
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 is available 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.

HOW CAN YOU TEMPER THE EFFECT OF A HIGH P/E GUIDELINE COMPANY?

Sometimes in valuing a closely held business, after a sound built up capitalization rate has been constructed, reasonable earnings projections made, and discounts for lack of marketability and lack of control fairly determined, resulting in a well reasoned and defensible valuation, out of the blue comes a NASDAQ traded company, in the same business, similar in many ways, which trades at a price earnings ratio so high it places in jeopardy the reasonableness of your conclusions. For instance, if the public company trades at 14 times earnings and a 14 P/E is applied to your private company, the indicated value would be 1 1/2 to 2 times what you have determined using other appropriate methodologies. True, the public company is stronger financially, has greater management depth, better product diversification and new product development programs. The likelihood of continued earnings growth of the public company is also more easily substantiated and there are brokerage house reports that talk glowingly of 15% to 20% earnings gains in the future. Thus, the public company's prospects are clearly brighter than those of the private one. Still, in valuing the private company, the high market multiple is worthy of consideration, and could be a problem if your valuation were challenged and someone on the other side wanted to apply the public P/E to your projected earnings. How can the high public P/E be reconciled to your capitalization rate?

Chris Mercer, with input from Jay Fishman, made an excellent presentation on this subject at the recent San Diego Valuation Conference. Chris Mercer delivered the presentation and repeatedly emphasized the point that "bold adjustments" (downward) of public P/E's frequently must be made before applying them to private companies. Some of the reasons for this that we all know are size, financial strength, management depth, product and geographic diversification, access to financing, etc.

A related approach may also be worthy of consideration and could be helpful in quantifying the differences. It goes like this:

- 1) By definition, a price earnings ratio of 14 is a cap rate of 1 divided by 14, or .07.
- 2) If an Ibbotson "small stock" investor required rate of return is determined to be 19%. (a risk free rate of 7% plus combined Ibbotson "equity" and "small stock" premiums of about 12%), and it is reasonable to assume that this 19% investor required rate of return is appropriate for the NASDAQ traded (14 multiple) "guideline" stock,

- 3) Then, since the portion of the investor required rate of return represented by "current earnings" is 1 divided by 14, or 7%, 12% of the return "expected by the market" is based on growth. Stated another way, the market has determined that the public company will achieve 12% per annum growth in earnings in perpetuity. Of the 19% required rate of return, 7% is from current earnings and 12% from growth.

Thus, it may be reasonable to conclude that 7/19ths, or 37% of the multiple is based on current earnings and 12/19ths, or 63% of the multiple is based on the assumption of 12% per annum growth in earnings. If the assumed rate of growth of the private company being valued is found to be zero, it seems logical to transfer to the private company, not the 14 multiple of the NASDAQ stock, but a multiple of 37% of 14, or 5.2.

If the private company is found likely to achieve growth of 4% per annum in perpetuity, then the multiple transferred could arguably be 11/19ths of the public company's, or 58% thereof, or instead of 14 times earnings, 8.1 times. If the private company's outlook supports 6% growth in perpetuity, the multiple transferred could be 13/19ths of 14, or 9.6 times earnings.

After applying the lower multiple to the private company, a lack of marketability discount would still be necessary to equate the private company to the publicly traded one.

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.