VALUATION

Valuing Pass-Through Entities Using the Guideline Public Company Method[1]

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The market approach is one of three generally accepted approaches to value. Under the market approach, indications of value can be obtained by analyzing transactions of ownership interests of companies in the same or similar lines of business. Like the income approach, it is referenced in IRS Revenue Ruling 59-60, as well as in other valuation standards, such as those of the Appraisal Standards Board and the AICPA. The Guideline Public Company Method is a method that is often used to apply the market approach. However, special issues arise when applying the guideline public company method to the valuation of pass-through entities (PTE).

GUIDELINE PUBLIC COMPANY METHOD AND PTE VALUE TO THE HOLDER

Assuming a value to the holder assumption, when the valuation analyst applies a valuation multiple to a PTE based on the guideline public company method (GPCM), it is assumed that the PTE's owner(s) will receive the same risk adjusted after-tax returns as the public company's owners. Under a value to the holder assumption, a price-to-revenues multiple assumes that the combination of cost of goods sold, operating expenses, and income taxes for the public company will approximate that of the PTE. A price-to-gross-profit multiple assumes that the combination of operating expenses and income taxes for the public company will approximate that of the PTE. A price-to-pretax-income multiple assumes that the income taxes to a holder of the guideline public company's stock will approximate that of the PTE. Clearly, as one moves down the income statement, under value to the holder, there are fewer expense items that could deviate as a percent of revenues. This would, at least theoretically, make the price-to-net-income multiple more reliable than the price-to-revenues multiple. But how reliable is even the price-to-pretax-income multiple?

Many of the tax-affecting issues that have been identified under the income approach also apply when valuing a PTE under the GPCM. This is because PTEs do not pay entity-level federal corporation income taxes, whereas guideline public companies from which pricing metrics are derived are subject to federal corporation income taxes at the entity level. Accordingly, the PTE conundrum needs to be considered when applying the GPCM in connection with value to the holder.

Let's consider the impact of income taxes on after-tax returns to an owner of a C corporation versus the owner of a PTE, assuming value to the holder. Table 1 presents the normalized income statement of a potentially comparable guideline public company and the after-tax returns to an investor in that company.

Assuming an equity valuation of $500 million for the guideline public company, pricing multiples are calculated based on six company-level metrics, and one metric is developed based on the holder's after-tax returns. This example also assumes an effective combined federal and state corporation income tax rate of forty percent and an effective combined federal and state investor dividend tax rate of twenty percent.

For this analysis, it is also assumed that the subject PTE has valuation multiples equal to seventy percent of the guideline public company's valuation multiples based on an analysis of risk

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TABLE 1: NORMALIZED INCOME STATEMENTS OF PUBLIC COMPANY & AFTER TAX RETURNS OF INVESTOR

	Hypothetical GPC C corporation		Multiple Assuming Equity Value of $500,000,000	70% of Guideline Public Company Multiples
C Corporation results of operations:				
Revenues	$500,000,000	100.0%	1.00	0.70
Cost of goods sold	200,000,000	40.0%		
Gross profit	300,000,000	60.0%	1.67	1.17
Selling, general & administrative expenses	100,000,000	20.0%		
EBITDA	200,000,000	40.0%	2.50	1.75
Depreciation & amortization expense	6,000,000	1.2%		
EBIT	194,000,000	38.8%	2.58	1.80
Interest	40,000,000	8.0%		
Pre-tax income	154,000,000	30.8%	3.25	2.27
Income taxes (40%)	61,600,000	12.3%		
Net income	92,400,000	18.5%	5.41	3.79
Individual income taxes:				
Dividend tax (20%)	18,480,000	3.7%		
Net income, after all taxes	$73,920,000	14.8%	6.76	4.73

TABLE 2: HYPOTHETICAL S CORP VS. PUBLIC COMPANY MULTIPLES

	Hypothetical S corporation		Public Company Multiples	
C Corporation results of operations:			Multiple	Indicated Value
Revenues	$5,000,000	100.0%	0.70	$3,500,000
Cost of goods sold	2,000,000	40.0%		
Gross profit	3,000,000	60.0%	1.17	$3,500,000
Selling, general & administrative expenses	1,000,000	20.0%		
EBITDA	2,000,000	40.0%	1.75	$3,500,000
Depreciation & amortization expense	60,000	1.2%		
EBIT	1,940,000	38.8%	1.80	$3,500,000
Interest	400,000	8.0%		
Pre-tax income	1,540,000	30.8%	2.27	$3,500,000
Income taxes	–	0.0%		
Net income	1,540,000	30.8%	3.79	$5,833,000
Investor income taxes:				
Income tax on pass-through income (40%)	616,000	12.3%		
Investor net income, after all taxes	$924,000	18.5%	4.73	$4,375,000

and other factors (but not financial/common-sized expense factors). Accordingly, the price-to-revenues multiple should be 1.00 multiplied by seventy percent equals .70, etc., for the subject PTE. The inputs for the subject PTE assume (1) revenues of five million, and (2) a normalized common-sized income statement that exactly matches the guideline public company, from the "cost of goods sold" line all the way through to the "pretax income" line (30.8 percent of revenues). The results are shown in Table 2.

Five of the six company-level multiples indicate a PTE value to the holder of $3.5 million, and one company-level multiple indicates a PTE value to the holder of $5.8 million. The PTE valuation based on investor net income after taxes is $4.375 million.

This example (Table 2) yields vastly different results, but which amount is correct? Should the majority rule? Five of the six company-level multiples indicate that $3.5 million is the PTE value to the holder. This clustering ordinarily would be a compelling factor in determining PTE value to the holder. On the other hand, the price-to-net-income multiple indicates a value of $5.8 million, and this is the amount of after-corporation taxes but before individual income taxes typically considered in connection with the income approach. This metric takes into consideration any differences between the subject PTE's costs of operations and the guideline public company's cost of operations and, it can be argued, is more appropriate when applying a value to the holder standard of value.

The problem with each of these six company-level multiples is that not one takes into consideration the holder's tax savings benefit of the subject company's PTE status. Since our definition of value is based on the after-tax risk-adjusted present value of future cash flows to the holder, the PTE tax savings benefit must be considered. The final value derived in the example shown in Table 2, $4.375 million, is the only one that accomplishes this; it follows then that $4.375 million is the appropriate conclusion of value.

What happens when we modify

TABLE 3: MODIFIED OPERATING EXPENSE AMOUNTS OF HYPOTHETICAL S CORP VS. PUBLIC COMPANY MULTIPLES

	Hypothetical S corporation		70% of Guideline Public Company Multiples	
C Corporation results of operations:			Multiple	Indicated Value
Revenues	5,000,000	100.0%	0.70	$3,500,000
Cost of goods sold	2,250,000	45.0%		
Gross profit	2,750,000	55.0%	1.17	$3,208,000
Selling, general & administrative expenses	1,250,000	25.0%		
EBITDA	1,500,000	30.0%	1.75	$2,625,000
Depreciation & amortization expense	60,000	1.2%		
EBIT	1,440,000	28.8%	1.80	$2,598,000
Interest	400,000	8.0%		
Pre-tax income	1,040,000	20.8%	2.27	$2,364,000
Income taxes	–	0.0%		
Net income	1,040,000	20.8%	3.79	$3,939,000
Investor income taxes:				
Income tax on pass-through income (40%)	416,000	8.3%		
Investor net income, after all taxes	$624,000	12.5%	4.73	$2,955,000

several of the operating expense amounts of the PTE subject company in the above example? Assuming increases of five percent in common-sized "cost of goods sold" and "selling, general and administrative expenses," the indicated values of each multiple now are vastly different, as you can see in Table 3.

By simply modifying two of the common-sized expenses, the five previously identical valuation amounts of $3.5 million now range from a low of $2.363 million to a high of $3.939 million.

It is not unusual for the subject PTE (or any privately held company) to have a different cost structure than the guideline public companies from which valuation metrics and multiples are derived. Consequently, a valuation analyst may frequently find that applying guideline public company multiples based on different income statement line items yields very different results. In this example, as in the previous one, the value derived from investor net income after all taxes ($2.955 million, in this case) would arguably indicate a more appropriate PTE value. Revenue, gross profit, EBITDA, EBIT, pre-tax, and net income valuation multiples can be reverse engineered assuming a final valuation amount of $2.955 million.

It is worth noting that when more than one guideline public company is considered with respect to the development of applicable valuation metrics, the process by which one selects metrics may change, but the same analysis presented above with respect to the final conclusion of value is necessary.

PUBLIC COMPANY METHOD AND PTE INVESTMENT VALUE

Value to the holder considers normalized results of operations of the subject interest in the hands of its current owner; investment value considers normalized results of operation of the subject interest in the hands of the buyer. The buyer may have significant influence with or without control. Accordingly, application of the GPCM involves consideration of the subject PTE's historical and projected revenues, expenses, and income taxes, inclusive of synergies, in the hands of the owner. If the buyer has the ability to

TABLE 4: MODIFIED INPUTS EFFECTING REVENUE

	Hypothetical S corporation		Public Company Multiples	
C Corporation results of operations:			Multiple	Indicated Value
Revenues	$5,500,000	100.0%	0.90	$4,950,000
Cost of goods sold	2,475,000	45.0%		
Gross profit	3,025,000	55.0%	1.50	$4,538,000
Selling, general & administrative expenses	1,100,000	20.0%		
EBITDA	1,925,000	35.0%	2.25	$4,331,000
Depreciation & amortization expense	60,000	1.1%		
EBIT	1,865,000	33.9%	2.32	$4,326,000
Interest	400,000	7.3%		
Pre-tax income	1,465,000	26.6%	2.92	$4,281,000
Income taxes	–	0.0%		
Net income	1,465,000	26.6%	4.87	$7,135,000
Investor income taxes:				
Income tax on pass-through income (40%)	586,000	10.7%		
Investor net income, after all taxes	$879,000	16.0%	6.09	$5,351,000

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increase the after-tax cash flows of the subject PTE, that fact must be taken into consideration in applying the GPCM and the investment value assumption.

Under value to the holder in the previous series of examples, it was assumed that the subject company multiples were seventy percent of the guideline public company's multiples. Given the potential for synergies with the buyer and the possibility that the buyer has a substantially lower risk profile than the guideline public company, it is possible that the thirty percent discount will be less, perhaps even zero percent. Facts and circumstances will dictate whether the valuation analyst applies multiples that are greater than, equal to, or less than the guideline public companies when applying the GPCM.

Another factor to consider is whether the buyer will be able to enjoy the tax savings and other benefits of the subject company's status as a PTE. If so, then such benefits must be incorporated into the valuation analysis.

Assume the same facts as in the previous example under value to the holder except that (1) revenues increase by ten percent from five million to $5.5 million; (2) the buyer has cost savings synergies that reduce "selling, general and administrative expenses" from twenty-five percent of revenues to twenty percent; (3) the buyer can take advantage of the subject company's PTE status; and (4) the guideline public company multiples are reduced by ten percent (not thirty percent).

As shown in Table 4, by modifying three inputs—revenues (increased by ten percent); selling, general and administrative expenses (decreased from twenty-five percent to twenty percent of revenues); and the discount applied to the metric multiples (thirty percent discount reduced to ten percent)—a substantially different range of values is derived (i.e., $4.281 million to $7.135 million). Under a value to the buyer assumption, the value is $5.351 million (which contrasts with $2.955 million under the value to the holder assumption). This analysis illustrates the sensitivity of changing even a few inputs when applying the guideline public company method.

If the same facts as in the previous example are assumed, except that the buyer will not be able to enjoy the benefits of PTE status and will have an effective C corporation federal and state income

TABLE 5: INVESTMENT VALUE OF OWNERSHIP

	Hypothetical C corporation		90% of Guideline Public Company Multiples	
C Corporation results of operations:			Multiple	Indicated Value
Revenues	$5,500,000	100.0%	0.90	$4,950,000
Cost of goods sold	2,475,000	45.0%		
Gross profit	3,025,000	55.0%	1.50	$4,538,000
Selling, general & administrative expenses	1,100,000	20.0%		
EBITDA	1,925,000	35.0%	2.25	$4,331,000
Depreciation & amortization expense	60,000	1.1%		
EBIT	1,865,000	33.9%	2.32	$4,326,000
Interest	400,000	7.3%		
Pre-tax income	1,465,000	26.6%	2.92	$4,281,000
Income taxes	586,000	10.7%		
Net income	879,000	16.0%	4.87	$4,281,000
Investor income taxes:				
Dividend tax (20%)	175,800	3.2%		
Investor net income, after all taxes	$703,200	12.8%	6.09	$4,281,000

tax of forty percent (same as the guideline public company), then the investment value of the ownership interest decreases from $5.351 million to $4.281 million, as shown in Table 5.

GUIDELINE PUBLIC COMPANY METHOD AND PTE FAIR MARKET VALUE

Many valuation analysts apply guideline public company multiples to the normalized historical results of operations of the PTE subject company when deriving fair market value (FMV). This application of the GPCM assumes that the hypothetical buyer will be unable to utilize the benefit of the subject company's PTE status and that prior transactions involving the guideline public company are relevant with respect to the pricing of the subject PTE. Are these valid assumptions, and are they consistent with the definition of *fair market value*?

The FMV standard of value requires consideration of value to the holder/seller (floor value) as well as value to the buyer (ceiling value). Relying on transaction prices of a guideline public company is consistent with this concept.

However, the other assumptions employed by implementing the GPCM in this manner require further analysis. When applying the GPCM, the transactions from which pricing metrics are derived involve non-controlling minority interests without the ability to impact the normalized results of operations of the public company. When the GPCM is applied to a minority interest in a PTE, the buyer may also have limited ability to change the normalized results of operations of the investee. If so, it is logical and appropriate to utilize historical, normalized PTE results of operations under the GPCM when applying the FMV standard of value to value a non-controlling minority interest.

Let's next consider the appropriateness of using the normalized PTE historical results of operations when valuing a controlling interest under the FMV standard of value. If the subject interest in the PTE enjoys the prerogatives of control and the buyer's after-tax economic return on investment is different than that of the seller, it may be inappropriate to utilize the seller's normalized PTE results of operations for valuation purposes under the guideline transaction method. The resulting indication of value would be based, at least in part, on the seller's returns, which may be different than the buyer's returns, or some other mutually agreeable amount. Some might argue that the buyer will not (or should not) pay for synergistic benefits that result from a transaction. Again, facts and circumstances will dictate whether that is true.

The valuation analyst should also investigate the likely population of buyers and determine if there are two groups of hypothetical buyers: one that can take advantage of the pass-through status of the subject ownership interest and one that cannot. If there are buyers that would enjoy the tax and other benefits of the subject PTE, they may have a financial incentive to pay more for the PTE ownership interest than for a C corporation. Under the FMV standard of value, the holder/seller is fully informed and is under no compulsion to sell; accordingly, the hypothetical buyer may be able to enjoy the continued benefits of PTE status and pay more than the valuation multiple of the guideline public company.

SUMMARY

If it is presumed that value is derived from the risk-adjusted after-tax economic returns to the owner, then the valuation analyst should consider the after-tax returns to the owner of the guideline public company when applying the GPCM. In addition, different facts and circumstances impacting control, profitability of the guideline public company, standard of value, ability of a buyer to take advantage of the PTE status of the business and other factors can have a substantial impact on the inputs used to derive the value of a business ownership interest. Utilizing the concepts described in this article when applying the GPCM will enable the valuation analyst to produce accurate, understandable, and defensible valuation conclusions. VE

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