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NEW METHODS PROMISE MORE ACCURATE VALUATIONS OF SMALL, PRIVATELY HELD BUSINESSES

Angela Sadang

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Accurate valuation of any business is challenging. When the business is small and privately held, the challenge is all the greater.

In the past, appraisers have used public company stock return data as a benchmark for valuing small private businesses. There are significant problems with this approach as appraisers have been challenged to find alternate data that might yield more accurate valuations. Fortunately, this is changing as new developments offer appraisers alternate data that might result in more accurate valuations.

Accuracy matters, not only for the obvious reason that it is the goal of every valuation process, but also because the small business sector is so significant for the economy as a whole. (The Office of Advocacy of the U.S. Small Business Administration defines a small business as an independent business having fewer than 500 employees.) Small privately held businesses comprise 99% of all employer firms in the US and latest figures show that there are approximately 28 million small private businesses in the US. Simply put, small businesses carry massive weight in the US economy. That means that it is a consequential matter to determine, individually and collectively, what these small private businesses are actually worth.

There are many difficult areas in valuing small privately held businesses. But there is one challenging aspect in the valuation process that deserves more detailed treatment: quantifying a reasonable discount rate or cost of capital. This is where new data sources will make a difference.

The traditional method of valuing small businesses is deeply flawed, but not through any fault on the part of the appraisers. Availability of data has been the problem. Due to the lack of empirical data with respect to the expected returns of private investors, business appraisers have been using public company stock return data (i.e., Ibbotson's and Duff & Phelps) as a surrogate for private return expectations to estimate discount rates that ultimately determine values of small privately held companies. Risk, liquidity, and size are among several reasons why anticipated public company returns are not an appropriate substitute for private company data.

Recently, there have been some developments that offer appraisers alternate sources of data in developing the cost of capital for small private companies.

First and most recently, two methods were introduced: the implied private company pricing line (IPCPL) and the implied private company pricing model (IPCPM). Both methods were first described in Business Valuation Review (Volume 31, No. 1) and attempt to solve major problems with the build-up method in determining the cost of equity component in a discount rate. IPCPL is a new model that is intended to estimate the cost of capital for a privately held firm whose revenues are less than $10 million. It is designed to eliminate the inherent problems in comparing public and private data and provide a more relevant estimate of the cost of capital for private small businesses. The IPCPL model seeks to eliminate "pitfalls for unsystematic risk, liquidity, small stock premium, pass through entity taxes, and cash/leverage by utilizing real transaction, market-clearing prices between buyers and sellers of comparable small private businesses."

Secondly, recognizing the differences in the expectations of private company and public company investors, Pepperdine Private Capital Market Project was launched by Pepperdine University in 2007. This ongoing annual study surveys various investor classes (i.e. banks, asset-based lenders, mezzanine investors, private equity groups, venture capitalists, angel investors, etc.) in the private markets periodically to determine their expected (and actual) returns on investment. It also seeks to understand the true cost of private capital across market types and the investment expectations of privately held business owners.

While appraisal professionals are still evaluating and analyzing data from both sources above, many believe they may help reduce guesswork and improve reliability in determining the appropriate cost of capital for small privately held businesses. The IPCPL is not yet widely accepted or vetted for litigation and peer acceptance. We are also not aware of any court case that has accepted the Pepperdine Private Capital Market Project as an acceptable methodology. Given sufficient time, both methodologies may gain wider acceptance by both appraisers and the courts. They may redefine the way in which appraisers determine the cost of capital in their valuations.

Small business valuation starts from carefully determining the cost of equity by making sure both size and firm-specific risks are captured in the calculation. This will lead to a more reasonable calculation of a discount rate or capitalization rate and as result arrive at true cost of capital. Data from both the IPCPL/IPCPM and Pepperdine University are additional reference points and may complement <u>but not</u> as of yet substitute for the build-up method and capital asset pricing model (CAPM) when estimating a small privately-held company's cost of capital.

About the Author

Angela Sadang, MBA, CFA, ASA, is a Director in the Litigation and Corporate Financial Advisory Services Group at Marks Paneth LLP. Ms. Sadang specializes in business valuation and has more than 15 years of experience providing corporate financial consulting services and performing valuations. She serves both publicly traded and closely held companies in a wide range of industries that also involves various asset classes.

Her valuation experience includes business enterprise and intangible asset valuation for financial and tax reporting, transfer pricing, mergers, acquisitions, divestitures, reorganizations, gift/estate tax compliance, family wealth planning and ownership succession, litigation support, shareholder disputes, ESOPs, going private or public, and fairness and solvency opinions. Most of her assignments include valuation of minority and controlling interests in the capital stock of closely held corporations, publicly traded securities and restricted securities, and preferred stock warrants, options, and debt securities. Ms. Sadang is also experienced in the valuation of intangible assets and intellectual property, including trademarks/tradenames, patents, customer relationships, employee contracts, and technology. She is in process of obtaining certification as an intangible asset appraisal specialist from the American Society of Appraisers.

Ms. Sadang is a Chartered Financial Analyst (CFA) as designated by the CFA Institute. She is also an Accredited Senior Appraiser (ASA) with specialty in business valuation as designated by the American Society of Appraisers. She holds a Master's Degree in Business Administration with a concentration in Finance from The Wharton School of the University of Pennsylvania. She is based in Marks Paneth's midtown Manhattan headquarters.

Contact Angela Sadang:
Phone: (212) 201-3012
Email: asadang@markspaneth.com

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