Private Vs. Public Company Valuation Data A View From The Bottom

By
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As a business valuation practitioner of approximately seven years, my entire focus has been to serve the valuation needs of the private, closely-held entity - the majority of which are family owned and controlled. I have often followed the path of most valuation practitioners of always at least making a concerted effort to research the vast data base of public information to assist in reaching a sound conclusion of value for a particular interest. As I believe most valuation professionals have found, particularly those dealing primarily with private company clients, the guideline public data is either non-existent or extremely difficult to compare. This is most often due to the unique nature and operations of the private entity being valued. It is to these unique elements of the private company I wish to focus this article and, hopefully, provide a more solid framework of understanding among valuation practitioners of the key differences between a private and public company. This article will address why public data is most often not comparable in a private entity engagement and provide an enhanced understanding of how these key differences relate to the applicability or non-applicability of premiums and discounts.

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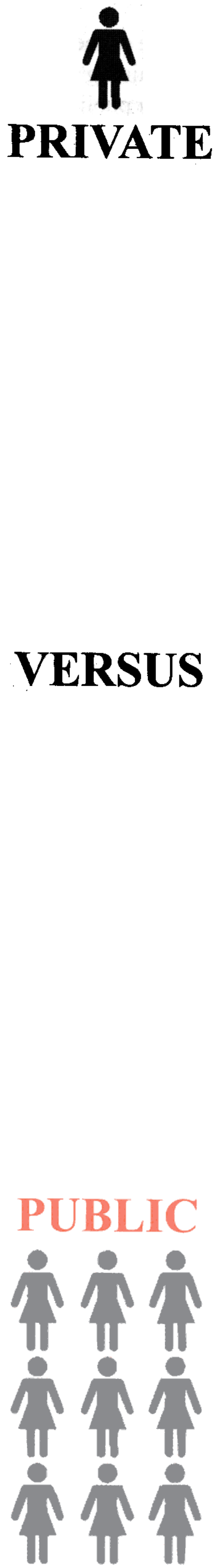
As a practicing CPA of approximately sixteen years, I have come to know three types of companies - those that are closely-held and have no current or future plans to go public; those that have reached a stage in the evolution of the entity when management desires a planned transition to the public market; and those either already in the public market or that plan from inception for a public offering. I will refer to each as closely held, will be public, and publicly traded, respectively. Each is generally unique in the quality, sophistication, and operating characteristics of the entity. A comparison of characteristics among each type of entity is helpful in understanding the value, and limitations, public market data may have in a private company business valuation assignment. Although not all inclusive, the following are some of the more obvious differences:

CHARACTERISTIC	CLOSELY HELD	WILL BE PUBLIC	PUBLICLY HELD
Formal, structured management teams	Generally no	Generally yes	Yes
Sophisticated technology & systems	Generally no	Generally yes	Yes
Formal budgeting & long-range planning	Generally no	Generally yes	Yes
Employee ownership opportunities	Generally no	Generally yes	Yes
Financial reporting to public sources	No	Yes	Yes
Audit level financial reporting	Generally no	Yes	Yes
Stringent & well-defined educational qualifications for key positions	Generally no	Generally no	Yes
Broad, global geographic presence	Generally no	Generally no	Yes
Sophisticated & sometimes extensive retirement & benefit options	Generally no	Generally yes	Yes
Well-defined company policies & procedures	Generally no	Generally yes	Yes
Priority toward return on shareholders investment	No	Yes	Yes
Income tax considerations take priority	Yes	Generally no	No
Ease of liquidation of shares	No	Limited	Yes
Volume of share trading activity	Little or none	Limited	Moderate to heavy
Broad & changing suppliers & customers	Generally no	Some	Yes

It is clear from this comparison that a closely held company is distinctly different from the two identified public company profiles as to the level of sophistication in management, operations, systems, and reporting, as well as to competition, customer base, priority toward shareholder returns, and structure and definition. It can be stated that in many ways, the private company operates in a much different world than the public company due to management's focus on personal goals rather than on increasing shareholder value, as is common in public companies. It can be further stated that the public "market makers" who drive much of the public data have different agendas than the prospective private company buyer.



Given these many contrasting characteristics of private versus public companies, two key questions become obvious to the valuation practitioner. 1) Why do business appraisers rely on public data as a source upon which to compare the financial condition and performance of a private company; and to develop an appropriate capitalization or discount rate, as well as to determine appropriate discounts/premiums to apply? And 2) what, if any, are the alternatives to public data?

The obvious answer to the first question is the abundance and accessibility of public market data, whereas private company data tends to generally be limited and difficult to obtain forcing the appraiser to turn to public data as an alternative. Therefore, in answer to the second question, despite the inherent differences, public data is the most reliable resource that must first be considered. Because of the tremendous volume of investor activity, public market data provides a reasonable proxy for considering appropriate investor rates of return and risk drivers in relation to private companies. Consequently, public data is the only feasible and best resource from which to develop an appropriate capitalization and discount rate. However, public data is not a reliable source for determining the appropriate earnings or cash flow base or in developing an appropriate discount or premium in a private company setting.

The earnings and cash flow of each business is unique, as it is driven by such elements as location, management, customers, suppliers, industry and economic impacts, and taxes. As a result, the earnings or cash flow base and the premium or discount must be developed by addressing all of these relevant issues, and their impact on company operations – e.g., control, liquidity, transferability, etc. According to ASA Business valuation standards, "A discount or premium has no meaning until the conceptual basis underlying the value to which it is applied is defined. A discount or premium is warranted when characteristics affecting the value of the subject interest differ sufficiently from those inherent in the base value to which it is applied." Under these same standards, control premiums and minority discounts are defined as follows:

"*Control Premium* - the additional value inherent in the control interest as contrasted to a minority interest, that reflects its power of control.

Minority Discount or Lack of Control Discount - An amount or percentage deducted from a prorata share of the value of 100 percent of an equity interest in a business, to reflect the absence of some or all of the powers of control."

If such definitions could be accurately quantified, a control premium would equate to the quantitative value of access to the decision-making powers of an entity in order to control, among other things, compensation, perquisites, purchase or sale of assets. A lack of control would equate to the quantitative value of <u>lack</u> of access to the decision-making powers of an entity in order to control the same issues. Acceptance of these definitions means that if the business appraiser appropriately computes a controlling interest level of earnings or cash flow and an appropriate capitalization or discount rate to apply, a premium is not necessary as we have already arrived at the controlling interest value. Similarly, if the appraiser appropriately computes a minority level of earnings or cash flow and an appropriate capitalization or discount rate to apply, a minority discount is not necessary, absent any restrictive covenants that would further aggravate the minority shareholder's lack of control. It is, therefore, important for the business appraiser to thoroughly understand and address all of the legal and company-specific control or lack of control issues pertaining to the interest

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being valued in developing an appropriate level of earnings.

Lack of marketability studies have as their basis public data studies generally pertaining to companies identified earlier as public or public candidates. Therefore, given the differences identified between public and private company profiles it is also important to adequately assess the company-specific issues as they relate to lack of liquidity or transferability issues. The public studies can be used as a foundation, but should not be the only source for the concluded discount applied. A thorough analysis of the company-specific issues as they relate to marketability should be performed and addressed in the valuation report. Reliance on public market empirical studies without comparison of these studies to the subject valued can lead to an erroneous conclusion.

Despite the many differences addressed in this article regarding public versus private company characteristics, public data continues to reflect the most active and easily attainable data from which to study investor behavior, risk in the marketplace, returns expected, and other transactional information. This data will help establish a foundation from which a private company analysis can build to a supportable discount or capitalization rate, or market multiple, and reasonable conclusion of value under an income or market approach. As private company databases, such as IBA, Pratt's Stats, or Bizcomps build their informational banks, private company guideline data may become more readily available and of a higher quality. However, the public marketplace reflects risk and return data that cannot be found anywhere else and should be used with a solid understanding of its source and nature. Application of such data should never be a substitute for a thorough analysis, both financial and non-financial, of a subject private company interest to reach an appropriate level of earnings and/or cash flow, discount and/or capitalization rate, and discounts or premiums to apply. It is the basis upon which the key elements of a private company interest appraisal should begin. ■

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