutes" (Principle of Substitution) that a "well informed" buyer would review before deciding how much he would be willing to pay for the target business.

Thus, guideline companies should aid the appraiser in defining the market for businesses that represent equally desirable substitutes for the target business.

The market for a business is best described on the basis of prices actually paid for businesses that are equally desirable (not necessarily identical) with the target business.

Both logic and empirical data indicate that the market for a business is not sharply defined. Neither is the market value of a business a single number.¹

Instead, the probability distribution of prices actually paid for businesses meeting specified criteria resembles a normal probability distribution skewed to the right.²

It is impossible to define such a market from a single guideline company. All we really know about the guideline company is that it falls somewhere within the range of market prices – a range that theoretically extends to infinity.

Comparing an individual guideline company with a target business implies that this guideline company is a potential buyer's only available alternative to purchase of the target business. In their search for equally desirable substitutes for the target business, real world buyers are not limited to

a choice from one, two or three "best fit" guideline companies. In the real world, buyers always have other alternatives.

Use of a single guideline company is incorrect regardless of how closely the characteristics of the guideline company match those of the target business. Also incorrect is trying to define the market for a business from prices of only two or three guideline companies.

The minimum number of guidelines companies to define the market with a reasonable degree of confidence is a function of the variables of each situation. However, a combination of statistical considerations and empirical data indicates that 5 or 6 guideline companies should be an absolute minimum. Ten, 20 or more guideline companies would be desirable.³

Now back to the problem of the guideline business with the high P/E ratio.

Had this guideline business been only one of an appropriate number (say half a dozen or more) of guideline companies, it would not have been compared individually with the target business. Instead, it would have contributed to the average P/E of all of the guideline companies, affecting this average to an extent depending on the number of guideline companies.

This solves the problem without the need for the somewhat tortuous reasoning proposed in the "How Do You Handle It?" column.

*Raymond C. Miles, ASA, CBA
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Endnotes

1. "There is no such thing as 'the value' of anything. Value is a range concept..." Value Added, Mercer Capital Corporation, January 1991.
2. See, for example, Business Appraising in the Real World - Evidence from the IBA Market Data Base, Institute of Business Appraisers publication p. 292.1, 1992. Also see, BIZCOMPS Central Edition of Recent Small Business Sales, 1994, pp. 13-16.
3. See Business Values in the Real World - Evidence from the IBA Market Base, Raymond C. Miles. Paper presented by Kenneth F. MacKenzie, CBA, at ASA Business Valuation Conference, Houston, Texas, October 23, 1993.

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.