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Business Valuation Terms Need Restructuring Based on Value Drivers

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As a relatively young profession, we are just beginning a transition beyond our original business valuation pioneers. These leaders shaped a plethora of theories and court precedents into a vocation. But, with the time span and diversity of early contributions, the profession suffers from a muddling of concepts and terms. It is time for a recalibration of valuation terms that grows out of the previously laid foundation.

The current environment exists because theory development was fostered by academic modeling, statistical study, and court cases over four decades, not rigorous variables analysis that defines a system and its baselines from the bottom up. In addition to confusing expressions, we have somewhat faulty assumptions and an incomplete set of variables. These aspects need to be detailed within a comprehensive structure. Revising terminology and adding new parameters to better define an engagement will improve alignment of results between analysts and benefit all business valuation stakeholders.

Standards of Value

The topmost element of defining value is Standard of Value. Here the issues of open-market value and intrinsic value need separation and delineation. In current valuation teaching, we are presented two primary types of value from which our standards are established. However, it appears that we are working backwards—trying to fit existing standards into these primary types—instead of the other way around. In *The Business Valuation Bench Book*,[1] William J Morrison and Jay E. Fishman tell judges:

> The process begins with the consideration of the *overarching Value Premise*, which represents the *general concepts of property* under which the standard of value falls. The two *fundamental Value Premises* are value-to-the-holder and value-in-exchange. Under value-to-the-holder, the owner realizes the benefits of ownership by the cash flow received by owning the business. Under value-in-exchange, the owner realizes the benefits of ownership by selling the business. (italics added)

Judges are told that valuation begins with determining whether worth is based upon an Exchange or Holder/Owner perspective. If true, it necessarily follows that the first determination in a valuation assignment is to make the same assessment. For our starting point, let's classify the existing Standards of Value under the overarching nature of value. A standard's nature is identified by the conditions presented in its definition. Exchange Nature refers to an open-market transaction, while Owner Nature refers to participants such as creditors, investors, and owners who are not buying or selling their interest.

1 William J, Morrison and Jay E. Fishman, *The Business Valuation Bench Book*, 2017, Business Valuation Resources; bvresources.com/products/the-business-valuation-bench-book.

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Exchange Nature standards. There are two standards for open-market transactions:

1. *Fair market value (FMV)* (U.S. Treasury) is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts; and

2. *Fair value (GAAP FAS 157)* is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in the principal or most advantageous market for the asset or liability.

Owner Nature standards. Prior to GAAP use of the term, fair value was the identifier used to express intrinsic worth. The foundation for much of the state law surrounding the definition of fair value is the Model Business Corporation Act (MBCA). The MBCA was issued by The Committee on Corporate Laws of the American Bar Association Section of Business Law in 1950 and has been revised several times. In 1999, MBCA defined fair value as:

> The value of the corporation's shares determined immediately before the effectuation of the corporate action to which the shareholder objects using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal without discounting for lack of marketability or minority status except, if appropriate, for amendments to the articles pursuant to section 13.02(a)(5).

In addition, the Delaware Supreme Court's landmark decision in *Cavalier Oil Corp v. Harnett* cited three reasons for why the application of discounts at the shareholder level was contrary to the fair value mandate:

1. Fair value does not assume a hypothetical sale of the minority's interest but assumes

that the minority will maintain his or her investment in the business;

2. Applying discounts at the shareholder level injects speculation into the appraisal process; and

3. Discounts penalize dissenting shareholders for enforcing their rights while providing majority shareholders a windfall by cashing out the minority at a discounted price.

Other terms relating to Owner Nature are:

- *Fair value (American Law Institute)*. The value of an eligible holder's proportionate interest in the corporation, without any discount for minority status.

- *Fair value (Fairness Opinion—Business Transaction)*. This is the price that is fair between two specific parties considering the respective advantages or disadvantages that each will gain from the transaction.

- *Divorce value*. This special case of fair value is the value of an asset to both spouses, considered to be investors, that considers intrinsic ownership issues related to the business. The basis of value is upon that which the original interest was transacted, at or subsequent to the date of the marriage.

- *Intrinsic value*. This is the true worth of an asset to investors based upon facts, circumstances, and expectations, ignoring open-market transactions because these transactions omit new, unknown, or unrecognized information. Business writers and investment management industries often use this meaning in relation to the prices of a public stock.

So how is that for confusing? The accounting profession moves to "fair value accounting"—the pricing of assets and liabilities at current market value—and applied the term "fair value" to implement this agenda. Historically, the term for owner-based intrinsic value has been "fair value." Now, under GAAP, it represents "exchange value." While this differentiation may have little meaning for public-company accounting, it is a key aspect to the value of small and medium business, especially in shareholder and partner matters. To properly define an intrinsic value engagement, we need to formulate a reliable standard that uses terminology different from "fair value" and to consider other contributing assumptions.

It is important to note that intrinsic value is concerned with shares of a business, which may represent an owner exit or a new investment. Thus, intrinsic value includes the impact of elements from the liabilities side of the balance sheet, which is differentiated from cash purchases of whole entities that exclude those elements. To this end, real estate appraisal terminology and the catch-all term Investment Value are adapted to arrive at:

> *Investment Value* is the value of an asset to the owner, or prospective owner, for individual investment or operational objectives, and considers the impact of issues that change intangible value in comparison to open-market value, such as the impact of cash-on-hand, leverage, entity type and distributions. The basis of value for a partial interest in the asset is upon that which the original interest was transacted.

The proposed Investment Value standard first addresses the entity level. Then, by noting the original investment basis, issues of eligibility and discounts for partial interests are settled based upon the holder's entry terms. One issue is for the profession to take a leadership position on this topic and define a name different than "fair value" for intrinsic valuation engagements. Another issue is to settle the basis for partial interests that satisfies the MBCA and other precedents. A third point, which is examined next, is to clearly separate Value Premise from Value

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Standard so that business combinations are addressed within variables structure. Value Premise must cover situations such as stand-alone business, acquisition for consolidation or acquisition for synergies, which today is ambiguously incorporated into the Investment Value term.

Value Premises

Rationalizing Value Standard leads to a revision of Value Premise. Value Premise has been muddled together with issues involving Standard and Market and subject to implied assumptions. For example, the term "Liquidation Value" appears to be a Standard, having the word "value" in its body, but it does not define conditions necessary to be a standard such as buyer, seller, and market. It is widely seen as meaning "being sold in pieces" and has conditions of being "orderly" or "forced," but is it open-market value or something else? Value Premise is better represented by targeted terms such as "in pieces" and "going concern" than expansive terms such as "Liquidation Value" that can be confused with other issues.

Although present jargon may not be ideal, Value Premise is clearly related to a subject's state of intangible value. Our current terms, "going concern" and "liquidation," however, do not fully explain the array of circumstances that analysts must consider. To function suitably, Value Premise will avoid crossing over with Standard and solely examine goodwill possibilities. A benefit of this construction is that either an Exchange Standard or Owner Standard can be paired with the following Value Premises, which is important in preparing fairness opinions regarding a specific combination of businesses and communicating the viewpoint of the value opinion.

Premise of (Goodwill) Value. The driver for Value Premise is the source(s) of goodwill. Goodwill may be absent, internally generated, or arise from external elements. With the buyer-seller-market relationship set by other assumptions, Premise defines intangible value context, which has six possibilities:

1. *No Intangible Value:* Entity has negative cash flow, has failed or will fail, and only has value in its component parts.

2. *Asset Group Value:* Entity has minimal cash flow and can theoretically operate indefinitely, but cash flow value is less than the value of the assets in place. Only a marginal return on assets is present.

3. *Stand-Alone Intangible Value:* Entity has cash flow value greater than the value of its assets and theoretically can operate indefinitely.

4. *Potential Intangible Value:* Entity has negative cash flow but with nonoperating resources, or a guarantor, which allow it to persist, pursue profitability, and theoretically operate indefinitely if it is successful.

5. *External Intangible Value:* Entity combined with another company creates new intangible value adding to its stand-alone value and theoretically operates indefinitely.

6. *Breakup Intangible Value:* A unit of an entity is divested from its parent and has intangible value that may be different than the intangible value when operating within the parent business.

In practice, these Premises show up as clusters of valuation multiples in transaction data. So classification by Value Premise would also lend itself to categorizing transaction data and determining market value under a particular context, which would be extremely valuable. Exhibit 1 displays drivers by EBITDA multiplier; the categories are loosely arranged by increasing cash flow and MVIC.

Data collect in the clusters shown in Exhibit 1 for multiple reasons. Startups have small cash flow

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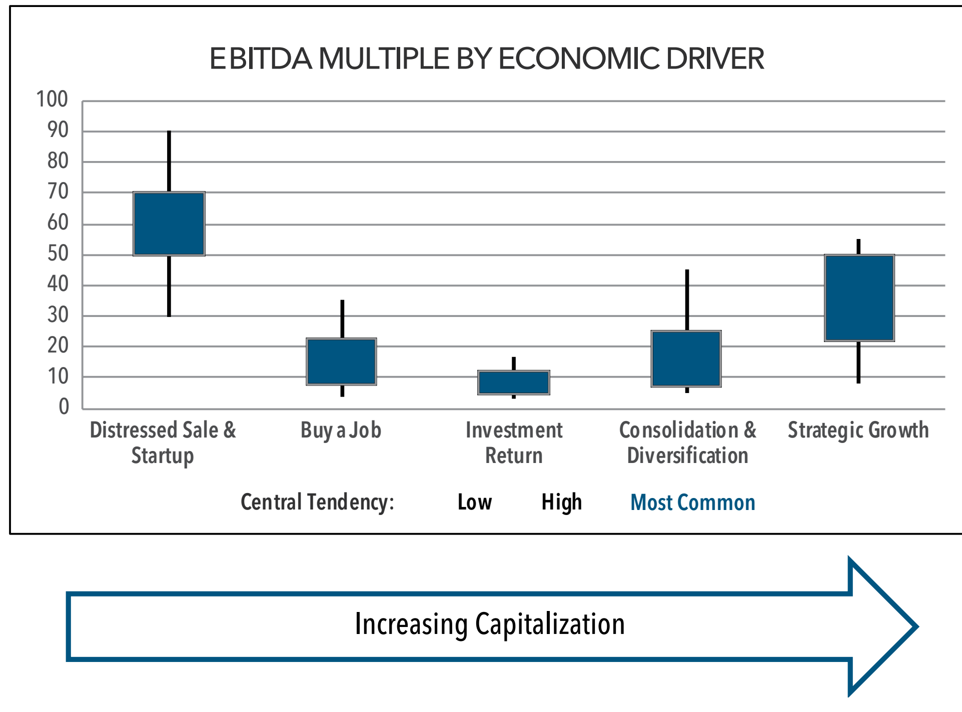
Exhibit 1. Value Drivers



resulting in high EBITDA multipliers versus potential earnings. Distressed businesses have small cash flows in relation to assets. A Main Street business provides above-market owner compensation and independence, so "Buy-a-Job" multipliers can reflect low entry cost and lifelong job security. Other high multiplier deals are for product line extensions or to take a competitor out of the market, both of which improve industry dynamics in favor of the acquirer. Strategic interests typically have the highest value as the combination of two particular companies is projected to expand and lever the number of available future opportunities, offering a high reward.

Knowledgeable buyers and sellers may take any of these positions, which makes the need for a value premise to cover all these situations necessary. Borrowing terminology from the equipment appraisal field, the proposed Value Premises are:

- Piece Value (now called liquidation);
- Value in Place (now called going concern);
- Value in Consolidation (value from cost savings combination);
- Value in Synergy (value from new growth combination); and
- Breakup Value (value after separating from holding entity).

Market Premise. In addition to Value Premise reflecting Goodwill composition, the most important remaining condition to standardize is a Market Premise for Exchange conclusions. Historically, distinction on market has been assumed between Standard and Value Premise. An open market conveys full value. The idea of this premise has to do with whether a proposed sale has access to a full complement of potential buyers or whether the available number of buyers is diminished.

The term "open market" represents the concept of an asset transfer without duress. In principle, an open market is an exchange accessible to all

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economic participants, where only the forces of supply and demand determine price. In a restricted market, constraints of time, geography, or other factors reduce the number of available buyers.

Time constraint deserves special attention to avoid confusion with liquidity. The open-market exposure time for an asset is the *time required for a sale to be completed in a subject's primary market*.[2] An illiquid asset such as a whole company does not have ready buyers and requires lengthy market exposure and due diligence investigation before a sale. As long as time is allowed to complete the selling process, full value will be conveyed and meet an open-market test.

On the other hand, time constraints limit market exposure and reduce the number of available buyers. This impedes the seller's options to ignore undesirable offers and wait for better ones. Typically, a deadline to sell an illiquid asset and the resulting lack of competition reduces price. Other limitations may be that the asset only appeals to a very small geographic area or that, by agreement with other shareholders, a partial interest may only be sold to family members; or, if the value of the asset is too low, it will not be acceptable to a licensed broker and cannot reach the market. Market Premises proposed are:

- Open-Market (now called Orderly);
- Restricted Market (now called Forced):
  - Time restriction;
  - Geography restriction; and
  - Contract restriction.
- No Access to Market.

Only the three market conditions—Open-Market, Restricted Market, and No Access to Market—appear necessary as an analyst can specify any type of restriction in his or her description of the valuation problem.

Discount Terminology

As with the series of standards and premises above where each condition is an element that adds together to form a complete analysis, the discount for lack of marketability (DLOM) has multiple elements. The interrelationship of all these elements is not necessarily recognized by those in practice, and confusion over terminology exists.

DLOM analysis suffers in application because the term "marketability" in DLOM is misconstrued with the term "liquidity" due to its founding in relation to studies of public markets and subsequent comparison to the lack of a public market. Lack of a public market is not the same as having no market, which the academic originators implied. Private markets exist; they are simply illiquid. Because of this early mischaracterization, some equate marketability and liquidity. But the term "marketability" in relation to private assets represents a broad connotation related to a measure of overall appeal. The nature of liquidity, meanwhile, is directed at the time an owner must wait to convert an asset to cash. To clarify the strata, the term "DLOM" is claimed to be the multiaspect, overall examination of attractiveness—of marketability—and subfactors categorize analysis into three components: liquidity, control, and salability.

Liquidity. A liquid interest enjoys the benefit of having its company information widely published to a broad pool of qualified, able, and interested buyers and is able to quickly convert a sale to cash (two days in public markets). An illiquid interest is unknown, does not have ready buyers, and requires lengthy market exposure before sale. Generally, controlling interests of both private and public companies are illiquid, brought to

2 Two days for stock shares in public markets, three months if secondary markets are available to a private stock, six to 18 months for whole companies, public or private.

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market through professionals. Noncontrolling interests in private companies may have no liquidity at all because professional marketing services are unavailable to sell them. Only a tiny market segment of noncontrolling interests is truly liquid: those in large, diversified companies traded on public stock exchanges.

In theory, when liquidity is immediate, full value is realized because the principal investment and its appreciation are returned to the owner without risk. Conversely, when liquidity is zero, value is based solely upon dividends because the owner cannot realize the initial investment and appreciation. The effect of market type and liquidity is shown in Exhibit 2.

Control. Controlling interest is when an equity holder controls a high enough percentage of ownership to enact changes at the highest level of a company. A shareholder agreement or other externalities may also convey, diminish, or block entity control. Noncontrolling interests cannot enact changes in a company alone.

Salability. Salability is the capability of an asset to be exchanged for cash or cash equivalents and/or an asset's relative suitability for trade versus similar assets that are selling. For similar assets having the same liquidity and control, salability is related to adjustments for dividend, holding cost, exit costs, and market conditions.

So one point is to eliminate confusion of the terms "marketability" and "liquidity" by using the correct terms within valuation literature. Many analysts only apply the liquidity factor for DLOM due to confusion with the term "marketability." A second point is that clearly establishing DLOM to be a multifaceted analysis of relevant discount

Exhibit 2. Market and Liquidity Effect

VALUE IMPAIRMENT		
LIQUIDITY / CHANNEL	INTEREST TYPE	MAXIMUM VALUE
INVESTMENT BANK	PUBLIC CONTROL INTEREST	PUBLIC ↕
TWO DAY	PUBLICLY TRADED SHARES	PUBLIC ↕ / PRIVATE ↕
EXIT PLAN	PRIVATE EQUITY	PRIVATE ↕
BROKER	CLOSELY HELD COMPANIES	PRIVATE ↕
NO MARKETING	CLOSELY HELD MINORITY INTEREST	PRIVATE ↕
NO EXIT NO DIVIDEND	CLOSELY HELD MINORITY INTEREST	ZERO VALUE

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drivers is pertinent because each of these elements has a different impact on value.

Conclusions

Revising valuation terminology based upon value drivers is important to all stakeholders—analysts, clients, attorneys, judges, and other participants. The structure proposed explains the necessary conditions for determining value and rationalizes confusing and overlapping terms. The main changes are:

- Value standards should be rationalized under two Natures that reflect Value-in-Exchange and Value-to-the-Holder principles. While we have FMV and GAAP Fair Value for the former, we do not have an adequate definition for intrinsic matters that satisfies Value-to-the-Holder conditions. The proposed term for the intrinsic value standard is a revised version of Investment Value, which is already commonly used, but not effectively defined for use as a standard.

- In the standardization effort, the terms "Going Concern," "Liquidation Value," "Orderly Liquidation," and "Forced Liquidation" should be replaced by an expanded Value Premise and adding Market Premise. Value Premise describes the nature of intangible value. Market Premise identifies any restrictions of the expected number of buyers available at the valuation date.

- The term "marketability" should be replaced in all literature when used in relation to liquidity by the word "liquidity," and the term "Discount for Lack of Marketability" should be established as a multi-element analysis of appeal based upon the components of liquidity, control, and salability.

The next step should be that the standards boards of the valuation professional organizations (VPOs) take this proposal under consideration. As a CVA, I am a member of NACVA; therefore, I recommend that the NACVA Standards Board study adoption of the protocol as a recommended practice, then incorporate into it the development standards under NACVA Professional Standards, teaching materials, USPAP, and the Glossary of Valuation Terms, should it prove acceptable.

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